RIVERVIEW QUARTERLY INSIGHTS

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DOG ON A LEASH: TRYING TO MAKE SENSE OF MARKETS

We haven't written much lately to our clients and friends about the markets and the economy. Not because there's nothing going on, but rather because there's so much going on, all of it chaotic. A review of articles in The Wall Street Journal from mid-April tells a pretty confusing story:

- **April 18-19:** The Dow Jones Industrial Average "staged its best two-week performance since the 1930s, a dramatic rebound that has left many investors with a confounding reality: soaring share prices and a floundering economy." The Dow increased 15% over that 2-week period. Many investors agree that this increase was driven by the Federal Reserve's and federal government's stimulus efforts.
- **April 22:** A plunge in oil prices, during which a contract for U.S. Crude oil fell below zero dragged down global markets. And trading in overnight stock futures skyrocketed, "luring more investors to join in the action" by creating nonstop activity.
- **April 28:** One article stated that the "economic earthquake the coronavirus has unleashed is likely to trigger a wave of corporate distress and bankruptcy unseen in years." In the same issue, another article noted that stocks rose, "with investors betting that stimulus measures and the easing of coronavirus-lockdown measures around the world could help kick-start economic activity."
- **April 30:** The U.S. economy shrank in the first quarter "at its fastest pace since the last recession." Forecasters expect a much larger contraction in the second quarter.
- **May 1:** Europe's economy suffered a record decline in the first quarter, and nearly four million people in the U.S. filed for unemployment benefits in the prior week. In other news, the S&P 500 rebounded 34% since its March 23 low, and increased 12.7% in April, its best performance since January of 1987.
- **May 9-10:** April unemployment reached a record 14.7% as the pandemic wiped out "a decade of job gains in a single month." Stocks shrugged off that jobs report, with the Dow rising 1.9% on that Friday.

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- **May 11:** The Russell 2000, an index of small companies, rose 12% in April outpacing the growth in the S&P 500.
- **May 21:** Yields on government bonds "stalled near all-time lows, a sign that investors are anticipating a difficult economic recovery and years of aggressive monetary stimulus." Bond yields fall as their prices rise.
- **June 2:** The Congressional Budget Office, a nonpartisan legislative agency, stated that the U.S. economy "could take the better part of a decade to fully recover from the coronavirus pandemic and related shutdowns."
- **June 5:** An article entitled, "Wall Street Parties Despite Turmoil" asks the question "[w]hy is the market rising even as U.S. cities burn, Hong Kong becomes a flashpoint in China relations with the West and the prospect of a second round of coronavirus infections remains real?"
- **June 6-7:** Several articles point out that the U.S. labor market added 2.5 million jobs in May and that the Dow gained 6.8% in the prior week. On the other hand, in the same edition, Jason Zweig's column pointed out that the gains in the stock market were due primarily to a few growth stocks, and that seldom if ever "has the gap between the haves and the have-nots been as wide as it is now."
- **June 9:** The Nasdaq Composite Index hits a record high close, and the S&P 500 turns positive for the year.
- **June 11:** The Federal Reserve signaled that it plans to keep its overnight interest rate near zero for years.
- **June 12:** The Dow falls over 1,800 points on fears of a second coronavirus surge as states begin emerging from lockdown.
- **June 13-14:** Two front-page articles: one, entitled "Global Economy Faces Steep Climb to Recover," notes that April was a "crippling month;" while the other, entitled "Investors Bet on Volatility," notes that hundreds of billions of dollars are being invested purely in volatility by both large and small investors.
- **June 22:** A wider range of stocks (beyond those in the technology sector) is helping the U.S. stock market "claw back most of its losses for the year."

This list is lengthy on purpose: it points out just how disconnected the stock market and the economy seem to be in this moment.

The relationship between the stock market and the economy has often been analogized to a dog on a leash. Both head in the same general direction, but not always in the same line or at the same time (this is especially true if, like me, you have a basset hound). This divergence is due to the way the two handle information. Economic data is always backward looking; it tells you what has already happened. For example, a recession is often defined as a drop in gross domestic product lasting more than a few months. So by the time the economic data shows a recession has happened, the economy has already suffered harm.

