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What Investors Can Learn from CEOs, Army Rangers, Pilots and Police

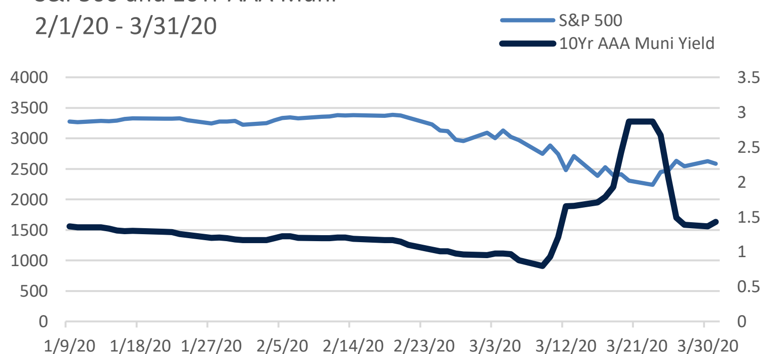
"The Stress Effect: Why Smart Leaders Make Dumb Decisions and What to Do About It", by Henry Thomson, presents compelling analysis into how stress impacts leadership decision-making. What do studies of this nature have to do with private wealth management? Much more than you might think.

Reasoned Decision-Making in Adverse Environments

Stress impacts the brain's cognitive and emotional intelligence, critical abilities needed to make sound decisions. Understanding how this occurs can be highly applicable to individual investors.

Like most wealth managers, we emphasize common sense such as "stick to your plan", "think long-term", and "capitalize on volatility". While such admonitions are valid, they are much more easily implemented in routine times than in the heat of the moment. As Mike Tyson, former heavyweight champion, once said, "everyone has a plan 'till they get punched in the mouth".

Today's global healthcare crisis and associated market turbulence certainly qualifies as such a blow. The S&P 500 fell more than 33% in only a month, while the AAA 10Yr municipal curve whipsawed wildly from 0.80% on March 9th all the way up to 2.88% on March 23rd before receding to 1.53% on April 6th.



Source: Bloomberg

"The Stress Effect" studies traits associated with both effective and poor decision-making under pressure. While special operations seemingly have little to do with private investment portfolios, there are common threads, including a need to recognize and effectively manage pressure-driven stimuli. This can be challenging, yet doing so is a key ingredient in achieving long-term financial goals. As we help clients navigate today's challenging times, four recommendations seem particularly worthy of consideration.

Tune In By Tuning Out

McKinsey & Co. recently published crisis guidance for executives that suggests they "take a breath and allow the brain to focus on what's most relevant".[1] In our realm, investors are bombarded with "noise", especially when markets are volatile, much of which is irrelevant to personal financial plans and circumstances. This creates a risk of excessive attention being paid to extraneous information, and alarm-inducing headlines often coincide with times in which selling can be most damaging.

Similarly, investors may benefit from tempering the tendency to follow the herd. Often people find it difficult to go against the grain and, in investing, studies have demonstrated that too much emphasis is placed on "groupthink" rather than personal considerations. Try and tune out the noise and instead zero in on what matters to your family's long-term plans. As appropriate, revisit and adjust the assumptions that drive your financial plans but think twice about arbitrarily following the crowd.

Small Steps Can Have a Big Impact

Predicting market tops and bottoms is tempting, but arguably a fool's errand. What may prove far more productive is taking proactive, readily achievable actions concerning matters over which you have control. For example, discuss with your portfolio manager the merits of rebalancing back to asset allocation targets, tax-loss harvesting, or refinancing debt when interest rates fall.

Manage Your Emotional Intelligence

Henry Thomson writes, "when stress increases, cognitive and emotional intelligences are compromised. Perception changes and, in many cases, becomes less accurate."[2]

Emotional intelligence is an individual's ability to identify, evaluate and manage their sentiments and those present in the broader environment. Intense stress tends to elevate short-term impulses. Paralysis or panic can be devastating in the military or law enforcement, yet similar risks and tendencies also hinder stress-filled investment decision-making. Our adrenal response is hardwired and cannot be turned off. Nonetheless, in consultation with your advisor, you can take steps aimed at tempering emotions. For example, establishing asset class exposure ranges and stress-testing the impact of negative market scenarios on your financial plans can have a desensitizing effect during turbulent markets.

Recognize Your Biases and Behavioral Tendencies

Everyone's thought process is influenced by environmental distinctions and personality nuances. We can't change who we are, but we can try and recognize decision-making biases. Individuals tend to gravitate towards confirming information and under stress often solicit, internalize and act upon information clouded by these biases. For example, those who are instinctively "equity bulls" or "perma-bears" should take this into account when considering investment actions as momentum accelerates in either direction.

