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Facing the Future with Optimism and Courage
April 2018
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# Volatility Is Back

And nobody is happy. Last year, stocks marched steadily higher with only minor pullbacks. It was a year that lacked volatility and annual returns exceeded long-term averages in most domestic and international equity asset classes. The largest peak to trough decline for the S&P 500 Index was just 3% – an unusually low drawdown. As I noted in the January issue of this newsletter, last year's equity returns were – *"a rare gift from on high for which thoughtful men and women must pause and give thanks."* (There are two types of people in the world – those with too much class to say, "I told you so" and people like me.) Experienced equity investors knew that the low volatility could not last forever. Since the beginning of February, volatility has returned and investor sentiment seems to change on a daily basis in response to the headlines. Year to date, through April 13th, The S&P 500 has experienced a daily loss in excess of 1% 13 times and a gain in excess of 1% 15 times, often with wild swings from one day to the next.

Volatility creates uneasiness in many investors and catastrophic financial journalism can unsettle even the most steadfast heart. The *Wall Street Journal's* headline on March 24th - "Stocks Sink to Worst Week in Years" did its part in adding to investor angst. I'll leave it to you to figure out why the headline stated "Years" instead of the more accurate "Two Years". In the recent bout of volatility, the S&P 500 Index fell about 10% from its all-time high, set in January. The average intrayear decline (peak to trough) in the S&P 500 Index since 1980 – about the time I started investing – has been just under 14%. In 19 years since 1980, the S&P 500 experienced intrayear declines greater than 10%, yet it finished with a gain in 13 of these years. Stocks fell more than 12% in 2015 and 13% in early 2016. These declines have been all but forgotten by investors because stocks recovered relatively quickly.

Investors who know stock market history – especially the history they have lived through – shouldn't be surprised by this latest spike in volatility. Long-term investors shouldn't allow short-term losses to influence important financial decisions. The three most important attitudes to maintain during episodes of volatility are optimism, patience and discipline. This is easier said than done. Our natural inclination is to "do something". Unfortunately, that something usually involves portfolio tinkering that is likely to have a detrimental impact on your portfolio's long-term performance. The ability to maintain composure during times of market volatility is what separates successful investors from disappointed investors. Those who have managed to ignore the noise, keep a long-term focus and not react emotionally to past volatility have been richly rewarded.

A fact that is never mentioned in the financial media is that no one can make sense out of the market's day-to-day fluctuations. Not before or after the fact. This must be kept a secret because if it became known, the financial media would lose most of its audience. The financial media has its Chicken Littles on speed dial, and whenever stocks decline more than 1% in a day, they appear everywhere; giving us insightful sounding opinions that are subject to change by this time tomorrow. Truth be told, prognostication is the occupation of charlatans and most celebrity market commentators built their reputation on one or two good calls. But few, if any, have a predictive track record that outperforms coin flipping. When the market is calm, investors are content to take advice from the voice inside their head. When volatility spikes they become anxious and seek advice from forecasters. Unfortunately, the insight that forecasters offer is often just the voice inside their heads. If investors knew the long-term track records and financial incentives that motivate these forecasters, they'd pay less attention to their ongoing, ever present babble.

Investors have instant access to stock market updates that allows them to monitor their portfolio's performance on a daily basis. This seems like a reasonable, responsible thing to do but all the evidence indicates that paying too much attention to your portfolio will likely harm, not help, its long-term performance. What most investors consider to be useful data is just noise. Day traders and institutional investors obsess over minute-by-minute swings in stocks prices but long-term investors don't need a stock market app on their smart phone.

Investing in common stocks is fraught with uncertainty and comes with a substantial risk of periodic, temporary loss of principal. The finance industry employs thousands of people whose job is to worry about risks in the markets. And there is never a shortage of things to worry about — geopolitical risk, corporate earnings, valuations, interest rate changes, inflation, monetary policy, political dysfunction, etc. There's never been, nor will there ever be, a day when all these "experts" give a clear signal about whether it's time to put more money into the market or take your money out.

