Preparing For The Next Recession

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History Of Recessions

In the United States, recessions have been a normal part of our economic cycle, dating all the way back to the late 18th century. Although painful at times, recessions are a natural part of the economic cycle. The length and severity of a recession is not predictable nor known, however, what is known, is looking back through history and studying the data and trends that have emerged over those past recessions. With the "Great Recession" only 10 years in the rear-view mirror, talking about another upcoming recession may evoke all kinds of emotions. So, let's take a brief look at what history has taught us to help better prepare us in the future.

Recessions have been around all the way back to 1785! Since then, there have been 47 recessions in the United States, dating back to the Articles of Confederation. Throughout the years, there have been different events that triggered them, but the data shows certain patterns emerge from inflated bubbles and over speculation to "supply and demand" and consumer confidence issues.

What is a recession? Recessions are characterized as significant economic declines for at least **six consecutive months** and generally coincide with a drop in five key economic indicators (with trade, manufacturing, and industrial activities reduced).

The five key economic indicators are:

- Real GDP
- Income
- Employment
- Manufacturing
- Retail Sales

Why do recessions happen? Generally speaking, recessions occur when there is a widespread drop in spending (e.g., consumer, manufacturing, corporate) and an adverse "supply and demand" shock to the economic system. This economic draw back causes a reduction in spending. Inflation rears its head and business miscalculations and errors occur, ultimately leading to business failures and job layoffs. Since what specifically triggers a recession is not predictable, let's take a look at three past recessions and try to learn through history.

The Gulf War Recssion

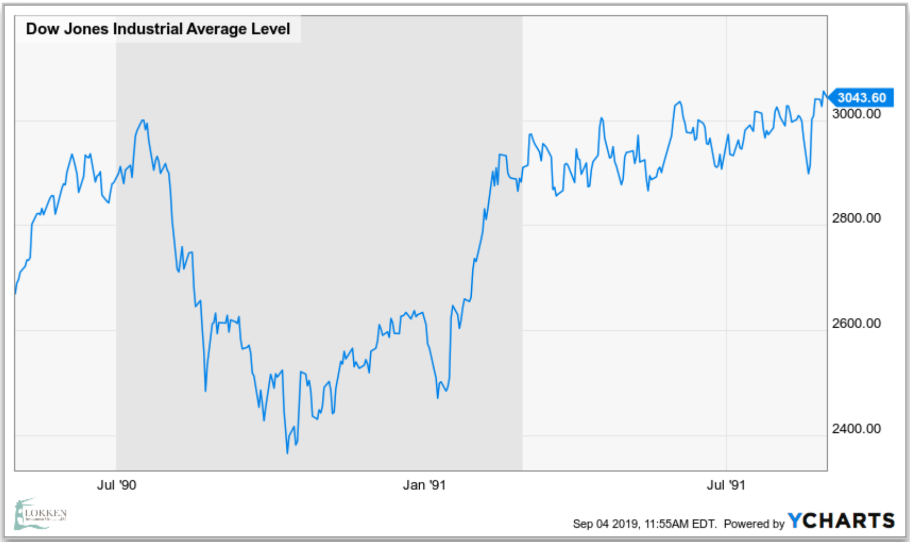
In the early 1990's, the United States experienced an eight-month recession from July 1990 to March 1991, known as "The Gulf War Recession." The stock market dropped 21%, the GDP contracted by 1.5% and unemployment rose to 6.8%.

While this was a relatively fast recession, taking less than a year to recover, it still caused upheaval in the economic cycle. It was in part due to restrictive monetary policy, as well as global tensions with Iraq invading Kuwait.

Due to tensions in these regions, oil prices rose, and supply and demand became an issue with resulting spikes in the price of oil. This in turn caused manufacturing trade sales to decline and had a negative effect on consumer confidence and household spending overall.

As we have seen repeatedly throughout history, most bear markets coincide with recessions. This was the case in The "Gulf War Recession." The grey area below shows the economic period of recession and the blue line represents the drop in the Dow Jones Industrial Average.

What did we learn from this recession? Consumers matter and consumer consumption (whether be it oil or other commodities) is important for sustained economic growth.