Effective decision-making in extreme market conditions does not necessarily mean standing pat. However, a clear assessment of personal needs and goals should drive your thought process, not emotional reactions to stress. At Appleton, we are here to help.

1. "McKinsey & Company: "Decision-Making in Uncertain Times", 3/25/20

2. Henry Thomson: "The Stress Effect: Why Smart Leaders Make Dumb Decisions and What to Do About It", 2010

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals	• 2020 began with strong demand fueled by record mutual fund inflows. Tax-exempt yields followed USTs lower with the 10Yr AAA munis falling to 0.78% on 3/9. • The onset of Coronavirus prompted a severe sell-off of perceived credit risk, including municipals. March subsequently reversed a long trend of tax-exempt fund inflows with $32B of net outflows. • Growing market dislocation led the Fed to act quickly and decisively to shore up the fixed income markets, aggressive policy action that has continued into April. • A 200+ bp move in the 10Yr AAA yield caused considerable angst, but also created relative value vs. USTs, drawing in crossover buyers, banks and insurance companies. The 10Yr AAA muni/UST ratio hit 303% on 3/20 before renewed buying strength brought muni yields down to 1.33% at quarter end (vs. a high of 2.79% on 3/20) and narrowed the 10Yr ratio to 199%. • March's yield move largely wiped out earlier Q1 price gains. The curve steepened during Q1, a trend that may continue with Fed Funds anchored at 0-25 bps. • Liquidity has been highly sought after and cash alternatives are in high demand. This coupled with an extension of most tax deadlines to July 15th has re-priced VRDNs, driving yields close to 60bps and diminishing the role these securities have been playing in our Intermediate portfolios. • Municipal issuance in January and February increased 41% vs. 2019, although this was reversed in March (-39% YoY). Issuance will need to accelerate significantly to reach early 2020 annual expectations of $430B. • Net negative issuance for the year may end up far exceeding JP Morgan's prior estimate of -$20B, a development that would help offset high levels of market outflows. • Our 10Yr UST trading range is 0.60-1.20% for the remainder of 2020. Municipals look attractive relative to USTs, and so long as ratios remain in a 150%+ range, we expect to see a strong bid. • Our Intermediate Municipal duration target remains 4.65-4.75 years. We expect the curve to maintain its relative steepness and are focused on quality with an eye on relative value opportunities in what may remain volatile markets.
Investment Grade Corporates & Treasuries	• Although massive Fed stabilization efforts have helped investor confidence begin to re-emerge, we remain vigilant and are only invested in what we feel are high quality, IG names. Our portfolios are well diversified by asset class and sector. • The Fed has already expanded its balance sheet to $5.2T, with Bloomberg expecting it to eventually reach $12T. This backstop has enhanced liquidity and prompted IG corporate OAS to fall from 373 on 3/23 to 272 to end the quarter. • The Fed's efforts have also calmed the short-term funding markets. The massive ramp up in support for the Repo, CP and short-term UST markets ($500B+ already committed and up to $5T potentially available) is a strong signal the Fed will do whatever it takes to prevent further dislocation. • IG issuance has surged as companies look to fortify balance sheets. More than $200B of IG debt came to market in March raising YTD totals to more than $500B. Although concessions are higher than average, buyers are stepping up. • USTs have been reacting to very bad economic data with the 2Yr recently falling to 0.26% and the 10Yr to 0.77%.[1] As conditions begin to normalize, we will be looking for potential yield curve steepening given the Fed's enormous balance sheet expansion.
Equities	• Q1 2020 featured two distinct halves before ending down 20%. The S&P reached an all-time high on 2/19 before the Coronavirus pandemic sparked a 35% fall from 2/19 to 3/23. • March was marked by extreme volatility, with the S&P 500's value fluctuating by a daily average of 4.9%. This historic volatility was met with unprecedented fiscal and monetary policy responses that have helped stabilize the capital markets. • We are closely watching earnings relative to expectations. Q1 and Q2 earnings growth is currently projected at -8% and -17% respectively. Consensus FY '20 estimates of -6% factor in a strong 2H. We suspect the full year figure to weaken over coming months – how much is the question. • We continue to favor large cap growth stocks and are seeking quality and balance sheet strength. Stock correlations have been dropping of late, a development we applaud as investors looking to add value from stock selection. • Of note, the S&P 500's dividend yield of 2.18% currently exceeds the 10Yr UST yield of 0.75% by a highly unusual amount.[1] • Other positive indicators include declining volatility (the VIX has fallen from a high of 83 to 43.4[1]), anticipated rebalancing into equities (JPM projects +$3.71T in net equity demand through year-end), and growing insider buying.

1. As of 4/6/20

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