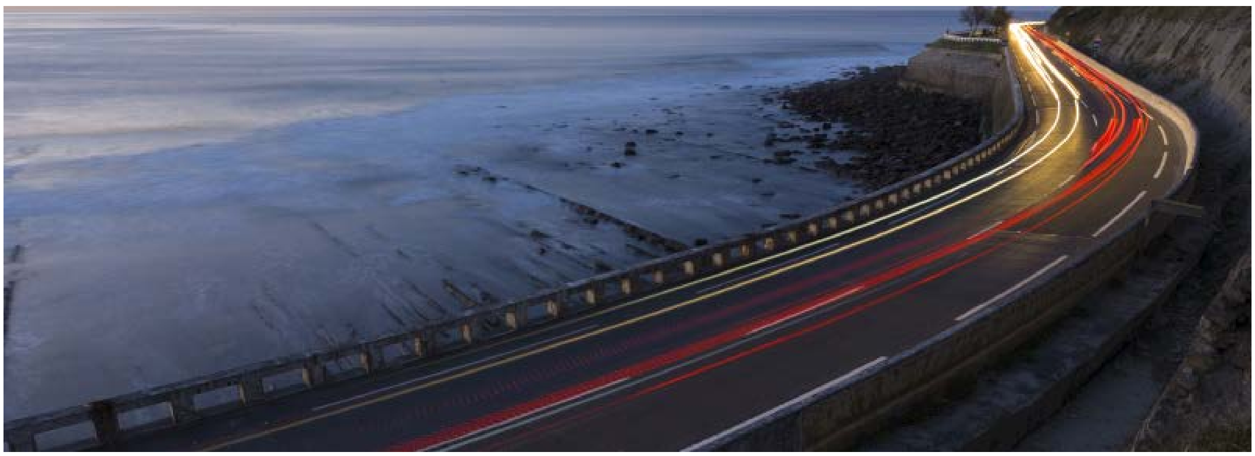
FIDELITY VIEWPOINTS®

Test drive your investment strategy

Scenario planning may help you focus on the long term through a market downturn.

by Fidelity Viewpoints – 03/11/2020



Keep perspective: Downturns are normal and typically short

- ✓ **Market volatility may make you question investment strategy, but it's important to consider the long-term implications of your strategy.**
- ✓ **Planning tools may be able to help you visualize the potential impact of different investment strategies over the long term.**

When it comes to money matters, you could say people have 2 ways of thinking—the long view and the right now. Both can work in different situations. But when it comes to investing, particularly in falling markets, short-term thinking can be dangerous to your long-term financial health.

When you see the value of your investments drop, do you want to sell? It's a normal emotional reaction to loss. But selling at market lows means locking in losses and giving up growth potential if markets rebound. Sure, it would be great if we could easily time the ups and downs of the market, but history shows that’s just not possible. On the other hand, keeping your money in cash sacrifices any potential growth that investing might achieve.

So how do you manage your emotions during market downturns? One way is to work with an investment professional who can help you test drive your investment plan by illustrating the potential trade-offs of different strategies under different market scenarios. Doing this before the market pulls back can keep you cool when it does.

What bailing out can cost

Consider Sally and Hector, ages 64 and 65, a hypothetical couple who are a few years from retirement. They have about $1.1 million, which is currently invested 35% in US stocks, 15% in international stocks, 40% in bonds, and 10% in cash, and their home has about $800,000 of equity.

