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INSIDE

11 Stock Market Crises Over 148 Years: What Does The Data Tell Us?

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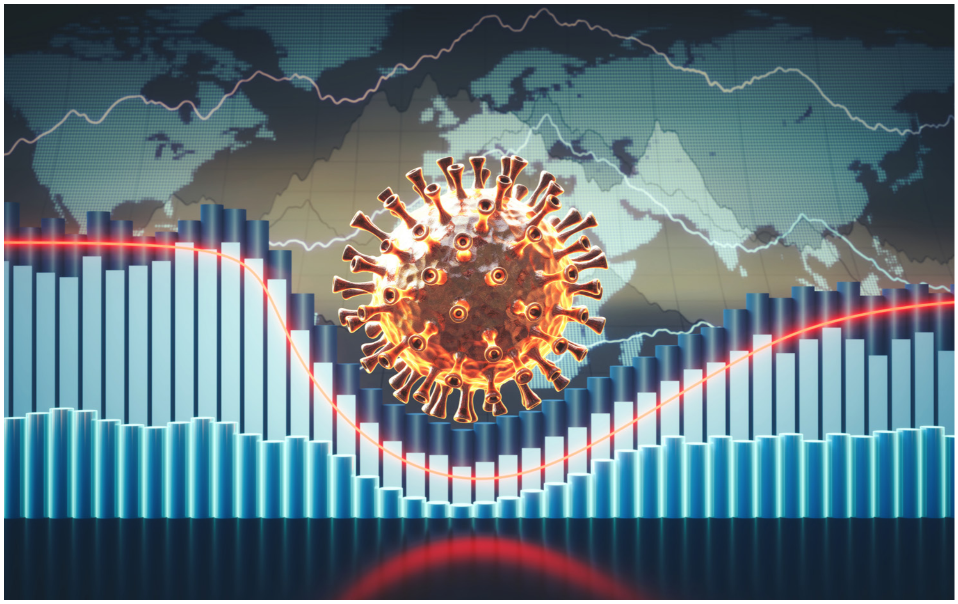
by **DUNCAN LAMONT**



Before last week's rebound, US stocks had lost around 25% since mid-February, as measured by the S&P 500 Index. Like many of you reading this, my savings have taken a big hit. I set up a junior ISA for both of my children in February, and that money has also fallen by around a quarter. I know we always say that investing in the stock market is for the long term, but that doesn't make holding your nerve through this any easier.

Every single time there is a downturn it feels like we are drowning. When will the storm end? When will we be able to catch our breath? Where is the dry land? Importantly, how we respond to these downturns can have a big impact on our future wealth.

Risk of loss is the price of the entry ticket for the stock market

The unfortunate truth is that stock market declines of this magnitude, and worse, occur from time to time. Volatility and the risk of loss are part of the "price of the entry ticket" for stock market investments.

There have been 11 occasions in the 148 years between 1871 and 2019 when stocks (as measured by the S&P 500 Index) have destroyed at least 25% of value for investors (see table). In 2001 and 2008 downturns, losses exceeded 40%.

In the worst case, the Great Depression of the 1930s, investors lost over 80% of their money. It took over 15 years for them to make their money back - if they remained invested.

Other stock market falls were not quite so calamitous. In seven of the 11 episodes, investors would have recouped all losses in two years or less if invested in the S&P500 index. In the other four - 1893, 2001 and 2008 - the period to breakeven was four to five years.

How long did US stocks take to recover losses from a 25% crash?

Market crash	Maximum loss	Years to breakeven from -25% point
1877	-33%	1.8
1893	-25%	4.0
1903	-26%	1.1
1907	-34%	1.2
1917	-28%	1.5
1929	-82%	15.2
1970	-25%	0.8
1974	-39%	2.0
1987	-26%	1.5
2001	-42%	4.1
2008	-49%	4.8
Median	**-33%**	**1.8**

Past Performance is not a guide to future performance and may not be repeated.
Source: Robert Shiller, Schroders. Monthly data 1871-2020. Data is for S&P 500 and assumes investors retained their exposure to the stock market.