"The Gulf War Recession"

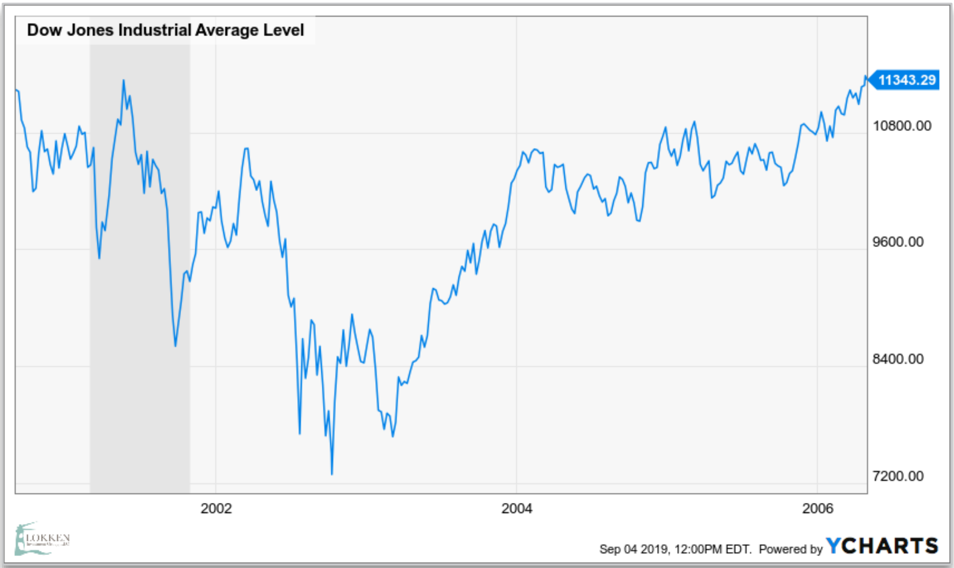
- Stocks Dropped 21%
- Took less than 1 Year to Recover

The 9/11 Recession

In 2001, there was another eight-month economic downturn, “The 9/11 Recession.” This started in March of 2001 and lasted through November of 2001.
The stock market lost 38%, the GDP contracted by 0.3%, and unemployment rose to 5.7%. This recession took a little over three years to recover.

Economists attribute this recession to several factors from the Y2K scare, the collapse of the dot-com bubble and the 9/11 attacks to a series of accounting scandals in the major U.S. corporations. This period of time was unique in that people’s fears were heightened for an extended period, given the magnitude of the attacks on the United States on September 11th.

What did we learn from this recession? That again, consumer sentiment is a very large factor during a period of recession and that consumers are a very large driving force for economic stability. In some ways, we are still feeling the painful effects from this particular recession and still pushing forward to recover as a nation.



“The 9/11 Recession”

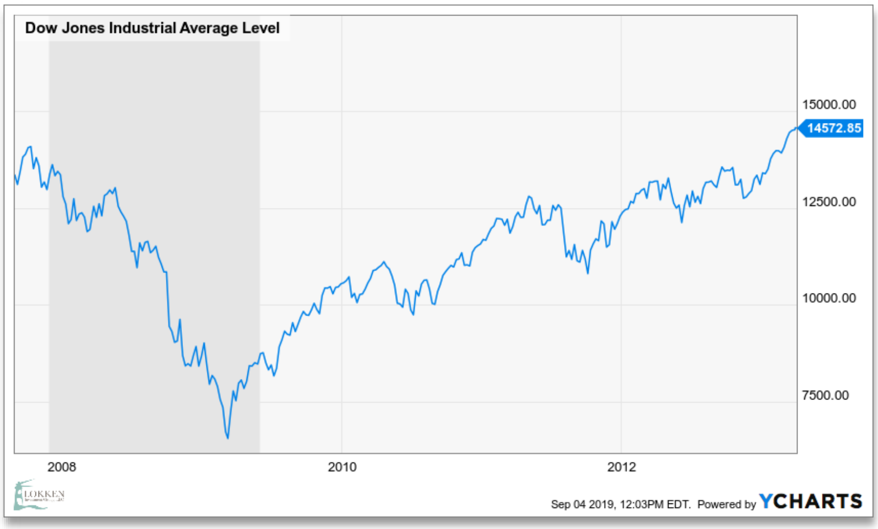
- Stocks Lost 38%
- Took over 3 years to recover