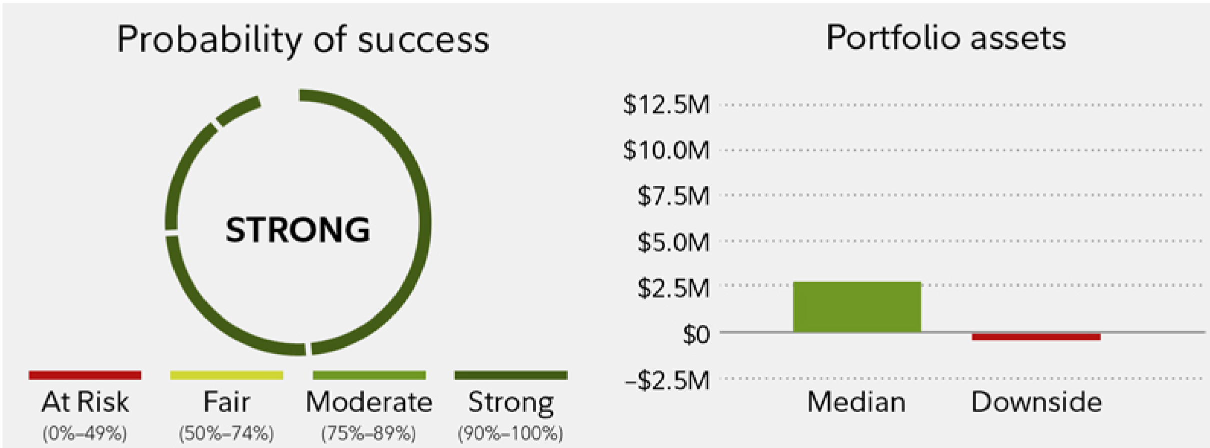
A recent sharp stock market drop rattled the couple. Hector had trouble sleeping and was checking his portfolio daily. The couple seriously considers selling most of their stocks and putting that money in a money market fund to ease their stress and try to protect what they had saved.

When they meet with their financial advisor, she helps them explore the potential impact of making a big change in their investment strategy. She uses planning software that runs hypothetical scenarios and illustrates the potential implications of the investment paths they are considering.

Scenario 1: Maintain their balanced portfolio

To help Sally and Hector consider their options, their advisor runs a series of hypothetical scenarios using an investment analysis tool. These market simulations are illustrations based on the historic performance of stocks, bonds, and other investments. They run 1,000 market simulations, and the projections show that if Sally and Hector stay invested in a balanced portfolio, their savings have a "strong" probability of lasting until the couple reaches age 96.[1] Only in the very worst market scenarios would they fall short, according to the analysis. In a more typical "median" market, the couple could potentially leave nearly $3 million as a legacy for their family.

Sally and Hector can potentially leave a legacy if they stick with their balanced portfolio



	Percentile	Portfolio assets
Median	50.0%	$2,804,804
Downside	2.5%	($345,762)

This Monte Carlo analysis illustrates the potential results of a financial plan using 1,000 trial runs.
"Percentile" indicates the percentage of potential results that fall below the value shown.