On the other hand, the markets are always trying to determine what information means and what it might imply for the future. So it is not surprising that stock prices fall when there is a rise in coronavirus cases, because this information suggests that more infections will slow growth even further (whether or not that actually happens).

Often the stock market and the economy move consistently. But during stressful times like these they can diverge more in the short run due to a few factors. First, the Federal Reserve's unprecedented amount of monetary stimulus, and to a lesser degree Congress's fiscal stimulus, are certainly major contributors to the speed and magnitude of the stock market's rebound since the end of March. The Fed's extraordinary actions are undeniably responsible for much of the positive stock market performance in the second quarter, and thus much of the decoupling of market returns from current economic data.

The disconnect – as well as increased stock market volatility – are also being fueled by two common drivers of human behavior: fear and greed. The former results in greater stock sales (and therefore a drop in prices) while the latter results in more purchases (and therefore a rise in prices). During times of extreme market distress such as we experienced in March, both occur out of proportion to the actual data being communicated.

In his "Intelligent Investor" column in the June 13-14 edition of The Wall Street Journal, Jason Zweig (often quoted by us) notes that

> By shutting down the economy, the coronavirus unleased a new generation of gamblers on the stock market: people, mainly young men, going stir-crazy from quarantine and the lack of professional sports to bet on. They've turned to trading stocks. To these thrill-seekers, the magnitude of moves matters as much as the direction; a big loss can be as much fun as a big gain.

Such "thrill-seeking" may help to explain the significant increase in volume of trades in stocks of smaller, financially distressed companies, particularly energy companies, cruise lines and companies like Hertz that have filed for bankruptcy. Zweig suggests that the wild swings in these distressed stocks is likely beginning with these day traders, and that their activity is then being amplified by algorithm-based trading programs that are generating even more trades based upon the momentum and volatility created by the day traders.

(By the way, there's nothing wrong with speculating in the stock market, just as there's nothing wrong with any other form of gambling. As long as you recognize that it IS gambling, not investing, and as long as you limit the amount at risk to an amount you can safely lose without harming your financial future.)

The problem with speculators and volatility traders is that they cloud the market data with ever more noise (and more volatility, which makes volatility trades more popular, and so on). The truth, however, is far more boring. When looked at from a 5- or 10-year lens, the economy and the stock market show pretty similar movement.

So in the moment, the market is disconnected from the economy (somewhat) and roiled up by gamblers and riding a wave of monetary stimulus. But we've seen this before (Dot.Com Bubble, Great Financial Crisis, anyone?), and the turmoil always works itself out in ways that, in hindsight, seem predictable if not inevitable.

Are stock prices inflated? Or is the economic forecast too backward-looking and gloomy? We're not in the forecasting business, so we won't place a bet. And even if we thought we had an answer, future events (vaccine discoveries, second waves of infection, elections) could render that answer meaningless. Instead, we'll just keep relying on the same principles that seem a little boring only because they never change: have enough cash on hand, stay invested and diversified, try to stifle any "fear of missing out" impulses. Stay safe, hug the people in your bubble, spread kindness and try not to worry about (or indeed even look too often at) your investments.

SPOTLIGHT ON PLANNING

IRS CLARIFIES COVID-19 RELIEF MEASURES FOR RETIREMENT SAVERS

The Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in March 2020 ushered in several measures designed to help IRA and retirement plan account holders cope with financial fallout from the virus. The rules were welcome relief to many people, but left questions about the details unanswered. In late June, the IRS released Notices 2020-50 and 2020-51, which shed light on these outstanding issues.

Required minimum distributions (RMDs)

One CARES Act measure suspends 2020 RMDs from defined contribution plans and IRAs. Account holders who prefer to forgo RMDs from their accounts, or to withdraw a lower amount than required, may do so. The waiver also applies to account holders who turned 70½ in 2019 and would have had to take their first RMD by April 1, 2020, as well as beneficiaries of inherited retirement accounts.

One of the questions left unanswered by the legislation was: "What if an account holder took an RMD in 2020 before passage of the CARES Act and missed the 60-day window to roll the money back into a qualified account?"