The Great Recssion

Our third example, “The Great Recession,” was the worst recession the United States experienced since the “Great Depression” and was the longest economic downturn since World War II. It lasted from December 2007 to June 2009. The stock market plummeted by -54% and took over five years to fully recover. The GDP fell 4.3% and unemployment reached 9.9%. It is estimated that almost $8 trillion in household stock market wealth was lost and $6 trillion in home value wiped out. It is also estimated that as many as 10 million Americans lost their homes. *(Source: St. Louis Federal Reserve)*

This recession was in part due to the subprime mortgage loan crisis, along with rising household debt, real-estate bubbles, rising unemployment, and a drop in overall consumer confidence and spending. In addition, Congress initially rejected the bank bailout bill which sent the stock market into a further downward spiral.

What did we learn from this recession? That again, the consumer is a very significant part of the economic cycle. "The Great Recession” had a dramatic impact on consumer spending and consumer confidence. It also had a profound impact on the labor market, as it took time for people to find jobs again. With thousands of people losing their homes to foreclosures and short sales – consumer sentiment was very low. People stopped spending and the economy stalled.



“The Great Recession”

- Stocks Dropped 54%
- Took over 5 years to recover

Sequence of Return Risk

As we look at these past examples, being retired during a recession and withdrawing from your investments becomes a very significant discussion. This is called the "Sequence of Return Risk" and happens to be **one of the biggest investment risks during retirement**.

If you were withdrawing from your investments during "The Great Recession" when the market was way down, there were major implications on the probability and fear of running out of money during retirement. Likewise, you may have also lost a considerable amount of your wealth in the stock market. On the flip side, if you have been fortunate to be withdrawing from investments during periods of economic expansion or "Bull" markets, then you may have a higher probability of success and subsequently, less anxiety and fear about running out of money.

Let's look at what the "sequence of return" looks like from a case study perspective. Take three individual investors who are all in retirement and withdrawing from their investments at a 6% withdrawal rate. Each has a portfolio worth $1 million and is taking $60,000 a year out of their portfolios. All three investors will hypothetically receive an average investment gain of 7% year-over-year from age 66 to age 90. But as the example will illustrate – **timing is everything!**

Case Study

$1,000,000 in investments

$60,000 withdrawals (6%) *

7% average annual gain

* Includes an annual 2.5% "Cost of Living" increase.

Hypothetical Example

Mrs. Doe had the good fortune of having positive stock market years early on in her portfolio when she was withdrawing money. At age 90, Mrs. Doe still had over $1 million in her account.

Mr. White was not as lucky. Early on in his retirement, he had to withdrawal money during an economic downturn. Consequently, at age 90, Mr. White depleted his assets and ran out of money.

Mr. Rush maintained an average rate of return of 7% throughout all the years of his withdrawals. This resulted in a positive outcome for him but maintaining the same rate of return for over 20+ years, we know is not a reasonable scenario to hope for and used for comparison purposes.

This example illustrates how important the “Sequence of Return” is during retirement years and withdrawing from retirement assets. It also shows the necessity of a liquidity bucket, diversification, and asset allocation as investment strategies in preparation for a recession and “Bear market.”

Three Unique Return Scenarios
All 7% Average Return

AGE	Mrs. Doe	Mr. White	Mr. Rush
66	22%	-7%	7%
67	15	-4	7
68	12	12	7
69	-4	15	7
70	-7	22	7
71	22	-7	7
72	15	-4	7
73	12	12	7
74	-4	15	7
75	-7	22	7
76	22	-4	7
77	15	-7	7
78	12	12	7
79	-4	15	7
80	-7	22	7
81	22	-7	7
82	15	-4	7
83	12	12	7
84	-4	15	7
85	-7	22	7
86	22	-7	7
87	15	-4	7
88	12	12	7
89	-4	-	7
90	-7	-	7
Ending Value	$1,099,831	$0	$430,323

How Much Liquidity Do I Need?