On the flip side, over the last 148 years and two months, **US stocks have returned a frankly amazing 8.9% a year, 6.7% a year ahead of inflation.** Over the same period, US cash returned only 4% a year.

It is worth noting that these figures are all in nominal terms, so they include any uplift that may have come from inflation - things look worse in inflation-adjusted terms. For example, although the US market had made up its dotcom losses by October 2006 in nominal terms, it was not until April 2013 that it broke even in inflation-adjusted terms.

On the flip side, over the last 148 years and two months, US stocks have returned a frankly amazing 8.9% a year, 6.7% a year ahead of inflation. Over the same period, US cash returned only 4% a year.

Dash for cash, stick with stocks, or double-down?

There are three common investor responses to a market crash:

- Dash-for-cash: abandon the stock market in favour of the perceived safety of cash
- Stick-with-stocks: the "do nothing" approach
- Double-down: invest additional money in the stock market, either as a lump-sum or by drip-feeding money in

Lump-sum investing exposes investors to the risk that they make that investment at a bad time, adding the challenge of trying to pick exactly the right time, when the market is about to start recovering. It also assumes that investors can access a large cash pile to finance that investment.

In contrast, the drip-feeding approach is a bit like "buying low" but with the humility to accept that we have no idea when the lows will occur. "Buying lower" (than before) might be a better description. In the remainder of this article, we assume that this is the approach taken in the double-down response.

The response matters

In the 11 previous occasions when the US stock market has fallen by 25% or more, we analysed how long it would have taken for an investor's portfolio to get back to its pre-crash value under each response. We assume that an investor is choosing between these responses when the market has already fallen by 25%. This is the position that many investors find themselves in today.

For the purpose of this analysis, in the double-down response, we have assumed that an individual invests an annual amount equivalent to 5% of what the portfolio is worth in the month when it first declines by at least 25% (at least 25% because we are using monthly data and the change from one month to the next could result in a drop of more than 25%). So, for a portfolio worth £10,000 which had fallen in value by exactly 25%, the monthly investment would be 5% x 7,500 / 12 = £31.25 per month. This is equivalent to just over 0.3% of the pre-crash value of the portfolio. This would not be an unrealistic amount for many investors. It can easily be scaled up or down for different amounts. These figures are for illustrative purposes only and are not a recommendation.

It follows that investing new money will increase a portfolio's value faster than doing nothing. As a result, for the double-down response, we have also calculated the length of time to get back to the pre-crash level plus the value of additional investments. This final figure is fairer for comparison purposes and all comments which follow relate to it.

The table below summarises our results. Note that the stick-with-stocks results are the same in the table below as those shown earlier.

Number of years before all losses are recouped

There is a real risk that individuals are so scarred by recent experience that they are put off from investing in the stock market for a long period of time – and dash for cash. However, our research shows that, historically, that would have been the worst financial decision an investor could have made. It pretty much guarantees that it would take a very long time to recoup losses.

For example, investors who shifted to cash in 1929, after the first 25% fall of the Great Depression, would have had to wait until 1963 to get back to breakeven. This compares with breakeven in early 1945 if they had remained invested in the stock market. And remember, the stock market ultimately fell over 80% during this crash. So, shifting to cash might have avoided the worst of those losses during the crash, but still came out as by far the worst long-term strategy. Similarly, an investor who shifted to cash in 2001, after the first 25% of losses in the dot-com crash, would find their portfolio today still worth only around 90% of its year-2000 value.

The message is overwhelmingly clear: a rejection of the stock market in favour of cash would have been very bad for wealth over the long run.