In April, IRS Notice 2020-23 extended the 60-day rollover rule for those who took a distribution on or after February 1, 2020, allowing participants to roll their money back into an eligible retirement account by July 15, 2020. This seemingly left account owners who had taken RMDs in January without recourse. However, IRS Notice 2020-51 rectified the situation by stating that all 2020 RMDs — even those received as early as January 1 — may be rolled back into a qualified account by August 31, 2020. Moreover, such a rollover would not be subject to the one-rollover-per-year rule.

This ability to undo a 2020 RMD also applies to beneficiaries who would otherwise be ineligible to conduct a rollover. (However, in their case, the money must be rolled back into the original account.)

This provision does not apply to defined benefit plans.

Coronavirus withdrawals and loans

Another measure in the CARES Act allows qualified IRA and retirement plan account holders affected by the virus to withdraw up to $100,000 of their vested balance without having to pay the 10% early-withdrawal penalty (25% for certain SIMPLE IRAs). They may choose to spread the income from these "coronavirus-related distributions," or CRDs, ratably over a period of three years to help manage the associated income tax liability. They may also recontribute any portion of the distribution that would otherwise be eligible for a tax-free rollover to an eligible retirement plan over a three-year period, and the amounts repaid would be treated as a trustee-to-trustee transfer, avoiding tax consequences.1

In addition, the CARES Act included a provision stating that between March 27 and September 22, 2020, qualified coronavirus-affected retirement plan participants may also be able to borrow up to 100% of their vested account balance or $100,000, whichever is less. In addition, any qualified participant with an outstanding loan who has payments due between March 27, 2020, and December 31, 2020, may be able to delay those payments by one year.

IRS Notice 2020-50

To be eligible for coronavirus-related provisions in the CARES Act, "qualified individuals" were originally defined as IRA owners and retirement plan participants who were diagnosed with the virus, those whose spouses or dependents were diagnosed with the illness, and account holders who experienced certain adverse financial consequences as a result of the pandemic. IRS Notice 2020-50 expanded that definition to also include an account holder, spouse, or household member who has experienced pandemic-related financial setbacks as a result of:

- A quarantine, furlough, layoff, or reduced work hours
- An inability to work due to lack of childcare
- Owning a business forced to close or reduce hours
- Reduced pay or self-employment income
- A rescinded job offer or delayed start date for a job

These expanded eligibility provisions enhance the opportunities for account holders to take a CRD.

The Notice clarifies that qualified individuals can take multiple distributions totaling no more than $100,000 regardless of actual need. In other words, the total amount withdrawn does not need to match the amount of the adverse financial consequence. (Retirement investors should consider the pros and cons carefully before withdrawing money.)

It also states that individuals will report a coronavirus-related distribution (or distributions) on their federal income tax returns and on Form 8915-E, Qualified 2020 Disaster Retirement Plan Distributions and Repayments. Individuals can also use this form to report any recontributed amounts. As noted above, individuals can choose to either spread the income ratably over three years or report it all in year one; however, once a decision is indicated on the initial tax filing, it cannot be changed. Note that if multiple CRDs occur in 2020, they must all be treated consistently — either ratably over three years or reported all at once.

Taxpayers who recontribute amounts after paying taxes on reported CRD income will have to file amended returns and Form 8915-E to recoup the payments. Taxpayers who elect to report income over three years and then recontribute amounts that exceed the amount required to be reported in any given year may "carry forward" the excess contributions — i.e., they may report the additional amounts on the next year's tax return.

The Notice also clarifies that amounts can be recontributed at any point during the three-year period beginning the day after the day of a CRD. Amounts recontributed will not apply to the one-rollover-per-year rule.

Regarding plan loans, participants who delay their payments as permitted by the CARES Act should understand that once the delay period ends, their loan payments will be recalculated to include interest that accrued over the time frame and reamortized over a period up to one year longer than the original term of the loan.

Retirement plans are not required to adopt the loan and withdrawal provisions, so check with your plan administrator to see which options might apply to you. However, qualified individuals whose plans do not specifically adopt the CARES Act provisions may choose to categorize certain other types of distributions — including distributions that in any other year would be considered RMDs — as CRDs on their tax returns, provided the total amount does not exceed $100,000.