During a recession ("Bear" market) it is beneficial to have a liquid bucket of cash to avoid the repercussions of a negative "Sequence of Return" scenario. As a rule of thumb, we recommend having **two to three years** of anticipated portfolio income in a liquid bucket.

If you look back at four prior "Bear" markets [1973 to 1974], [1987], [2000 to 2002], and [2007 to 2009], the average loss of a balanced portfolio* was -18.45% and the average time a portfolio took to recover was **30 months**.

Here is an example of a three-year liquid bucket:

- Mrs. Doe was living comfortably on $50,000 a year; she was receiving $25,000 a year from Social Security, Pensions and Guaranteed Income plus $25,000 from her portfolio withdrawals - totaling $50,000 in annual income.

- Mrs. Doe put $75,000 (3 x's her annual withdrawals) of cash in her liquid bucket. When the recession hit, she used her cash in her liquid bucket, rather than withdrawing from her portfolio. This allowed her portfolio time to "weather the storm" and recover in a healthy manner.

How Much Liquid??

Bear Market	Balanced Portfolio *	Time to Recover
1973-73	-26.4%	38 months
1987 "Crash"	-13.9%	15 months
2000-02	-10.7%	39 months
2007-09	-22.8%	30 months
Averages	***-18.45%***	***30 months***

*Note: Balanced Portfolio = 50% S&P 500 and 50% US Treasuries

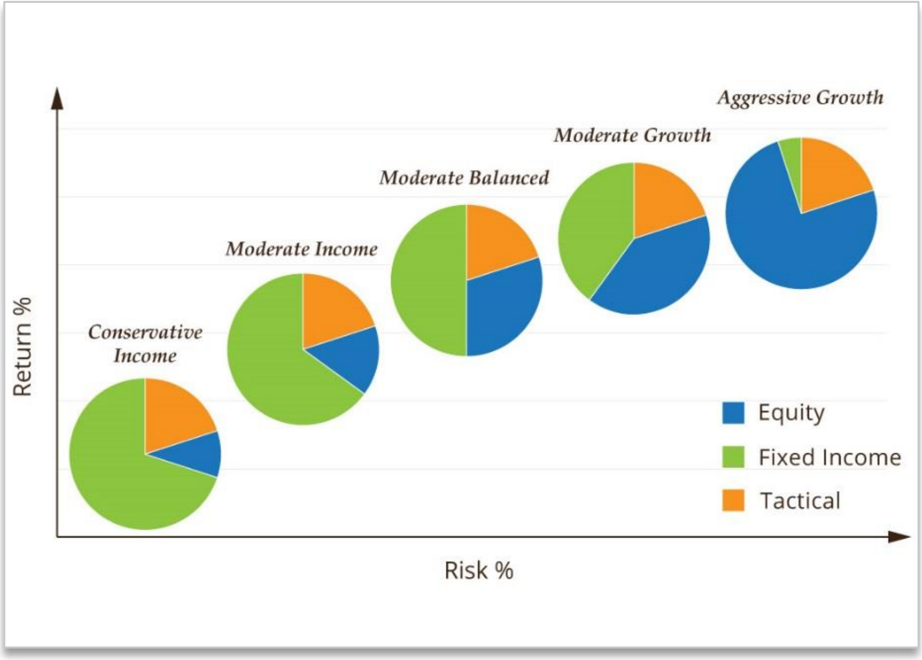
Asset Allocation

Asset allocation is the implementation of an investment strategy that attempts to balance risk versus reward. Adjusting the percentage of each asset class in an investment portfolio is how asset allocation works. Asset allocation needs to also match an investor's risk tolerance, goals, and timeframe. However, when preparing for a recession, a more tactical approach may be implemented to help "weather the storm."

There are several types of asset classes you could use, for example, US Stocks, Developed International Stocks, Emerging Market Stocks, High Quality US Bonds, Foreign Bonds, High Yield Bonds, Real Estate (REITs) and Commodities to name a few.

Research has shown that approximately 94% of a portfolio's potential future return is determined by asset allocation. Less than 6% is determined by the actual investment selection. Yet, most investors tend to spend the majority of their energy on investment selection versus asset allocation.