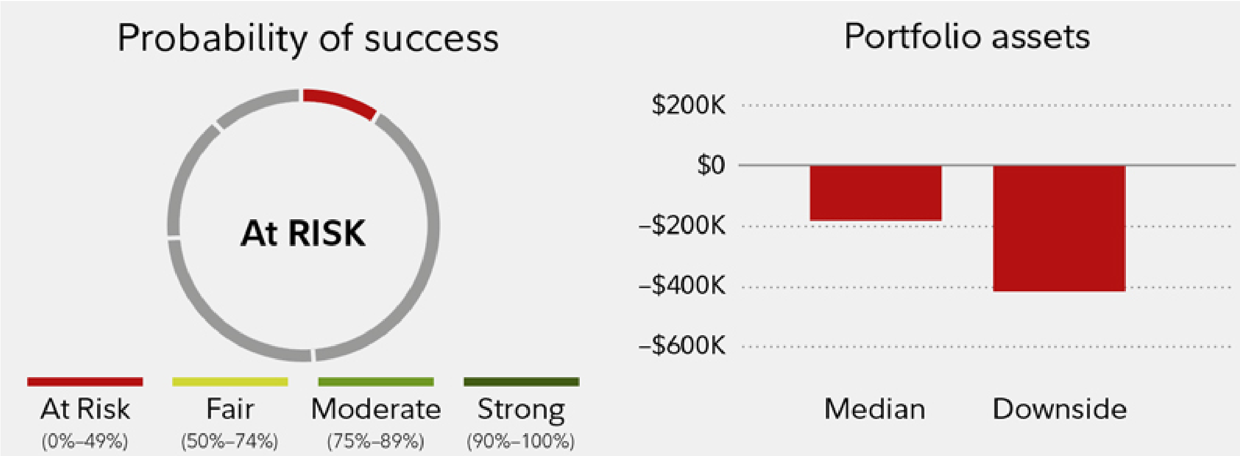
IMPORTANT: The projections and other information generated by eMoney Advisor regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Results may vary with each use and over time. The percentile indicates the rank of the scenarios among the 1,000 simulations. So, 50% of scenarios outperformed the median and 50% underperformed. The downside shows the scenario in the worst 2.5% of scenarios, 97.5% performed better. The probability of success is based on the percentage of market scenarios in which the plan funded the income needs to the planning age. These scenarios assume Hector claims $32,000 of Social Security annually, indexed for inflation, starting at age 66 and Sally claims $24,000 annually, indexed to inflation, starting at age 65 and that the couple will have $90,600 in annual expenses, adjusted for inflation, from retirement at age 66 to age 96. The starting balance is $1.1 million.

Scenario 2: Adopt a conservative investment strategy

If the couple were to adjust their investment strategy in the hopes of minimizing losses, the picture changes. Using the same investment analysis tool, the advisor tested what it might mean if the couple were to adjust their investments from a balanced portfolio to a more conservative portfolio, with only 20% of their investments in stocks and 80% in bonds and short-term investments, like money market funds. After running 1,000 hypothetical market scenarios, the illustration suggests that instead of a legacy, the couple's retirement plans could be at risk, and they could face a shortfall of about $185,000. That's assuming a median market scenario.

In a very difficult market, defined in this case as the worst 2.5% of hypothetical market scenarios, the illustration suggests the couple might have faced a shortfall of more than $400,000. A savings shortfall might mean some difficult lifestyle choices.

Sally and Hector may run out of money if they try a more conservative investment strategy



	Percentile	Portfolio assets
Median	50.0%	($184,340)
Downside	2.5%	($413,445)

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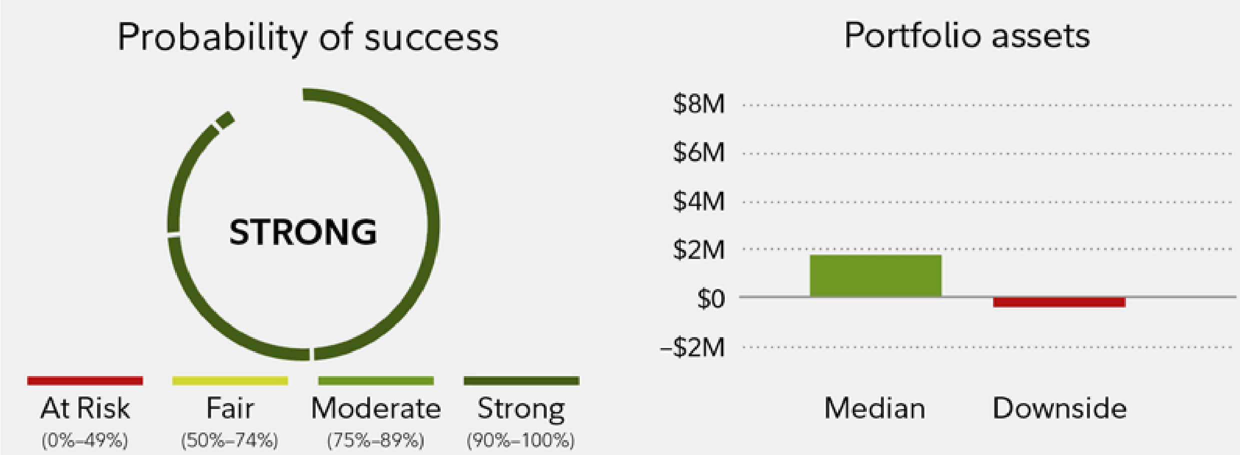
Scenario 3: Adopt a moderately more conservative investment strategy