For more information, review IRS Notices 2020-50 and 2020-51, and speak with a tax professional.

[1] Qualified beneficiaries may also treat a distribution as a CRD; however, nonspousal beneficiaries are not permitted to recontribute funds, as they would not otherwise be eligible for a rollover.

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MARKET SNAPSHOT

MARKET SUMMARY – Short- and Long-Term Index Returns

Stocks staged a strong rally in the second quarter as a result of global central bank support, fiscal stimulus from major governments, and some improvement in various coronavirus metrics (cases, hospitalizations, deaths etc.). To completely recover from the declines of the first quarter, US, international developed, emerging market, and global real estate stocks needed to post gains in the second quarter of roughly 27%, 31%, 31%, and 41% respectively. Though the US stock market got close to recouping its losses, the other markets clearly have more progress to make.

	STOCKS				BONDS	
	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
2Q 2020	22.03%	15.34%	18.08%	11.17%	2.90%	1.76%
1 Year	6.53%	-5.42%	-3.39%	-15.91%	8.74%	4.00%
5 Years	10.03%	2.01%	2.86%	1.62%	4.30%	4.49%
10 Years	13.72%	5.43%	3.27%	6.97%	3.82%	4.20%

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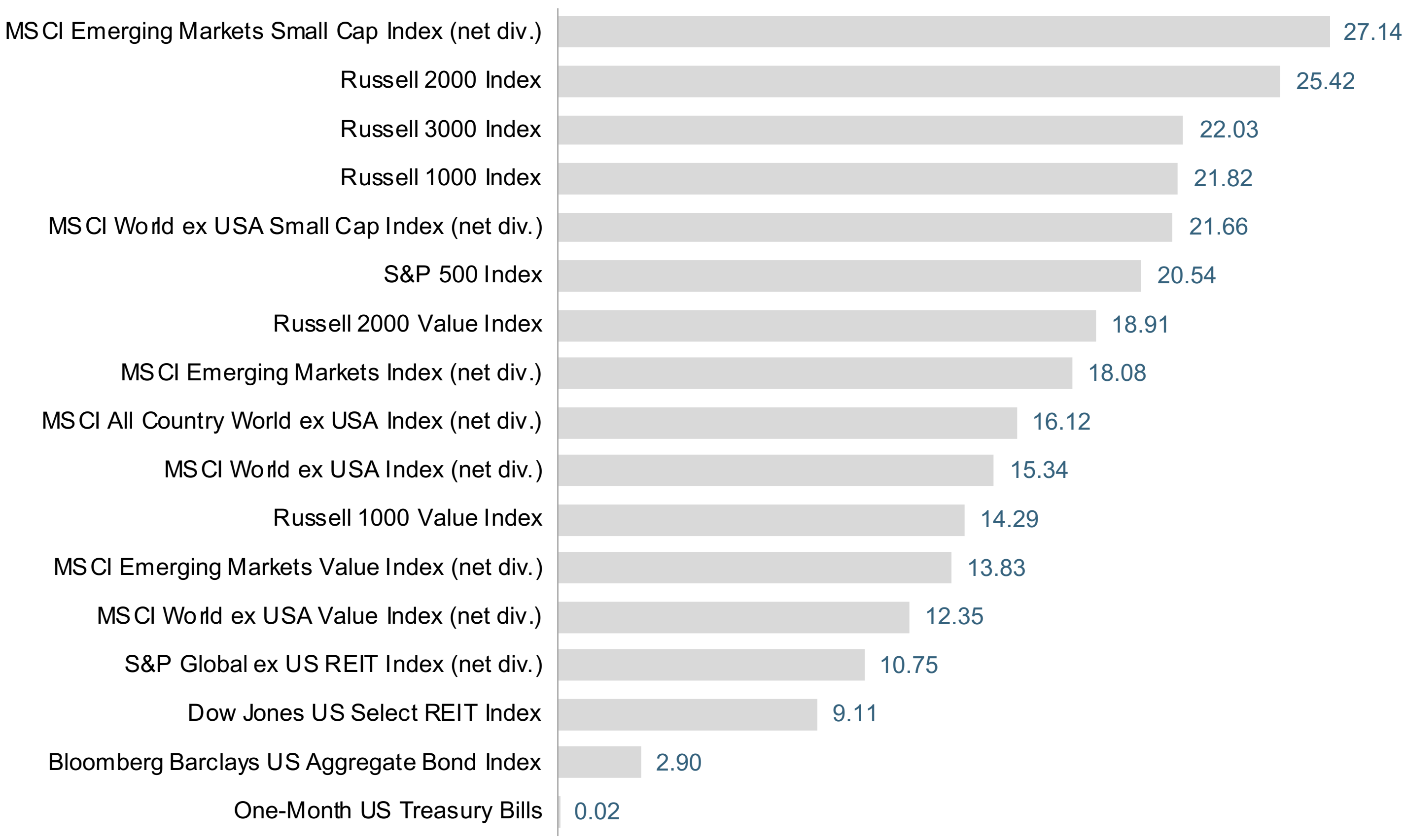
GLOBAL MARKETS - Second Quarter 2020 Index Returns (%)