Below, is an example of how asset allocation works. The circle towards the bottom left represents a portfolio with mostly fixed income (low risk) investments or a more conservative strategy and the circle to the top right shows a portfolio that is mostly invested in equity (stocks) or a more aggressive growth portfolio. In preparing for a recession, you may find yourself drawing back on risk and moving towards the left on this axis.



Diversification

Similar, yet distinct from asset allocation is the concept of diversification. Diversification can be loosely translated into **"don't have all your eggs in one basket."**

For example, you may have decided that to reach your goals your asset allocation suggests a 40% exposure to stocks. To accomplish this goal many investors might buy one or several mutual funds that cumulatively hold several hundred individual stocks. Investors naturally assume that by having exposure to several hundred stocks they would automatically be "diversified," but careful examination of the types of stocks held is necessary to determine the diversification.

Many mutual fund managers are free to pursue stocks in any sector without much thought to diversification. If your mutual fund(s) are all concentrated in a few sectors, you may be creating a "non-diversified" portfolio. Such a portfolio would likely have more imbedded risk than a properly diversified portfolio. Here's an example showing the approximate weighting of the S&P 500 and a "non-diversified" portfolio:

Sector	S&P 500 Weighting	"Non-diversified Portfolio"	Difference
Communication Services	10%	23%	**+13%**
Consumer Discretionary	10%	2%	**-8%**
Consumer Staples	7%	18%	**+6%**
Energy	6%	0%	**-6%**
Financials	14%	5%	**-9%**
Healthcare	15%	12%	**-3%**
Industrials	10%	3%	**-7%**
Materials	2%	0%	**-2%**
Real Estate	3%	5%	**+2%**
Technology	21%	32%	**+11%**
Utilities	3%	0%	**-2%**

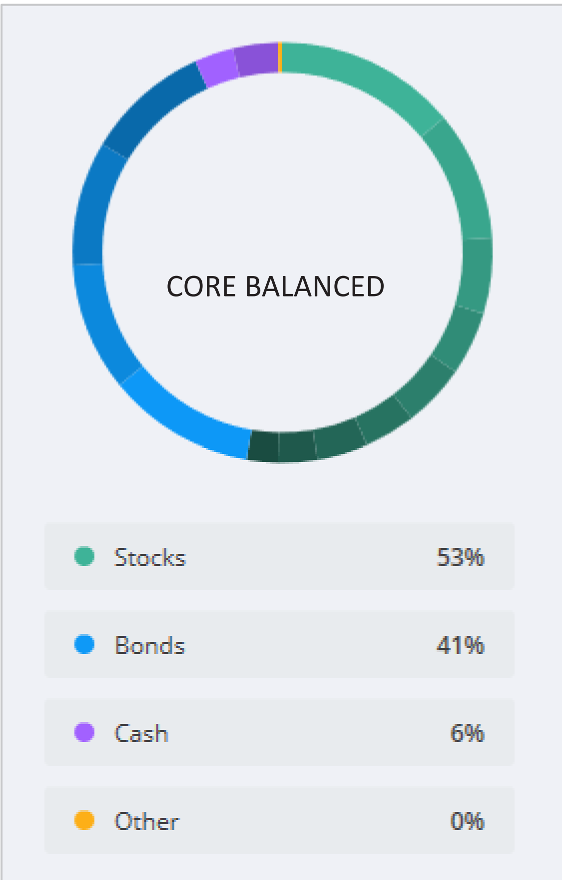
There may be a valid reason to construct a non-diversified portfolio. For example, if you are trying to "beat the market," it is often necessary to be non-diversified in your stock selection. However, for most investors "beating the market" is not their primary goal. Remaining solvent during a recession often takes priority. Diversification is a key risk management concept that is often forgotten.