Instead of reacting emotionally, Sally and Hector revisit their long-term goals and their financial situation. They certainly don’t want to run out of money in retirement, but they are still uneasy about the markets. They want to consider a more conservative investment option. So their advisor shows them the range of potential outcomes with a slightly more conservative portfolio of 40% stocks and 60% bonds.[2]

With this approach, the illustration indicates their plan is still strong. In the worst 2.5% of 1,000 market simulations, the more conservative investment portfolio might reduce their savings shortfall slightly, compared to a balanced portfolio of 50% stocks and 50% bonds. But in the median market scenario, the conservative option might significantly reduce their wealth and legacy versus the balanced investment strategy.

Scenario 3



	Percentile	Portfolio assets
Median	50.0%	$1,772,826
Downside	2.5%	($337,157)

This Monte Carlo analysis illustrates the potential results of a financial plan using 1,000 trial runs.
"Percentile" indicates the percentage of potential results that fall below the value shown.

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Hector and Sally talked with their advisor. They had begun the planning process concerned about the short-term loss in the value of their portfolio. But taking a look at the long-term implications of making changes, and running 1,000 hypothetical market scenarios helped them focus on their long-term strategy. They decided to maintain a balanced portfolio, more comfortable now that they understood the balance between market risk and potential long-term growth.

Think long term

One of the challenges in investing is that downturns happen fairly regularly. When they do, it's natural to feel anxiety or even remorse about the losses. That's particularly true if you are living on your savings, or about to enter retirement. An investment plan can be designed for all kinds of markets, good and bad. But you need to be willing and able to stick with it over the long term. That's where the coaching and scenario planning that an investment professional can provide can help.

The next time you feel worried, it may make sense to take the time to evaluate your choices. Try to get out of the moment by thinking about your goals and your long-term plan. If you need to talk to a professional, we can help.

1. The scenario analysis depicted in this story uses Monte Carlo analysis, which is based on a mathematical modeling process that attempts to take into account the changing and uncertain nature of the markets to evaluate the likelihood of certain outcomes under various market conditions and presents a probability of success, i.e., an estimate of the probability that a minimum amount of assets is achieved at the end of the simulated period (investment horizon). Monte Carlo analysis use estimates of asset class expected rates of return, and expected volatility and correlation, to model an asset allocation (each a simulation). In each simulation, a rate of return is generated for each asset class using the mean and standard deviation of the market index in the randomly chosen year. Up to 1000 trial runs are calculated resulting in a range of values that is further analyzed to produce a statistical probability (i.e., the probability of success) of an investment strategy.

2. In the hypothetical illustration shown, the moderately conservative 40% stock and 60% bond portfolio is defined as 28% domestic stock, 12% international stock, 45% bonds, and 15% short-term investments.

Monte Carlo analysis does not predict or project the future value of actual investments or holdings in an investor's portfolio or the present or future value of actual lifetime income. All illustrations and simulations are based on assumptions which may be inconsistent with an investor's personal situation. Actual results may vary, perhaps significantly. In addition, the analysis will be further impacted to the extent that: (i) the characteristics of an investor's investments materially deviate from those of the broadly diversified asset class used in the analysis, and (ii) there are significant weightings in a portfolio that cannot be allocated to a primary asset class. Other investments not considered might have characteristics similar or superior to those analyzed. Performance returns for actual investments will vary and will generally be reduced by fees or other expenses not reflected in the hypothetical illustrations.

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Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

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