			Double-down (drip-feed)	
	Stick-with-stocks	Dash-for-cash	To get back to pre-crash value	To get back to pre-crash value + value of additional investments
1877	1.8	6.9	1.8	1.8
1893	4.0	6.2	1.8	2.0
1903	1.1	6.2	1.0	1.1
1907	1.2	8.8	1.1	1.1
1917	1.5	6.3	1.3	1.4
1929	15.2	34.0	6.3	6.7
1970	0.8	5.0	0.8	0.8
1974	2.0	5.3	1.6	1.7
1987	1.5	4.3	1.4	1.5
2001	4.1	Still underwater	3.3	4.3
2008	4.8	Still underwater	3.3	3.6

Source: Federal Reserve Bank of St. Louis, Robert Shiller, Schroders. Stock market data is for S&P 500. Monthly cash return 1934-2020 based on 3-month Treasury bill, secondary market rate; 1920-1934 based on yields on short-term United States securities; 1871-1920 based on 1-year interest rate. 1871-1920 data only available annually so a constant return on cash has been assumed for all months during this period. Other data is monthly. All analysis is based on nominal amounts.

Should investors buy more?

This is a very personal question. Irrespective of any investment considerations, not everyone will be able to buy more, whether they want to or not. Alongside the significant health consequences of Covid-19, people are suffering job insecurity and cash flow difficulties. The need to pay rent and bills, to buy food, to feel financially secure, trumps any opinions about whether the stock market is good value or not. All comments which follow need to be taken with that caveat in mind. That is in addition to the caveat that it remains very difficult to quantify how bad things will get during the current downturn.

However, at least in regard to that second caveat, that is no different to any previous market crash. Do you think investors knew in 1929, after the first 25% fall, that the stock market was going to fall another 75%? Or that in 1893, 1903, 1917, 1970, or 1987, they knew that -25% was close to the low point?

Our analysis finds that, in most cases, the double-down response would not have made a huge difference to the length of time needed to recover losses compared with doing nothing. It shortens the recovery period in six cases, makes no difference in four and results in a worse outcome in one.

However, the one time that it made a big difference was in the worst downturn of all, the Great Depression. Then, drip-feeding a small amount into the stock market would have cut the length of time to recovery by more than half – 6.7 years compared with 15.2 years.

Although it may seem surprising that the double-down strategy does not make a bigger difference, this is partly because the assumed size of the investment is relatively low – investing an amount equivalent to 20% of the portfolio value, rather than 5%, would have closed the gap quicker in each case.

Actions have consequences

Everyone's circumstances are different, and this is in no way intended as financial advice. Nonetheless, for those who are already invested in the stock market, the steps you take now will have an impact on how your portfolio recovers from the current downturn. Anyone thinking of moving to cash should consider the consequences, with savings rates at close to zero.

In contrast, history shows that investors who hold their nerve are likely to end up with a better long-run outcome. Those who are in a position to be able to add to portfolios could end up even better off and are unlikely to end up worse off.

However, this only holds in the long run. No one has a crystal ball to be able to predict how and when the current downturn will end. Repeating what I wrote earlier, risk of loss is the price of the entry ticket for the stock market. Higher long-term returns are the potential payoff. The mental scars of what we are living through will be with us for a generation, but the financial scars need not be.

The populations of key countries are shrinking

Republished from Informedinvestor.com.au

by **MICHAEL COLLINS**

Released by US film producer Mike Moore, the documentary Planet of the Humans tells how renewable sources of energy are flawed solutions to mitigate the dangers of climate change.

About halfway through the documentary, a scientist laments that the environment's biggest problem is that "there are too many human beings using too much, too fast". The warning here and elsewhere in the documentary is that only a reduction in the world's population can save the planet.