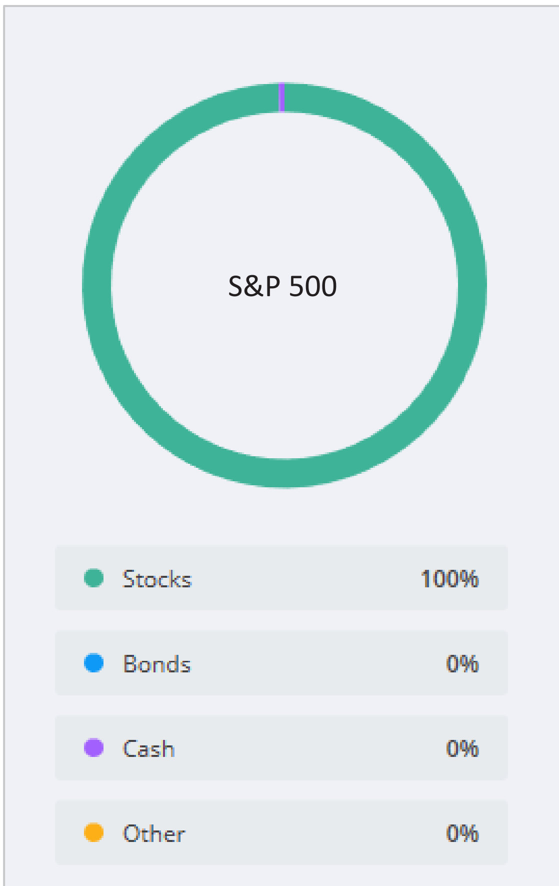
Risk Tolerance

Putting it all together… Lokken Investment Group has the tools and knowledge to help guide you in preparing for a recession. While we cannot know exactly when the next recession might hit, we use a data-based approach and research-driven investment philosophy that allows us to continually study key economic indicators in preparation. In addition, we use a risk assessment tool that identifies how much risk is in a portfolio.

After taking a short assessment, our tool will produce a risk tolerance number. You may then compare that number to the actual amount of risk in your portfolio and see if these two numbers are aligned. Our tool will help you answer these questions: 1) "Does the amount of risk in my portfolio align with my risk comfort level?" and 2) "Is my portfolio prepared for a recession?"

Below is an example of two types of portfolios, on the left a more conservative approach called the "Core Balanced" model with 53% invested in stocks and on the right a more aggressive, higher-risk, portfolio with 100% invested in the S&P 500.





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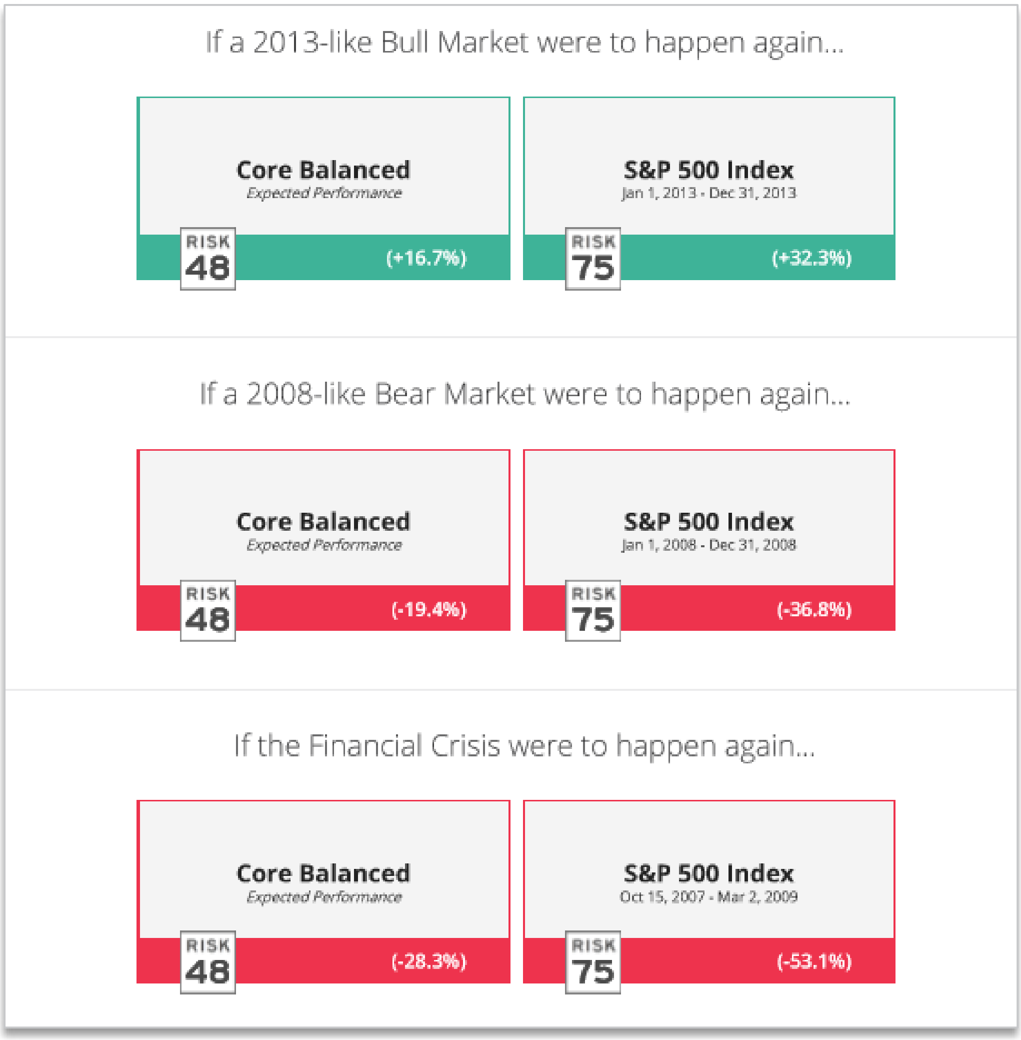
Risk Tolerance

