Quarterly Insights

Election Spotlight - Portfolio Decisions Under Uncertainty

By Aaron Huey, CFA

This year's presidential race has been full of unexpected events. How should investors make portfolio decisions in the face of uncertainty?

To explore this, let's examine prediction markets. PredictIt, an online platform where participants can bet on election outcomes, offers contracts on who will win the 2024 U.S. presidential election. You can pay an amount to win a dollar, with the payoff increasing for less likely outcomes.

On June 26, the day before the first presidential debate, you could pay $0.55 to bet on a Trump victory and win $1 if Trump wins. Conversely, you could pay $0.45 for a Biden victory and win $1 if Biden wins. This indicated that Trump was a slight favorite at that time, as a higher payment was required to win $1. Meanwhile, you could pay just $0.04 for a bet on Harris winning.

One week later, the costs shifted dramatically: $0.58 for Trump, $0.25 for Biden and $0.21 for Harris. Trump's odds improved slightly, while Harris and Biden were roughly even, 18 days before Biden's announcement to withdraw. By the end of July, the costs were $0.53 for Harris and $0.49 for Trump, reflecting the new reality.

June 27 –

President Joe Biden and former President Donald Trump participate in debate.

July 13 –

Trump survives an assassination attempt at a campaign rally in Pennsylvania.

July 21 –

Biden leaves race and endorses Vice President Kamala Harris.

How should this information influence your investment strategy?

If you lean Democrat, you might be tempted to pay ~$0.50 for a Harris victory, or if you lean Republican, you might do the same for a Trump victory. In either case, you have a ~50% chance of winning $1 and a ~50% chance of winning nothing. However, an alternative strategy would be to split your bet proportionally among the candidates. This approach offers a similar expected payoff but with reduced risk. An investor focused on the long-term would likely prefer this approach than betting all or nothing.

Because of the uncertain election outcome, investors who fear their preferred candidate will lose might be tempted to make major portfolio shifts, like moving from stocks to cash or delaying investments until they believe conditions seem favorable. But how do you decide when to get back into the market?

Betting it all on one candidate reflects a similarly risky investing approach. While investors may feel safer going all in on their favorite candidate, they risk missing out on average market returns. Markets have on average produced positive returns regardless of which party is in power. Furthermore, there is little difference between those returns. Splitting your bet among the candidates is like maintaining a thoughtful asset allocation, accepting market returns despite uncertainty.

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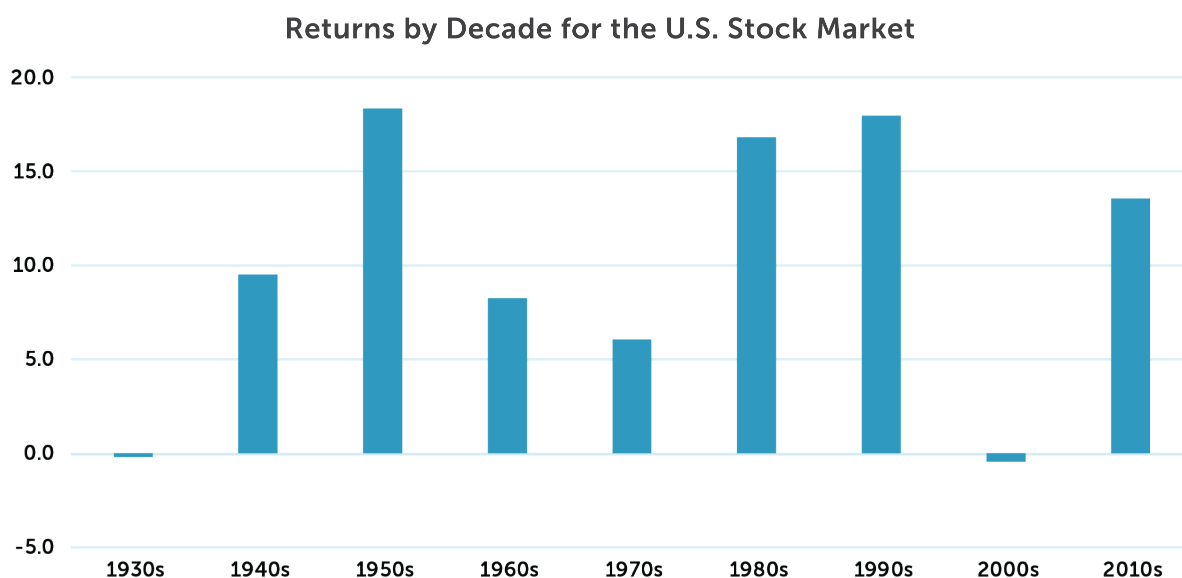
What Kind of Returns Can You Anticipate from Your Portfolio?