Equity markets around the globe posted positive returns in the second quarter. Looking at broad market indices, US equities outperformed non-US developed markets and emerging markets.

Value stocks underperformed growth stocks, and small caps outperformed large caps.

REIT indices underperformed equity market indices in both the US and non-US developed markets.



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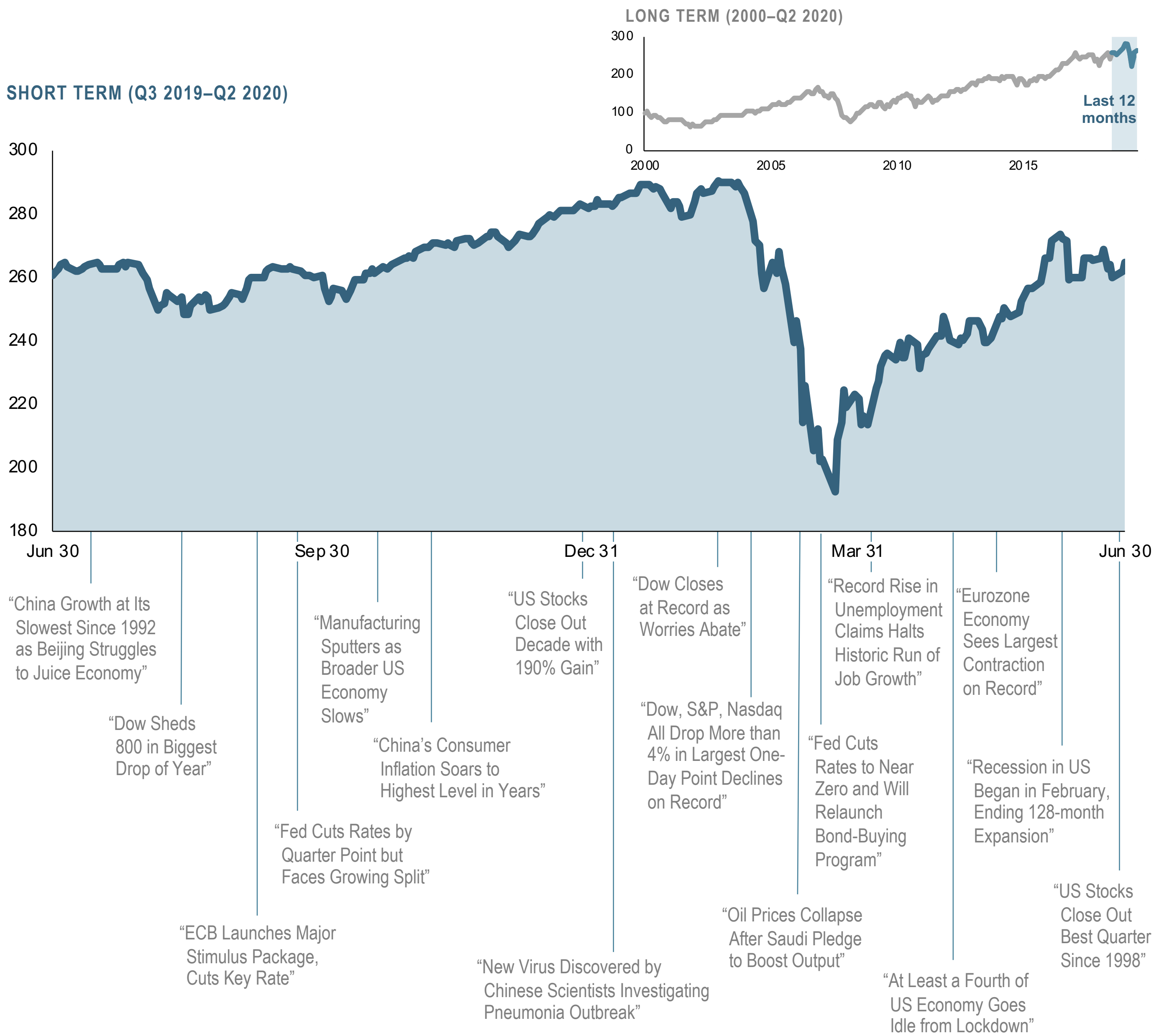
WORLD STOCK MARKET PERFORMANCE