Why is understanding risk important? Let's take a brief look at how these two portfolios (Core Balanced and S&P 500 Index) have responded to a "Bull market" versus a "Bear Market." As you can see in the chart below, a portfolio more aggressively invested in the S&P 500 Index in the "2013 Bull market," while carrying much greater risk – also returned greater gains. However, that same portfolio in the "2008 Bear Market," experienced greater losses!



Do You Get Seasick? The examples above show us that with more risk in your portfolio, you can achieve greater gains, but during a storm, if you get motion sickness... you may not want to get in the boat! Not everyone can stomach that type of market volatility nor should they! Each person's financial situation and retirement goals are different. We encourage you to take step towards identifying your risk tolerance number, looking at your portfolio and seeing if it is aligned with your comfort level and most importantly, letting us help you prepare for the next recession.

Bottom Line

Recessions are scary events and are potentially destructive to investment portfolios. Those in retirement and dependent upon their investments to sustain their retirement lifestyle are particularly vulnerable to the "sequence of return risk."

Adding to our recession anxiety are the still healing emotional and financial scars inflicted by the Great Recession of 2007-09. Virtually everyone in America was impacted to some degree by the worst economic disruption in a generation. These lasting memories continue to influence investor behavior.

The next recession we experience will not necessarily be as destructive as the Great Recession, but the severity of the next recession is unknowable. All we know is that another economic recession is essentially inevitable. **Now is the time to prepare!**

Although there are certain signs of economic weakness, most economic data points lead to continued growth, not a recession. The primary data we refer to is shown in the table below *(As of September 10, 2019)*:

Economic Data	Trend	Source
Leading Economic Indicators (LEI)	Positive	www.conference-board.org
US Retail Sales	Positive (All-time high)	www.census.gov
Employment	Positive (3.7% Unemployed)	www.bls.gov
Yield Curve (10-2 yr Treasuries)	Neutral (0.05%, close to inverted)	www.treasury.gov
Manufacturing	Negative ("Trade Wars" induced slowdown)	www.instituteforsupplymanagement.org
New Construction	Positive	www.census.gov
US Inflation Rate	Positive (1.81% inflation)	www.bls.gov

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Bottom Line

Despite much of the data pointing to continued economic growth for the next 6-9 months, it is nonetheless imperative to understand the risk inherent in your current mix of investments. If your current risk profile is comfortable for your situation, then perhaps no action is needed at this time. However, if your risk profile is not aligned with your current investments, then now would be an opportune time to change your investment mix to more clearly match your risk profile.