By Jared Kizer, CFA

When building an investment portfolio, clients commonly ask what rate of return is reasonable to expect over the long term. Related to that point, clients often wonder why their portfolio's returns may be different relative to well-known benchmarks, or indexes like the S&P 500. Let's dig into both.

What rate of return is a fair long-term expectation?

Many investors believe that an appropriate expected return for the broad U.S. stock market is 10% annually based on the long-term average. However, over longer periods of time, the difference between expected returns and actual returns can be substantial, particularly for high-risk portfolios. While staying invested over a longer time helps mitigate this difference, it does not eliminate this investing reality. One can get a sense of this by looking at the decade-by-decade annualized returns of the broad U.S. stock market and comparing it with a 10% expected return.



Source: Ken French data library, U.S. total market returns series.

The total market return came close to 10% in only two decades – the 1940s and 1960s – and it beat that expectation in four decades. This illustrates one of the primary challenges of investing: Returns can diverge significantly from expectations, even over long periods of time. Nevertheless, investors would be wise not to abandon their well-thought-out investment plan when this happens. A smarter strategy is to design your portfolio to mitigate this risk through broad diversification.

What drives differences in portfolio returns relative to well-known benchmarks?

For investors in well-diversified portfolios, the two main building blocks are high-quality bonds and stocks. Within the stocks category, you'll not only have exposure to the broad U.S. stock market but also to international and emerging markets. Your portfolio may also have increased exposure to small company stocks and value stocks. That means there are four primary drivers of both expected and realized returns in your portfolio – but a market benchmark like the S&P 500 only captures one of those drivers. Importantly, the returns you earn in either an absolute sense or relative to a market benchmark may be different. Let's look at the four primary investment categories and what the current indicators of returns are showing:

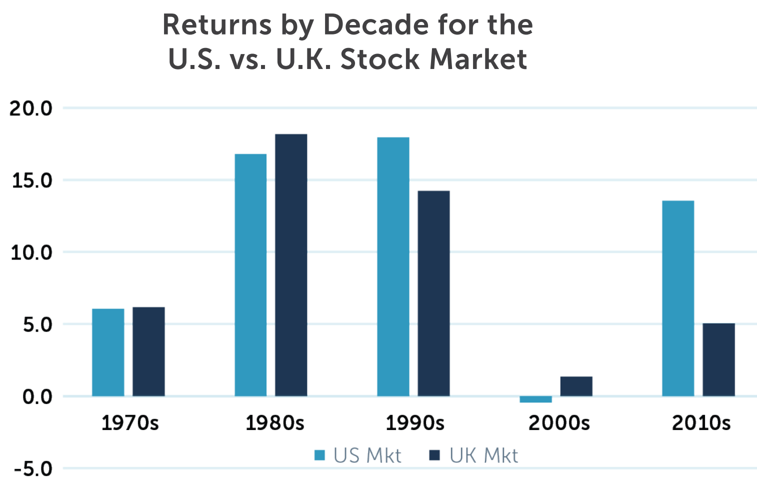
1. ***Returns on high-quality fixed income investments***

   A good indicator of long-term expected returns on fixed income, or bonds, is the current interest rate, or yield. Understandably, when interest rates are relatively high, as in the 1980s and 1990s, you can expect realized returns on fixed income to be higher. Similarly, you can expect lower returns during periods of low interest rates, like the 2010s. This means that the returns you can expect on fixed income, even over long horizons, can be different depending upon the historical starting point. Currently, we believe sensible long-term expected returns on high-quality fixed income are around 4% per year.

2. ***Returns on the broad U.S. stock market***

   For stocks, providing an estimate is far more complicated. A good place to begin is looking at starting price-to-earnings (P/E) ratios – which you calculate by dividing a stock's current price by its earnings per share (EPS) – and expected inflation. Generally, investing in stocks when P/E ratios are lower tends to lead to higher long-term returns, as this indicates you are entitled to more earnings and dividends for each dollar invested. However, this relationship can be unpredictable. Currently, the P/E of the broad U.S. stock market is around 25. The long-term average has been around 16, indicating that U.S. stocks are expected to provide lower returns than in the recent past.