Don't make the mistake of assuming that volatility and risk are synonymous. Your real, long-term financial risk is arriving at the precipice of retirement without sufficient assets to finance your desired lifestyle. To be a successful long-term investor you must learn to withstand short-term losses. Unfortunately, when market volatility spikes, many investors can't stomach the losses – temporary as they might be – and head for the exits. Most will be sitting in cash until long after stocks rebound. This creates the "behavior gap" – the difference between what the stock market yields and what the average investor receives from their stock investments. One reason I have little respect for the financial media is the harm it has done to investors who've listened to the fear mongering of its pessimistic forecasters and remained on the sidelines for the past ten years.

Most people seek help from a financial advisor for advice about portfolio allocation and fund selection. But the greatest long-term benefit they will receive from good financial planning isn't something as nebulous as a rate of return. It's the achievement of their financial goals. It's the arrival of the day when they no longer worry about money and can enjoy the benefits of their prosperity. Your portfolio should be anchored by a written financial plan - one that reflects your risk tolerance, long-term goals and time horizon. Be patient and let the stock and bond markets work for you. Keep enough of your portfolio in cash, U.S. Treasury securities and short-to medium-term, high-quality bonds to dampen the inevitable outbursts of stock market volatility. Use these fixed income assets to finance portfolio withdrawals.

This latest bout of volatility was unpredictable – another example of the randomness of short-term market movements. Next week might be the best week in market history, or the worst – I have no idea. I'm going to go out on a limb and predict that it will be somewhere in between. But I take solace in knowing that no one else knows either. Current woes aside, I believe that the global economic expansion will continue. If you can stay focused on the big picture and the long-term, today's volatility will become less of a distraction. My sincerest sympathies to all those who are attempting to time this market or trade in and out of individual stocks or market sectors that they expect to outperform. Such attempts are likely to prove futile. It's much better to deal realistically with the uncertainty of the stock market and adopt strategies that offer the highest likelihood of success over the long haul. Be patient. History tells us that slow and steady wins the race. Consistent, periodic funding of your long-term investments has always been the best strategy for financial success. Create a prudently allocated globally diversified portfolio and rebalance it annually and you'll maximize the chances of obtaining your long-term financial goals. In other words – act like an adult.

## SPIVA 2017

I've often mentioned S&P's Indexes Versus Active (SPIVA) Scorecard – its semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. The Scorecard provides ongoing evidence of the inability of active fund managers to provide risk-adjusted outperformance over multi-year time horizons. The year-end 2017 SPIVA Scorecard was released last month and it covers the 15 years ending December 2017.

The Scorecard also tracks the longevity of mutual funds. There were 1,970 domestic stock funds available to investors on January 1, 2003. By January 1st of this year, only 817 (41%) were still in business. The 59% that went missing in action were poor performers that were either merged into other funds or liquidated. So, if you had ten actively managed stock funds in your portfolio 15 years ago, it's likely that 6 of them no longer exist. It's unlikely that by your own research or through the advice of your financial advisor you would have chosen only those funds that were among the 41% that survived because outperforming funds are unidentifiable in advance.

Over the past 15 years, 92% of actively managed large-cap domestic stock funds underperformed the S&P 500 Index. Each day the global financial markets process millions of trades that aggregate vast amounts of information. This hyperactive trading yields consensus pricing that is difficult to outsmart. This works to the benefit of passive, index investors who accept market pricing as the best estimate of fair value. It hinders active managers who must identify mispriced securities ahead of their competitors. Most are unable to do so consistently for the same reason that even the best major league players fail to get a hit in 70% of their at-bats – talented opposition.

Proponents of active management admit that it is difficult for large-cap fund managers to outperform the S&P 500 Index because the stock market efficiently prices large company stocks. But they assert that in less efficient markets, such as small-cap stocks and emerging market stocks, active managers have an edge. This assertion is a myth that is not supported by the evidence. The SPIVA Scorecard discloses that for the past 15 years, 95% of actively managed emerging market stock funds underperformed their benchmark index and 96% of actively managed domestic small-cap funds underperformed the S&P 600 Small Cap Index. The reason is simple - what John Bogle calls the "cost matters hypothesis". It doesn't matter whether markets are efficient or inefficient, investors in that market, as a group, must fall short of the market's return by the costs they incur. Index funds provide broad diversification and are less expensive than actively managed funds. By eliminating manager risk and keeping management fees and transaction costs as low as possible, index funds have provided investors with superior results over the long haul - even in asset classes in which markets are less efficient at setting prices.