MSCI All Country World Index with selected headlines from past 12 months

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2019, all rights reserved. It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

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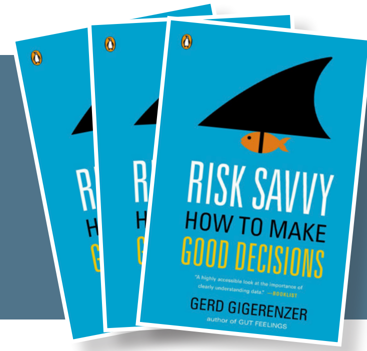
BOOK REVIEW



RISK SAVVY HOW TO MAKE GOOD DECISIONS

by Gerd Gigerenzer

Would you take a pill if it increased your chances of having thrombosis (blood clots, usually in the legs) by 100%? Of course not. Would you take it if it increased your risk from one in seven thousand to two in seven thousand? Of course you would. But as you've already figured out, they are the same: increasing from one to two is a one hundred percent increase, even if both odds are tiny. This is the point of Gerd Gigerenzer's 2014 book, Risk Savvy: How to Make Good Decisions. And even though it's six years old, the lessons it teaches remain relevant.

The view of how risk savvy investors are varies wildly. The academics who developed the "Efficient Market Hypothesis" believe all investors are routinely rational, making investment decisions dispassionately, based on all available information. On the other hand, the academics behind "behavioral finance" believe that investors make their decisions based on rules of thumb, or heuristics, like risk aversion (meaning, roughly, that people tend to fear losses to a greater degree than they crave gains) that lead to irrational decisions.

Gigerenzer's views are different, and more nuanced. He disagrees with the assessment made once by The Economist magazine that people are "fallible: lazy, stupid, greedy and weak." (In fairness to the magazine, Gigerenzer points out that, for example, 20% of Americans think they are in the top 1% income group, and another 20% think they soon will be.) Instead, Gigerenzer asserts that we live in a "risk illiterate society," a problem that can be cured by making people more risk savvy.

He also observes that cultural differences can affect the way people think about risk. For example, in "France, Germany, Italy, the United Kingdom and the United States, doctors' beliefs about diet and health – such as taking vitamin supplements or exercising – more closely resemble those of the general public in their country than of doctors in other countries."

The book lists some rules of thumb of its own, in order to increase risk savviness:

- Always ask: What is the absolute risk increase? For this proposition, he cites the example this article opened with. A 100% risk increase is not absolute; it's only relative to the initial number. The absolute risk increase is from one in 7,000 to two in 7,000.
- Always ask for the reference class: Percent of what? If the weather forecast says there is a 30% chance of rain tomorrow, does that mean (1) 30% of the time tomorrow; (2) over 30% of the local geography; (3) 30% of meteorologists think it will rain while the rest don't; or (4) on 30% of the days within the forecast range? Research shows that each of these beliefs is held by different groups of people.
- Dread Risks. People have an innate fear of low probability events that can kill a large number of people, and avoid them more than higher probability events that over time kill many more people. The classic example is air travel: many more people fear it than fear traveling by car, even though car travel kills many, many more people each year. The solution, by the way, in the book is that "[i]f reason conflicts with a strong emotion, don't try to argue. Enlist a conflicting and stronger emotion."