Well, in that case, the battle against climate change is winnable because the populations of many countries are shrinking. The OECD says that only three (Israel, Mexico and Turkey) of its 37 members have fertility rates above the replacement rate of 2.1 children per woman. The UN reports the reproduction rates of all European countries are below replenishment levels. The EU forecasts that the populations of 12 of its 27 member countries will shrink in coming decades as only immigration props up numbers in the others. The World Bank predicts China's population will decline by 100 million people by 2050, that East Asia's will shrink from the 2030s and Brazil's will contract from the late 2040s by when India's population growth will be static. Already dwindling are the populations of Russia (since 1992), Japan (first in 2008 and uninterrupted since 2010) and Italy (since 2014). But for immigration, many Anglo countries with declining birth rates including Australia and the US would be shrinking population-wise too.

Many demographers say, if anything, the global bodies are underestimating the declines in population numbers. They say global bodies are failing to acknowledge that the social and economic forces that lowered birth rates in advanced countries are now universal across the emerging world. These factors include expectations of low infant mortality, rising female education, better career prospects for women, and urbanisation. Fewer births in the emerging world, these demographers say, will see the world's population diminish from a peak of between eight and nine billion people from around the middle of this century, whereas the UN forecasts the world's population to increase another three billion to 10.9 billion by 2100.

The consequences of declining populations could be significant and mostly grim, any environmental benefits aside. Fewer births reduce what is probably the biggest motivational force in society; young parents seeking a better life for their children. In economic terms, declining populations are a bigger challenge than ageing populations because the former herald a lasting shortfall in private demand that points to lower output, even if GDP per capita might rise. Businesses will invest less if fewer people are consuming less. Such outcomes hint at the 'Japanification' of economies; deflation and almost permanent recessions for economies that prove impervious to stimulus.

Government finances face difficulties as the shrinking and ageing of populations accelerates because a smaller working-age cohort must support more elderly who cost more health-wise. A stretched bunch of fewer workers could lead to reduced innovation and productivity gains. Government policy, especially with regards to taxation and social-security spending, could become skewed towards the elderly rather than productivity should older voters form a voting bloc. For the countries affected, a drop in population numbers might undermine their global power - and any rejigging of the world order rarely happens without friction. To sustain population numbers, rich countries might rely more on immigration but that risks social and political strains (including in source countries), especially if long-dominant ethnic groups become minorities.

These outcomes indicate the biggest threat raised by shrinking populations; that the unprecedented change is a shock. Capitalist societies are geared for growing populations, as happened over the 19th and 20th centuries when the world's population increased eightfold from one billion around 1800. Over that time, all aspects of societies were designed to accommodate more people, a trend that engenders much optimism and dynamism. Much might need to be adjusted as fewer people mean less of everything. Policymakers could no longer assume positive economic growth as a given. Companies could no longer reflexively plan to expand. Investors could no longer presume higher revenue by default. Town planning might be about shrinking social infrastructure. And so on. In 1937, UK economist John Maynard Keynes foresaw the problem and cautioned that "a change-over from an increasing to a declining population may be very disastrous". At the very least, as many urge, it's time that society stops ignoring what might be an unrelenting challenge of the upcoming age.

To be clear, demographic projections largely extend trends, and birth rates could rebound at any time to make mockeries of such forecasting techniques. It barely needs to be said that a rising population is no guarantee of economic success and that younger populations come with bespoke challenges too. Declining populations could come with benefits. These could include reduced environmental damage, fewer clashes over the world's resources and reduced inequality if labour shortages boost wages. Perhaps changes might be less disruptive than expected because populations only shrink slowly.

Such musings reinforce how much is speculation when it comes to analysing a sustained decline in populations because the world has never undergone a voluntary mass depopulation. There's no guarantee either of the supposed benefits such as the better environment that Planet of the Humans assumes.

For the full version of this article and to view sources, go to: magellan-group.com.au/insights/

Q&A: Ask a Question

Question 1

My partner and I are both in our 80s and have no children. We had wills done and in place some time ago, leaving our assets to our relatives. We have left our wills and also our powers of attorney and guardianship papers in a safety deposit box with the bank for safe-keeping as we feel it is safest there. However, we are concerned that if something happened to both of us at once, our family may not know where we have left it. We have tried telling them where we have left it many times, but we are afraid that they will forget it when the time comes. Are there any other options for us to ensure that our assets are distributed in the way we want it to?