3. ***Returns on broad international and emerging markets***



Source: Ken French Data Library, Dimensional.

The chart illustrates that returns can diverge across international markets even over longer periods of time. The way to mitigate this risk is to not concentrate your investments in any single country's market. Currently, we believe realistic long-term return expectations for a globally diversified stock portfolio are in the 7%–8% per year range.

4. ***Returns on value and small company stocks***

   The final driver of portfolio returns for some investors is whether their stock allocation looks significantly different from the overall global equity market, particularly whether it is tilted toward companies that are smaller and have lower P/E ratios. Over the longer term, we believe these tilts can be incrementally additive to returns. However, this also means that the returns of tilted portfolios will, by definition, be different from the market over both shorter and longer periods of time.

Conclusion

It is important to understand how your portfolio may differ from market benchmarks. For example, the S&P 500, an index tracking the performance of 500 U.S. stocks, likely only provides insight for how a portion of your portfolio is performing. Expected and realized performance of bonds, international stocks and other diversifying investment strategies will be key to setting reasonable expectations. Speak with your wealth advisor if you have questions about your portfolio allocation and whether you're on track to meet your goals.

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4 Year-End Tax-Saving Strategies

Autumn is here, and that means it's time for end-of-year planning. This part of the financial planning process not only ensures you meet mandatory deadlines, but it also brings up possibilities to minimize taxes and revisit your overall goals. With ample legislative changes on the horizon, these questions are designed to guide you through a few key strategies to consider before December.

1. ***Are you required to take an RMD from a traditional IRA, retirement plan or inherited IRA?***

   A required minimum distribution (RMD) is a withdrawal that must be taken from certain retirement accounts starting when the account owner reaches age 73. The first deadline to take an RMD is April 1 in the year after turning 73. All subsequent RMDs must be taken by Dec. 31. In addition, some account owners are required to withdraw the entire balance within 10 years. In July, the IRS issued new regulations related to RMDs that will affect beneficiaries who inherited accounts from which the original owner already begun taking RMDs. Effective Jan. 1, 2025, non-eligible designated beneficiaries (generally someone other than the original owner's spouse) must continue taking RMDs annually to satisfy the 10-year rule. Even if you're not required to take distributions this year, doing so could help save on taxes in the long run.

2. ***Is it time to revisit your estate plan?***

   Simply put, an estate tax is what the government charges on your assets for the right to transfer them to heirs upon death. As of the 2023 tax year, individuals are exempt from paying the federal estate tax if their estate is valued below $13.61 million, or $27.22 million for married couples. However, pending no action from Congress, the exemption amounts will drop to about $7 million per person when the 2017 Tax Cuts and Jobs Act expires on Dec. 31, 2025. If your estate exceeds that amount, you may want to speak with your wealth advisor and a team of estate and tax planning professionals to explore strategies you can begin implementing now to reduce your taxable estate. At the state level, estate tax rules also vary, so it's important to understand how the laws in your state may impact your planning.

3. ***Could you benefit from a Roth conversion this year?***

   A Roth conversion allows you to transfer pre-tax assets, such as traditional IRA assets, to a Roth account in a single amount or over multiple years. Depending on your circumstances, Roth conversions can provide several benefits, especially for optimizing your savings and minimizing taxes over the long term. While you'll owe taxes on the funds in the year you complete the conversion, once they are in a Roth, you won't have to take RMDs later as you would with a traditional IRA. The funds will also grow tax-free, enabling tax-free withdrawals once you've owned the account for at least five years and reached age 59½. That means planning conversions at the right time can help you reduce your overall lifetime tax burden and manage your tax bracket in retirement. Additionally, Roth conversions can play a key role in estate planning, allowing you to pass on tax-paid assets to your heirs. The deadline for Roth IRA conversions is Dec. 31 in the year you want it to affect your taxes.

4. ***Are you charitably inclined and intending to make donations to lower your tax bill?***

   Charitable giving is an important part of many individuals' financial plans. If you intend to make charitable donations before the end of year, your wealth advisor can work with you to identify the appropriate frequency and size of your contributions, recommend strategies to give efficiently, and align your giving strategy with your overall financial goals. Strategies to consider include bunching, qualified charitable distributions (QCDs), use of donor-advised funds (DAFs) and charitable trusts.

Keep in mind that the above strategies may not be appropriate for everyone, instead representing a few tax-saving strategies that have deadlines before year-end. Your wealth advisor can help you better understand the best opportunities for your needs.

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