For example, if you fear flying and are planning a trip with your children, counter the fear with the stronger emotion of the increased risk to which you are exposing your children by driving.

He makes an important distinction between "risk" and "uncertainty." Although in common usage the two are interchangeable, in the decision making process they aren't. Risk deals with known possible outcomes, like the odds of winning at games of chance or the lottery. Uncertainty deals with unknown threats (like pandemics). Good decision making in the face of risk requires "logic and statistical thinking." In the face of uncertainty, however, good decisions also require "intuition and smart rules of thumb." This contradicts much of the efficient market hypothesis and behavioral finance; the former pretends there are no rules of thumb, while the latter identifies them as the source of problems.

According to Gigerenzer, rules of thumb and intuition are used by experts to make quick decisions that do not allow for the luxury of time (for example, baseball players judging the trajectories of fly balls, or airplane pilots using a "fixed gaze" when landing). However, bad decisions are made when situations with known risks are treated as having no risk at all (the "zero-risk illusion"), or when uncertain situations are treated as simply those with known risks (named the "turkey illusion" after the experiences turkeys have shortly before Thanksgiving: the nice farmer feeds me a lot until the day he comes out with a hatchet, an uncertainty the turkey couldn't have anticipated). Gigerenzer sums up his decision making rules as follows:

- Risk doesn't equal uncertainty: The best decision under one is not the best decision under the other;
- Rules of thumb are not dumb: In an uncertain world, simple rules of thumb can lead to better decisions than fancy calculations;
- Less is more: Complex problems don't always require complex solutions, so look for a simple answer first.

Gigerenzer points out several examples of ways these rules aren't followed. Most importantly, he notes the difference between "positive error" and "negative error" cultures. In the former, errors are quickly identified and brought to light, so that the culture can learn from them. Airlines in general are positive error cultures, which is why air travel has gotten safer over the years. In the latter, by contrast, errors are covered up (often as a result of liability fears), so they are often repeated. Hospitals can be negative error cultures. This explains why so many more pilots use checklists while flying than doctors do while performing surgery. This, in turn, can lead to defensive decision making, in which excess tests or treatments are ordered to avoid liability, not because they are in the patient's best interest (I suspect Gigerenzer doesn't have many friends who are doctors).

Counterintuitively, defensive decision making can lead to excessive risk-taking. "If your intuition says that an investment is overvalued but you join in because everyone else invests in it, you may take undue risks." The solution to this problem, Gigerenzer says, is "to talk about errors and take the responsibility in order to learn and achieve better overall performance."

And speaking of investments, Gigerenzer has a few simple but very important rules. First, "don't buy financial products you don't understand." Had investors (including institutions) followed this rule, the Financial Crisis may not have had the horrible impact it did. This is not the same as being risk averse; it's not a call to put your investments in a savings account. Rather, it's a call to understand your investments well enough to know where the risk and the uncertainty lie. Second, trust your banker (or other advisor) but only if she understands (and can explain) what she's investing in, and she has no conflicts of interest (like making more money from selling one product over another). Finally, and most importantly, keep it simple. Gigerenzer provides three examples of this principle:

- Invest one-third each in stocks, bonds and real estate (although we at Riverview might not agree with the exact percentages, we do definitely agree with the general principle).
- Save 20 percent, spend 80 percent (again, these may not be the right percentages for everyone, but a solid rule of thumb).
- Diversify as broadly as you can.

The book covers many other areas where people should be more risk savvy, such as leadership, romance and medical treatments. But in every area, the message is the same. Look behind the percentages, get at the real data, understand what it's saying (and what it isn't saying). And at this point in history, that's a message we all need to hear a lot.

IMPORTANT DISCLOSURE INFORMATION

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