On Course Financial Planning

Facing the Future with Optimism and Courage

December 2017

Vectors

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In the News

This has been a banner year for domestic and international stocks. Year to date through November, the S&P 500 Index is up 18% – well above its long-term average annualized return of 10%. The MSCI All Country World Index tracks the performance of stock markets in 23 developed and 24 emerging market countries. The index covers approximately 85% of the global stock market. If the index has a positive return this month, 2017 will be the first year in the 30-year history of the index in which global stocks posted a gain in every month. October was the 12th consecutive month in which the index yielded a positive return – the first time that the index has risen for twelve consecutive months. Year to date, through November, the index is up 19% (in US dollars). This exceptional performance is the consequence of global economic growth – each of the world's 45 largest economies tracked by the Organization for Economic Cooperation and Development is growing this year and expected to post another year of growth in 2018.

When stocks produce the type of gains we've seen this year, some investors regret that they don't have more money invested in stocks while others wonder if it's time to move to the sidelines. But it's never a good idea to make dramatic portfolio changes in response to recent market performance. Market timing is a loser's game played by speculators and it should be shunned by long-term investors. One of the goals of financial planning is to eliminate the counterproductive emotions that lead investors to load up on stocks after they've gone up or sell them after they've gone down.

In a national survey by Bankrate, participants were asked: "What is the best way to invest money you won't need for ten years or more?" In other words, what's the best way to build wealth over the long-term? Their answers confirm my belief that most Americans have no idea how to build wealth over the long-term. Real estate finished in first place, chosen by 28% of the respondents. In second place was cash (savings accounts and CDs), the investment of choice for 23% of respondents who apparently don't understand the difference between preserving dollars and preserving purchasing power. Stocks finished a distant third, receiving only 17% of the votes. It is likely that over the long-term, real estate will underperform stocks and cash will underperform inflation. In the 45 years since I graduated from college, the Case-Shiller Home Price Index has had a real (inflation adjusted) average annualized return of 0.8% - the same as the risk-free 30-day US Treasury Bill. Over that time span, the S&P 500 Index has yielded a real average annualized return of just over 6%. While everyone needs cash reserves, it is foolhardy to make cash your primary financial asset. Many real estate investors claim that the benefit of real estate ownership comes from the leverage provided by a mortgage. For example, you could buy a $400,000 house with a 15% down payment of $60,000. If the value of the house increases 5% to $420,000, you will have received a 33% return on your $60,000 investment. But analysis of this sort ignores the interest payments, insurance premiums, real estate taxes, real estate commissions and maintenance expenses that must be subtracted from any gain to calculate an accurate return on investment.

The IRS has announced retirement plan contribution limits for 2018. The contribution limit for employees who participate in 401(k), 403(b), most 457 plans, as well as the government's Thrift Savings Plan will increase from $18,000 to $18,500. The catch-up contribution limit for employees aged 50 and over remains $6,000. The phaseout ranges for traditional IRA and Roth IRA contributions will increase slightly due to inflation adjustments. There is no change to the $5,500 limit on annual contributions to IRAs or the $1,000 catch-up contribution limit for individuals aged 50 and over. The section 415 maximum contribution to defined contribution plans increases from $54,000 to $55,000 and the catch-up contribution limit for employees aged 50 and over remains unchanged at $6,000. The maximum contribution to a SIMPLE retirement account remains unchanged at $12,500. Social Security recipients will receive a 2% inflation adjustment to their benefit.

The House and Senate have passed their respective versions of tax reform. A conference committee must craft a single bill to be approved by each chamber. Once the President signs the legislation, it will usher in significant changes to the tax code. There has been much discussion in the financial media over the details and differences in the two bills but until the final bill becomes law, there's no reason to change your tax strategy. One provision in the Senate bill will change the way investors account for capital gains when selling a stock or fund shares. Today, the default option for a partial sale of an asset is the "first in – first out" method. If you don't specify otherwise, the shares will be sold in the chronological order in which they were purchased. But to minimize capital gains taxes, investors can choose to sell shares with the highest cost basis first. The Senate bill provision, if adopted, would require that investors use the "first in-first out" method. Since the stock market has an upward bias over time, this seemingly insignificant change will increase the capital gains tax bill of many investors. It is odd to see Republicans write legislation that they would denounce, had they not themselves offered it. Forty one House Republicans have signed a letter asking the committee reconciling House and Senate tax bills to drop the first-in, first-out provision. Time will tell.

It's that time of year when investors are bombarded with economic and stock market forecasts for the upcoming year. Most will be similar to forecasts made last year at this time. A year ago, no one was forecasting the type of stock market returns that investors have enjoyed this year. Few, if any, commentators predicted that interest rates would remain as low as they have. In its January 2018 forecast issue, *Kiplinger's Personal Finance* magazine notes that the S&P 500 Index is up 21% in the 12 months since its 2017 forecast issue predicted a 6% increase for 2017. As a group, the eight stocks it recommended for 2017 underperformed the S&P 500 Index by 4%. Additionally, it confessed: "*As for our stocks to sell, investors would have been better off buying most of them instead.*" Nevertheless, the magazine's 2018 forecast issue is replete with predictions for interest rates and stocks along with recommendations of stocks to buy and stocks to sell in 2018. Reading forecasts is a waste of your time and readers who follow *Kiplinger's* recommendations are engaged in a classic example of the blind leading the blind.

If forecasts provide no value, why are there so many of them? I think it's because most financial products are sold to investors using stories derived from forecasts. Many (most?) forecasts aren't designed to help investors but to make financial products easier to sell. We need to differentiate between a forecast and an expectation. Wise investors expect that bear markets will occur at unpredictable intervals. They're disappointed but not surprised when they occur and don't make portfolio changes in reaction to them. Foolish investors use timing strategies and follow forecasts in an attempt to avoid bear markets, engaging in a loser's game that has caused much misery and grief for investors.

