BUSINESS

Road to Retirement: How politics will impact your nest egg

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With the election looming just a few days away, many investors are wondering if the outcome will impact their retirement portfolios. While the outcome is no doubt important in many ways, it's helpful to look at the bigger picture of the evolution of government intervention in markets. Government intervention is now so massive that failing to understand why and where our political leaders are directing money can hinder your prospects for both growing and living off your portfolio.

When it comes to the interaction between the government and markets, the overarching theme of the last 40 years has been for increasing federal intervention. It used to be that the federal government's role in markets was somewhat constrained. They could raise and lower interest rates through the Federal Reserve, and Congress could engage in some deficit spending to help the economy along. But otherwise, the financial markets were pretty much ruled by the collective judgement of millions of private investors deciding if things looked good or bad.

But today, government intervention is so large that it is overwhelming private investors and has now become the dominant force in financial markets. That means, for better or worse, the decisions made by a few people in Washington will impact our retirement portfolios. As an investor, you have to recognize the impact of the intervention and then position yourself for the outcomes that the government favors.

Photograph by Ellen Jaskol

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Let's take a look at how some of this is playing out. For many retired investors, interest rates are extremely important. When interest rates are higher, they allow you to invest in safer things like CDs, Treasury bonds, and investment grade corporate bonds and receive a nice income. But today, the Fed does not want high interest rates; in fact, it wants rates close to zero. The Fed is basically saying, "you can invest in the safer stuff like CDs, but we won't let you earn much money." If you want to earn some money, you have to adjust to the new rules of the game.

Think about government intervention in markets the same way you would think about other rules that the government implements. Let's say the government outlawed walking on the south side of any street. Now let's assume you wanted to open an ice cream shop and you had a choice of renting a storefront on either the north or south side of the street, which would you choose? Well, since the government will only allow people to walk on the north side, if you want to earn any money, you better open a shop on the north side.

Imagine the stock and bond markets are like the north and south sides of the street in the above example. The stock market is the north side, and the bond market is the south side. The federal government is telling you the south side does not offer much, and the north side is where they are going to focus their efforts.

You might be wondering whether the federal government can influence the direction of markets? Yes, if they are determined enough, and here's proof. You've probably heard the statement that the stock market is linked to the amount of profits that companies earn. If times are good and profits are up, the market goes up. If times are bad and profits are bad, the market goes down. This has roughly been true for the last 150 years, until this year.

Profits for companies that make up the S&P 500 stock index are estimated to decline about 40% this year. If earnings are down, the market should be down, but it's actually up. The difference is the massive government spending. The purpose of the intervention was to stabilize the economy, but because of how money moves through the system, the knock-on effect was to boost stock market values.

These days, it's probably more important to understand what the government is doing in markets and where they want investors to go, as opposed to how companies are doing. Now, both are important, but government support is more important right now. If it was removed, it's highly likely markets would be down significantly.

Whether the federal government should be so involved is a complicated question, and you won't find a consensus opinion out there. As an investor, while it's interesting to debate these issues, you should focus most of your effort on figuring out how you might benefit from where the government is directing its money bazookas. Basically, the somewhat unintended consequences of all this government spending is that they are reducing returns available from safer investments and enhancing returns available from riskier investments.

Now, markets will still be volatile, and investors will panic when they think something is changing in terms of government support. But you have to think longer term and try to understand the overall theme of growing government intervention. As mentioned, government officials, particularly within the Fed, want to make risk-taking less risky (aka walking on the north side) and punish prudence (aka walking on the south side).

It's likely that regardless of which political party controls Washington, the money will continue to flow. Politicians may shift around who gets how much, but having the newfound freedom to spend trillions is just too tempting to ignore. Now, because government leaders make mistakes, it's possible their approach won't work. So I wouldn't always walk on the north side, but I'd probably spend most of my time there.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.

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