This chart is the SPIVA report card of active managers. The far-left column lists twelve popular asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5,10 and 15 years. If the majority of actively managed funds in an asset class outperformed their benchmark S&P index, they get a passing grade of **P** for that time period. If the majority underperformed, they get a failing grade of **F**. The 15 YRS column includes the percentage of actively managed funds in the asset class that outperformed their benchmark index over the past 15 years.

| Fund Asset Class | 1 YR | 3 YRS | 5 YRS | 10 YRS | 15 YRS |
|---|---|---|---|---|---|
| Large-Cap Growth Stocks | P | F | F | F | F 7% |
| Large-Cap Value Stocks | P | F | F | F | F 14% |
| Mid-Cap Growth Stocks | P | F | F | F | F 5% |
| Mid-Cap Value Stocks | P | F | F | F | F 11% |
| Small-Cap Growth Stocks | P | F | F | F | F 1% |
| Small-Cap Value Stocks | F | F | F | F | F 11% |
| Domestic REITs | P | F | F | F | F 19% |
| Int'l Large Stocks | F | F | F | F | F 8% |
| Int'l Small Stocks | p | F | F | F | F 22% |
| Emerging Market Stocks | F | F | F | F | F 5% |
| High-Yield Bonds | F | F | F | F | F 2% |
| US Government Bonds | F | F | F | F | F 10% |

Data as of December 30 2017

Achieving your financial goals is not a one-year project. It's an activity spanning many decades. Every year there will be asset classes in which the majority of active managers outperform their benchmark index. This produces an illusion of skill that is regularly promoted by the fund industry. Data that challenges the assumption of skill threatens people's livelihoods and is ignored by the fund industry. There's no evidence for the persistence of outperformance among fund managers from one year to the next and the percentage of funds that outperform their benchmark index decreases as the timeframe increases.

The disclaimer that past performance is no guarantee of future returns applies to individual funds, not to the ability of active managers, as a group, to beat their benchmark indexes. Proponents of active management claim otherwise, but they cannot back up their arguments with data.

The SPIVA results overstate the performance of active managers because they are based on pretax returns. Most actively managed funds have high turnover, making them less tax efficient than comparable index funds.

Given the unpredictable nature of the stock market and the costs involved in trading, few funds deliver consistent outperformance. Yet, many investors still try to outsmart the market. Give it your best shot, but history indicates that the attempt will cost you in fees and taxes which will lower return. If you invest in index funds you cannot outperform the market. But if you invest in active funds, there's a high probability you will underperform index funds.

Owning a portfolio of index funds and periodically rebalancing it back to its original allocation is called passive investing. It has become the dominant trend in investing over the last two decades. Its loudest critics have been those who have the most to lose by its continued success. Despite investors' preference for simplicity, the mutual fund industry continues to offer a multitude of increasingly complex funds in an attempt to regain market share from index fund providers.

The term "passive investing" is a failure of marketing because it evokes negative emotions. Many investors equate it with a "do nothing" strategy, even though it is likely to maximize their return in the long run. Perhaps it should be called astute investing because it minimizes regrets, expenses, taxes, trading costs and the need to make ongoing investment decisions; while guaranteeing that you'll receive market returns minus the index funds' miniscule management fees.

This latest Scorecard flies in the face of everything Wall Street wants you to believe. Investors are repeatedly told that successful investing requires active trading and owning the right funds at the right time. Years ago, this bill of goods was an easy sell because the data provided by reports such as the SPIVA Scorecard didn't exist. Today, the evidence is an insurmountable hurdle for active management's propagandists to overcome; one that most choose to ignore or refute with anecdotes rather than data.