Mitchell's Musings 8-31-15: Stock Market Gyrations: What's the Right Lesson?

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Last week's "volatility" in the stock market produced predictable results. There was an attempt in the news media to find the "cause." The cause *de jour* was said to be investors' concern over the economic slowdown in China and the devaluation of the Chinese currency. But wait! As we have noted in prior musings, the devaluation was intended to stimulate Chinese net exports and thus stimulate the Chinese economy. So shouldn't investors have taken the devaluation to be a Good Thing, *if* they were worried about the growth rate of the Chinese economy? More importantly, if the stock market had gone up rather than down, wouldn't the news reports have attributed the rise in the market to the devaluation's effect on improving the Chinese economy? We could go on with this theme. To this author, these stories are what might be called elevator tales.

What's an elevator tale? In the building on the UCLA campus in which I have my office, the elevators have never worked well. One of the four elevators in the building is often out of service, although which one it is varies. And when the elevators are working, they do mysterious things such as reverse direction before getting to your desired floor or arriving at a floor without opening the door. Faced with the inexplicable over the years, I have heard fellow passengers express theories about elevator behavior. Examples: You have to press twice or more to ensure getting to your floor. Jumping up and down in the car will ensure that the door will open. (I always offer the explanation, if asked, that the underlying problem is that the donkey in the basement who pulls the rope didn't get enough carrots.) In short, whether it's elevators or financial markets, having stories to explain the inexplicable gives folks a sense of security and control.

There is a chronic description problem when the stock market's gyrations are discussed. The market went down because everyone was selling. If that were the case, one might ask who they were selling to. Isn't every stock sold also a stock bought? So couldn't we just as well say that everyone was buying? In the end, this type of analysis is saying nothing more than that the market went down today because the net consensus among traders was that the price should be lower today than it was yesterday. Some traders thought the new price was a good deal and bought at the new, lower level. Some thought it was a bad deal and sold. Everyone didn't do anything. Some folks bought; others sold. (And some of these "folks" were programmed computers.)

Despite the fact that stock markets are an amalgam of many traders (and trading computers), the ups and downs are routinely interpreted as if the market was a single struggling individual with bouts of optimism and pessimism. After stumbling, the market was trying to recover. The market was taking a corrective action. Such modern anthropomorphism is no more helpful to understanding gyrations in the market than were old explanations of natural phenomena as the whims of human-like rain gods and the like.[1]

Finally, there was advice in the news media from "experts" to actual ordinary folks (not computers) with their life savings in 401k and similar plans and in defined-contribution pensions. Typical advice was not to sell because the market goes down since a saver's horizon – retirement – is off in the future. But wait! Telling folks not to sell in a market downturn because the downs will be followed by ups is inconsistent advice. If you as an expert financial advisor know for sure that the down will be followed by an up, shouldn't you be advising folks to *buy*, not just hold? If there is certain to be an up, you will surely gain by buying, no? And, by the way, if the down is sure to be followed by an up, why was there a down in the first place? Was the market god angry?

When there is "volatility" in the stock market, the issue of pensions and pension finance inevitably comes up. Even apart from last week's turmoil, over the past year, broad stock market indexes such as the S&P 500 have essentially gone nowhere. So defined-benefit pension funds – which generally are built upon assumptions of long-run annual earnings of ±7.5% - have been reporting returns over their past fiscal year of much less than that. In some cases, such plans have cut their assumed future long-term rates of return to 7.25% or less.

Which brings me to what should have been learned about pensions from last week's stock market events, but wasn't. Yes, defined-benefit pensions have to deal with volatility, changes in the long-term outlook for likely returns, uncertain projections about life expectancy and inflation, etc. They can

[1] Los Angeles Times columnist Michael Hiltzik put it nicely: *"Stocks staging a stunning comeback," declared anchor (CNBC) Amanda Drury around 1:45 p.m. Eastern. A few hours later, one of her colleagues, sounding like a play-by-play announcer at the World Cup, announced that the Dow Jones industrial average were "trying to recover from an early 1,000-point plunge." The truth, obviously, is that as the reflection of millions of individual investment decisions along with algorithm-based trading, the markets don't "stage" anything.* See http://www.latimes.com/business/hiltzik/la-fi-mh-market-turmoil-and-the-problem-of-cnbc-20150824-column.html.

become underfunded if errors in such forecasts are made. But they have one attribute that defined-contribution plans, 401ks, etc., don't have; they are collective. They pool risks because many people are covered. The many people are not only those enrolled at a point in time but also over time. Old folks retire; new folks come into the plan.

The fact is that all of the factors that affect defined-benefit plan funding are also present in defined-contribution plans. If your individual rate of return turns out to be less than you assumed, you won't have enough money for retirement. If you live longer than you expected, you may run out of funds. The difference is that without risk pooling, the problems caused by incorrect assumptions are more severe to the individual than when there is risk pooling. If you run out of funds, you can't go back in time and redo your behavior. In contrast, a large plan with many individuals can make adjustments and corrections iteratively over a long period.

There is much research indicating that people are not very good at long-term planning and investment strategies. There are ways to mitigate some of these issues such as default opting into job-based saving plans and the offering of "life-cycle" investment options in such plans. And there are problems with having defined-benefit pension funding depend on the long-term good economic health of a particular employer. But the loss of risk pooling as the private sector has moved away from defined benefit and towards defined contribution pensions is a problem. The push to have the same thing happen in the public sector is intensifying the problem. And moves to privatize Social Security – individual accounts that move away from risk pooling – would be a disaster. In the end, Social Security is the ultimate collective, risk-pooling pension plan.

Too bad that when "everyone" was selling last week, they didn't have time to consider the virtues of risk-pooling. Too bad that when the market was "trying" to recover, it didn't think about the lessons for collective vs. individual pension systems. Maybe next week, the market god will be in a more contemplative mood.