That is an excellent question and one of increasing importance. It is most common for the surviving relatives of a deceased person to search for a will within the home. You can consider leaving a copy of your respective wills in your home with details and instructions of how to get the originals. However, this can be risky.

Another popular method of safe-keeping important estate planning documents is to leave them with your solicitor. The solicitor can then provide certified copies to you to be kept at home. It can be easier for family members to remember where your documents are held when it is with a trusted family solicitor, such as when another person in your family uses that same solicitor.

Finally, as you have to elect a person to be the executor of your will, or act as your Power of Attorney, you can always leave instructions with them. Naturally, many people typically choose a family member or a close friend that they trust to help them in times of needs, so they are often also great choices for who to nominate in helping to start the estate process when the time comes.

Question 2

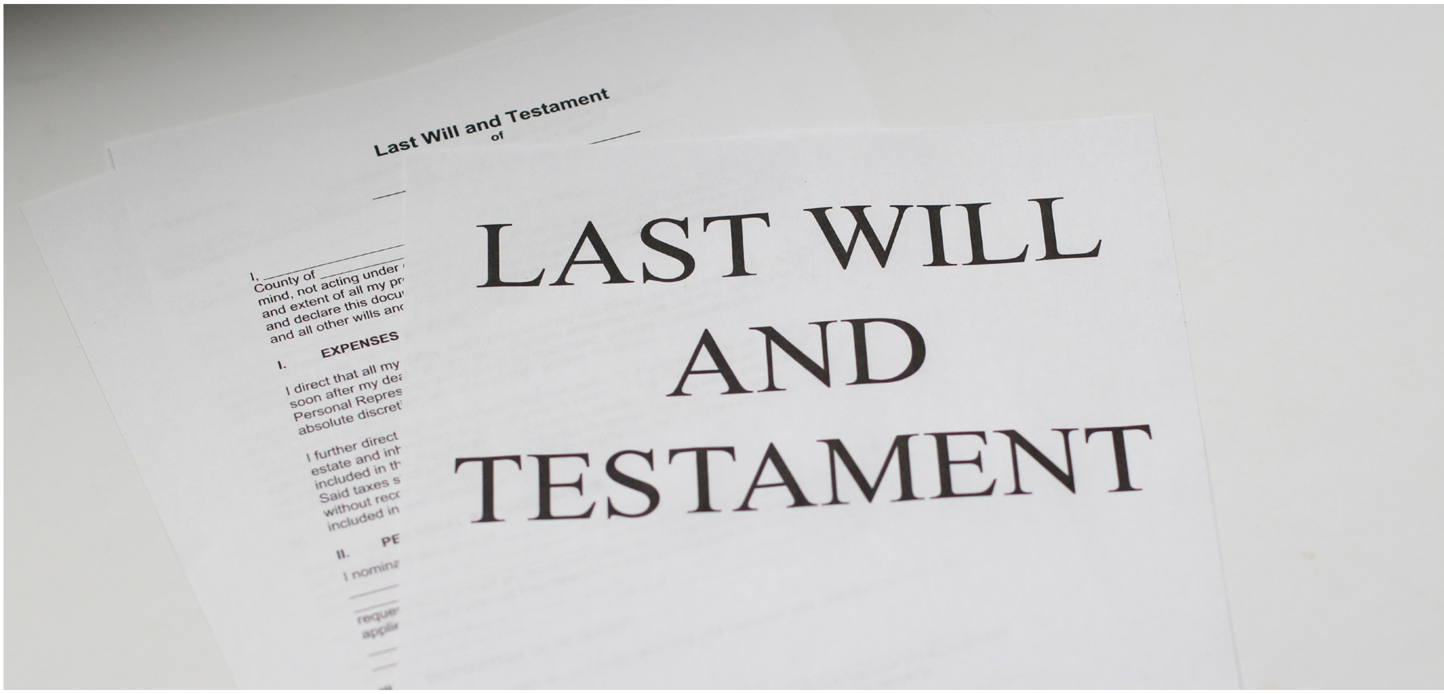
I read that there is a strategy that I can use to prevent a "death tax" for my non-dependent beneficiaries by using a Power of Attorney to withdraw my super balance when I am near death and deposit the proceeds into my bank account. I also heard that this might not be possible in all cases and a super fund can stop this withdrawal. How can I avoid this happening and make sure that this strategy will work for me? What happens if I pass away before this withdrawal is completed?