Are You Ready?

The economic data will likely begin to deteriorate in the months prior to an official recession. It may be prudent to further de-risk your investment portfolio at that time. Know how you plan to de-risk prior to the recession's arrival so that you are less likely to make emotional knee-jerk decisions which you may later come to regret.

How can we help?

If you need help, please feel free to reach out to us. Our team is experienced and ready to help. If you are not already a client, we invite you in for a complimentary risk-analysis and no-obligation consultation. We'll review your financial situation, goals, and needs. We'll put together observations and recommendations and give you plenty of time to ask questions along the way. If it is a "good fit" we will walk you through the transition process of becoming a client.

A little bit more about us…

- We are a Registered Investment Advisor (RIA), with the SEC, founded in 2008, offering fee-only investment planning and management services.
- We are a Fiduciary, working with over 200 clients and managing over $130 million in assets.
- Many of our clients have relocated to the beach to enjoy their retirement years.
- We work with clients to help them achieve their investment and retirement goals, creating customized investment and financial plans.
- Each client's goals are different – we listen carefully and set-up strategies accordingly.
- We monitor client's investments continually and make necessary changes along the way and ultimately, strive to give our client's peace of mind by being actively engage in protecting their hard-earned assets!
- We are transparent in our fee structure and do not work on commission nor sell specific products. Our fees range between 1-2% of assets we manage.

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This document is educational in nature. No specific products nor recommendations are discussed. No one investment program is suitable for all types of investors. This document is for educational and informational purposes only. We need to review your investment objectives, risk tolerance, and liquidity needs before we introduce suitable investment programs for you.

Asset allocation and diversification are investment methods used to help manage risk. They do not ensure a profit or protect against a loss. All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors some of which may be unpredictable. Each asset class has its own risk and return characteristics. The risks associated with the representative index asset classes discussed in this report include: **Alternative investments,** such as hedge funds and private capital funds, include the risk of investment loss, including the loss of the entire amount invested.

While investors may potentially benefit from the ability of alternative investments to potentially improve the risk-reward profiles of their portfolios, the investments themselves can carry significant risks. Government regulation and monitoring of these types of investments may be minimal or nonexistent. There may be no secondary market for alternative investment interests and transferability may be limited or even prohibited. **Hedge fund** str**ategies,** such as **Equity Hedge, Event Driven, Macro and Relative Value,** are speculative and involve a high degree of risk.

These strategies may expose investors to risks such as short selling, leverage risk, counterparty risk, liquidity risk, volatility risk, and other significant risks. In addition, they engage in derivative transactions. Short selling involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss to a portfolio. In addition, taking short positions in securities is a form of leverage which may cause a portfolio to be more volatile.

Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks which may also hurt a portfolio's performance. The use of derivatives for other than hedging purposes is considered speculative and involves greater risks than those associated with hedging. Equity Hedge strategies maintain positions both long and short in primarily equity and equity derivative securities.

Event Driven strategies involve investing in opportunities created by significant transactional events, such as spinoffs, mergers and acquisitions, bankruptcy reorganization, recapitalization and share buybacks. Managers who use such strategies may invest in, and might sell short, the securities of companies where the security's price has been, or is expected to be, affected by a distressed situation. Also, these securities may be illiquid and have low trading volumes. Macro managers trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Relative value strategies focus on exploiting perceived imbalances or valuation discrepancies between related markets or instruments. They involve the use of such instruments as convertible bonds, preferred securities, options, warrants and option-linked securities, sovereign bonds, swaps, swaptions (options on swaps) and other derivatives.

Commodities: The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or other factors affecting a particular industry or commodity.

Equity Securities: Stocks are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. The prices of **small/mid-company stocks** are generally more volatile than large company stocks. They often involve higher risks because of smaller and mid-sized companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Fixed Income: Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity. High yield fixed income securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities.

Municipal Bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer.

U.S. Government Securities are backed by the full faith and credit of the federal government as to payment of principal and interest if held to maturity. Although free from credit risk, they are subject to interest rate risk.

Foreign/Emerging Markets: Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Real Estate: Investing in real estate investment trusts (REITs) have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.