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First Quarter 2023 Investment Insight

It has long been said that the stock market climbs the wall of worry. There is never a shortage of crises in the news when it relates to the global economy. Since the great financial crisis in 2008-2009, there have been countless events that threatened to send the economy into a freefall. Below are just a few:

- **2011**: US debt downgrade
- **2012**: European credit issues with Greece defaulting multiple times on their debt
- **2013**: US government shutdown
- **2014**: end of quantitative easing
- **2015**: Fed Rate Hike / Greece misses debt payment
- **2016**: Brexit
- **2017**: North Korean nuclear missile test
- **2018**: US government shutdown / 20% market decline
- **2019**: Trade war with China
- **2020**: COVID / 34% market decline
- **2021**: COVID / Inflation
- **2022**: Inflation / Interest Rate Hikes / 25% market decline
- **2023**: Regional Banking liquidity

Despite all these events, and even well off the highs of late 2021, the MSCI All Country World (a global stock market index) has returned 7.72% annualized over the last decade.

The most common questions we are getting now are undoubtedly related to the regional banking issues noted above. The collapse of Silicon Valley Bank (SVB) and Signature Bank of New York has grabbed headlines for much of the last three weeks. Inevitably, a banking crisis brings back unpleasant emotional responses from 2007-2009 during the Great Financial Crisis. People watch the news and wonder if their money is safe or if they will be able to access it when they need it. They wonder if their investments will decline and how they can protect against these risks. All of these are completely natural emotional responses. I experienced many of the same feelings as I spent much of the March 11-12 weekend reading about the failure of SVB and looking for what steps the government would take to mitigate what had the potential to become a broader banking crisis. At some point that weekend my wife explained to me what she described as "the entirety of my knowledge of bank runs" which we watched here (https://www.youtube.com/watch?v=iPkJH6BT7dM).

It's A Wonderful Life (1947) is a movie that depicts a classic version of a bank run. Banks take in deposits and loan out money for people to build houses, start businesses, or many other things. Sometimes they buy slightly higher earning assets (like Treasury bonds). If everyone tries to withdraw all their money at one time, the bank doesn't hold that much cash. It can take them time to sell assets (or let Treasury Bonds mature) to fund 100% of deposits. In 1933, following the Great Depression, President Roosevelt signed The Banking Act of 1933 which created FDIC insurance. Currently, $250,000 ($500,000 for joint accounts) of money deposited in an accredited bank is insured by this government program. This program isn't funded by the government but is funded by premiums that banks pay into the program knowing that confidence in the banking sector is good for them. In return, FDIC insurance is backed by the full faith and credit of the United States government. This program has helped to eliminate much of the classic version of bank runs depicted in It's a Wonderful Life. However, part of SVB's problem is 84% of their deposits were over this FDIC insurance level and therefore, they were more susceptible to a traditional

bank run as they dealt with very high net worth individuals and businesses. Additionally, the US treasuries they bought were longer dated (over three years). The rate hikes throughout 2022 by the Federal Reserve reduced the value of those Treasury bonds. If held to maturity, they would be fully repaid with interest, but if forced to sell early to meet an unusually high number of withdrawals, they would have to realize a loss.

The government stepped in with strong action to protect depositors at SVB and a few other banks that failed in the days following. Many clients asked how this might spread as they are reminded of the failures of Lehman Brothers and Bear Stearns prior to the financial crisis in 2008-2009. What many people are not aware of is that there have been 562 bank failures dating back to 2001 and 214 since 2011 (after the end of the financial crisis). Most depositors are made whole by the FDIC insurance program quickly and the rest usually get back a significant portion of any dollars they have over FDIC limits, but they must wait for the bank to liquidate its assets.

So, why do we feel the need to describe a 1947 movie and give a history lesson on bank runs when we are supposed to be your financial planners? First, we’re here to answer your questions and help you through this kind of uncertainty. Second, while the banking sector has been volatile over the last three weeks, the broader stock market has been positive since the collapse of SVB. Finally, well, that requires a bit more context. The owner of the building and loan (think credit union) in *It’s A Wonderful Life* is George Bailey. Another character, Mr. Potter, who is heavily referenced in this scene, is the villain in the movie. He owns most of the businesses in the town, including the other bank, and makes money off virtually every aspect of the town’s daily life. My main takeaway from the clip that my wife showed me was when George Bailey says “don’t you see what’s happening here? Potter isn’t selling, Potter’s buying and why? Because we’re panicking and he’s not.”

This sentence about Mr. Potter reminds me of a quote from the famous investor, Warren Buffet: “Be greedy when others are fearful and fearful when others are greedy.” As humans we have competing emotions. It’s not just what our brains know, it’s what our hearts and minds feel as well. When we see our investment portfolios decline, we want to stop the pain as quickly as possible. Two primary cognitive biases we see in investing are the loss-aversion bias and the action bias. Loss aversion is the idea that most investors would much rather not lose $100 than gain $100. The action bias is the idea that we often feel compelled to act and change course, even if there is no evidence that making a change will lead to better results. These triggers, fueled by outside influences such as sensationalized 24/7 television, lead us to want to sell into declining markets.

However, as the chart below shows, when the market drops 25%, it is actually a great time to invest, historically. On average, the forward return off a 25% market decline is greater than 10% annualized. This even accounts for further declines after the 25% level is reached. All the "Trough" periods listed below are certainly times when great investors like Warren Buffet (and presumably Mr. Potter) have set aside their emotional inclinations and have chosen to stay the course and benefit from a disciplined rebalancing or buying strategy into these tumultuous markets.

When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data: Ycharts

Do great investors have an immense reserve of willpower to overcome these emotional biases to which so many investors fall prey? We would argue that they do not. Instead, they have a systematic approach that forces them to "buy because they're panicking and we're not" or "be greedy when others are fearful." They remove as many emotional trappings as possible and refuse to get caught up in what's different about this time. They build a process that is repeatable, sound, and time tested. Then, they simply execute the plan.

At Legacy, it all comes back to financial planning. Taking full advantage of our financial planning services will help reduce the stress and anxiety related to investing. Working towards a successful financial plan, regardless of age or income level, can help calm the emotions during periods of economic turmoil. Planning for periods like 2007-2009, March 2020, or 2022 by having solid planning staples like an emergency fund, an adequate savings/withdrawal rate, and proper insurance certainly helps get us through these down periods and back into the very pleasant market recoveries that tend to follow them. If you haven't gone through our planning process, please reach out to your relationship manager and ask them how to get started. Let us help you build a process in your life that is repeatable, sound, and time tested. We will help guide you to a path that improves your chances of a successful outcome. Then, simply execute the plan for it can lead to "a wonderful life."

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