There are circumstances when a super fund may block a super withdrawal by a Power of Attorney (POA). One circumstance is when the withdrawal is paid to a bank account that is in a name other than that of the super fund member. Your POA needs to ensure that the funds are being paid to your bank account for the withdrawal to take place.

Some funds are also very weary of withdrawals made by a POA. This is due to a history of financial abuse by POAs in the past. To maximise the likelihood that you can use this strategy, your POA document should include a clause stating that the POA has authority to make superannuation withdrawals from your super funds. A certified copy of your POA should then be lodged with the super fund and you should confirm they have received it and will act on your POAs instructions.

If the withdrawal has been lodged with the super fund prior to your passing, the strategy should continue to work. However, if it is lodged afterwards, it is no longer effective. If that happens, normal tax rules will apply to your funds.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wealthtoday.com.au**.



The Pros & Cons of Testamentary Trusts

WEALTH ADVISER SERIES:
Part 1 of 2

Introduction

This two-part series will provide you with useful information on Testamentary Trusts, outlining both the advantages and disadvantages of this financial instrument. In consultation with your financial adviser, this knowledge will enable you to make an informed decision about whether a Testamentary Trust is suitable for your estate planning needs.

How Trusts Work

Before we look at testamentary trusts specifically, we'll review the basics of how trusts actually work. A trust is a legal relationship where a person, people or entity (the trustee) holds and distributes assets (such as income and capital) for the benefit of others (the beneficiaries, which can include people or entities). The trustee performs this task on behalf of a settlor (the person who creates the trust by "settling" assets to be held in trust for the beneficiaries). To create the trust, the settlor enters into a legal agreement with the trustee, via a trust deed which outlines the obligations of all parties. Because the trustee has the effective control of the trust, it is obviously important that the settlor knows and/or fully trusts the trustee to act in both their and the beneficiaries' best interests.

The trustee is the manager of the trust's assets and is responsible for the trust's day-to-day administration. If the trustee is a company, that company's directors are responsible for the trustee function. The trust deed determines the proportion of the trust's income and capital that will be distributed to the trust's beneficiaries, and the degree of discretion the trustee has in carrying out its duties. based on considerations such as their respective needs and the tax effectiveness of the distribution.

Beneficiaries are not guaranteed income or capital distribution from a discretionary trust, only the right to be considered by the trustee. Because of the discretionary nature of discretionary trust distributions, trusts are widely considered to be a tax-effective asset. However, because tax laws change over time, it is very important that trust deeds are regularly reviewed to ensure they are delivering the most tax-effective outcomes for beneficiaries.

In addition to a trustee, some trusts also have a principal. The principal has ultimate control over the trust and has the power to appoint or remove the trustee at any time. This principal role is also referred to as an appointor, guardian, or nominator in some trust deeds, and can be a person or an entity.

TERMS:

APPOINTOR – see principal.

BENEFICIARIES – people or entities that are intended to benefit from a trust.

DISCRETIONARY TESTAMENTARY TRUST – a type of testamentary trust where the trustee has full discretion over which beneficiaries benefit from the trust, and the extent to which they benefit.

Testamentary Trusts

A testamentary trust is a trust established in accordance with a will (with the person who has prepared the will being known as a testator). It is therefore an estate planning tool. A testamentary trust may deal with either all or only a portion of a testator's estate (their net worth at the time of their death). A testamentary trust may be especially suitable for people who will have a significant windfall upon their death, such as the proceeds from a life insurance policy. They are also relatively inexpensive to establish.

A testamentary trust can remain in existence for up to 80 years if necessary, or any shorter time period if specified in the will, or if the trustee is permitted to select an earlier vesting date (the date that the trust will end). There may also be more than one testamentary trust associated with a will, if the testator (who in terms of the trust is also the settlor) has prepared more than one for the purpose of achieving different objectives (for example, for different children).

Upon a testator's death, their estate is administered by an executor (either a person or entity) nominated by the testator or by a probate court (a court that specialises in the administration of estates). The testator's (settlor's) net assets (i.e. gross assets at their time of death less any outstanding debts or otherwise specified Will distributions) are placed in the testamentary trust in accordance with their wishes, to be held by the trustee (who may also be the executor, but may not necessarily be). Beneficiaries of a testamentary trust typically include relatives of the settlor, and perhaps company entities in which the settlor has an interest. Where the principal role exists for a testamentary trust, the executor is often chosen for this role, and as mentioned earlier, has the power to remove or appoint the trustee.

TERMS:

ESTATE – an individual's net worth in terms of assets at the time of their death.

EXECUTOR – a person or entity who administers an individual's estate. If an executor is not nominated in the deceased individual's will, an executor may be appointed by a probate court.

FAMILY TRUST – a discretionary trust established to hold a family's assets or conduct a family business, with both assets managed and distributions made by a trustee.

GUARDIAN – see principal.

Advantages of a Testamentary Trust

The range of potential benefits of a well-drafted Testamentary Trust can be broadly classified into three main categories:

- Control over Wealth Distribution
- Asset Protection
- Tax Benefits

We will now look at each of these three categories in turn:

Control over Wealth Distribution

A well-drafted Testamentary Trust can:

1. Ensure that a Settlor's children (and grandchildren etc.) are provided for long-term. Although many people simply leave all of their assets to their surviving spouse, there is no guarantee that the settlor's children will eventually receive the inheritance, particularly if their surviving spouse remarries and has further children. A testamentary trust on the other hand allows a settlor to avoid this potential scenario. They also enable the opportunity for wealth provision for grandchildren and future generations, rather than solely providing for the current generation.
2. Enable a settlor to stagger the timing of beneficiary entitlements. It can potentially be dangerous leaving beneficiaries with a single, significant inheritance entitlements, especially in the case of young adults. However, smaller, regular payments to be distributed to beneficiaries over the longer term can be achieved via a testamentary trust. The settlor can also stipulate that distributions are dependent on certain events, such as the beneficiary achieving certain milestones, or that the proceeds are to be used for specific purposes, such as the deposit on a house or for their grandchildren's education. This avoids the potential for the settlor's accumulated wealth (i.e. the beneficiaries' windfall) to be quickly squandered.
3. Provide flexibility, with distribution by the trustee being based on future needs rather than current circumstances. People's circumstances invariably change over time. A testamentary trust provides a structure whereby a trustee can take this into account in terms of the trust's future beneficiary distributions.

TERMS:

INTER VIVOS TRUST – a trust that is made and which exists during a person's lifetime. It is the opposite of a testamentary trust, which only comes into existence upon a person's death if they have made provisions for such a trust to be established as part of their will.

LINEAL DESCENDANT TRUST – a form of testamentary trust that ensures only the lineal descendants (i.e. children, grandchildren etc.) of the settlor will benefit from the trust. Spouses of lineal descendants are excluded from any of the proceeds of a lineal descendant trust.

NOMINATOR – see principal.

PRIMARY BENEFICIARY – the first in line to receive a benefit.

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