In a follow-up to last month's article that criticized Morningstar's rating system, the *Wall Street Journal* noted that some funds misrepresent their Morningstar ratings in advertisements. In a review of 36 fund advertisements, the *Journa*l found that at least eight ads were inaccurate – either reflecting out of date ratings or failing to note that the rating was based on fund performance before subtracting the cost of sales commissions. The *Journal* noted an ad for a fund claiming a 4-star Morningstar rating even though the fund's rating had fallen to 3 stars before the ad appeared on the *New York Times* website. A spokeswoman for the fund company said the firm followed industry advertising rules. The Financial Industry Regulatory Authority (FINRA) regulates mutual fund advertisements and requires that advertised performance be accurate through the end of the most recent calendar quarter. Apparently, according to FINRA, it's OK to intentionally mislead investors but not for more than three months. Morningstar's star system is intellectually dishonest and fund companies who pretend that a fund's star rating has a predictive value are morally bankrupt.

As I noted last month, there has never been a repeat winner of Morningstar's Fund Manager of the Year award. I recently came across a Morningstar article from January 2010 that crowned Bruce Berkowitz, manager of the Fairholme Fund (FAIRX), the 2009 domestic stock Fund Manager of the Year and the domestic stock Fund Manager of the Decade. From 2000 - 2009, his fund outperformed the S&P 500 Index by an average of 12% per year. The article sang his praises: "*Berkowitz looks for good businesses with solid cash flows, has a contrary bent, and has timed his bets well.*" Wise investors would have noted the radioactive verb ***timed*** contained in the praises heaped on Berkowitz. Exceptional performance never stays a secret. The media promoted the fund and Fairholme advertised the fund's past performance and 5-star rating – making FAIRX the bestselling domestic stock fund in 2010 -- attracting over $3 billion of new money. Prudent investors would have noted that $10 billion of the fund's $15 billion was invested in just ten stocks – putting the fund's future performance on a tightrope over a deep ravine. I met a financial advisor at the time who was buying the stocks that Berkowitz owned in his fund for client accounts – hoping that the performance would continue and that they'd think he was a stock picking genius. It would be naïve to think that he was the only financial advisor or stockbroker who was doing this at the time or that similar deceptions are not occurring throughout our fair land today.

Fast forward to December 2017. The Fairholme fund now possesses a 1-star rating from Morningstar. Assets under management have declined more than $7 billion over the past 5 years and now sits at $1.9 billion. The fund's ten-year 4.0% average annualized gain through October 2017 is 3.0% less than its benchmark Russell 1000 Value Index. Like FAIRX, the Vanguard Value Index Fund (VIVAX) invests in large-cap domestic stocks that are currently out of favor or are in a sector of the economy that is currently out of favor. A $10,000 investment VIVAX in January of 2010 would be worth $25,929 as of the end of September 2017. A $10,000 investment in FAIRX would have grown to just $14,962. It's easy to understand why performance chasing investors flocked to FAIRX, a fund that most of them never heard of before Berkowitz received his awards but who now regret the day they invested in it.

Happy Birthday

On Course Financial Planning celebrated its 13th birthday last month. In 2004, who would've imagined that OCFP would thrive in the years ahead and that Bear Sterns and Lehman Brothers would go out of business? The years have been challenging, rewarding and stressful enough to keep me fully engaged. I'm grateful for the perspective and advice that I received from experienced financial advisors who mentored me as I began this journey. Without their help, I would have run out of time and energy long before I ceased making avoidable mistakes. Here are some observations about what I've experienced and learned over the years -

I've been proud to work in a fiduciary capacity with my clients to help them get and stay on course to achieve their long-term financial goals. The strategy in our collaborative adventure has been to maintain a long-term focus, ignore short term market gyrations, shun any temptation to time the market, keep an appropriate percentage of assets permanently invested in stocks and maintain an optimistic view of the future.

I am an advocate of Leonardo da Vinci's dictum, "simplicity is the ultimate sophistication"; which applies to investing as much as any other area of life. Any important investment concept can and should be explained to clients in a clear and concise manner. I've devoted much of my writing trying to simplify investing without being simplistic. Simplicity is the end product of mastery while simplistic solutions and strategies often ignore important details. Each year I've witnessed Wall Street create more intricate, illiquid, expensive financial products that promise to protect investors from the next bear market. I'm amazed at the number of funds and investment products that are created solely to sell a story and keep client money in motion. The more complex an investment, the more numerous are its potential failure points, making it more fragile than simpler, transparent investments. Most financial advisors who sell these products don't understand their potential downside any better than their clients. I've never regretted sticking to these simple concepts -- portfolios should be widely diversified, hold transparent, understandable, liquid assets in an allocation that reflects a client's goals, risk tolerance and time horizon. Fixed income investments provide diversification, cash flow and cash reserves. Therefore, owning anything but the highest quality, dollar denominated bonds is ill-advised and counterproductive.

Ninety percent of successful financial planning is just good old fashioned common sense. Financial planning deals with a myriad of questions about how to use limited resources to fund and achieve financial goals in the face of uncertainty. Over the span of several decades, unexpected events will occur that will necessitate adjustments to spending and investing plans. No investment strategy will work 100% of the time, we are looking for the one that will work most often. Low-cost, tax efficient index funds provide investors with whatever returns the capital markets are generous enough to yield. Historically, these market returns have been sufficient for most investors. Planning, or lack thereof, your behavior and emotional responses to the headlines will have a greater impact on your retirement lifestyle than anything that happens today on Wall Street. The desire for quick riches is a common flaw of our human nature. That's why each generation of investors repeats the mistakes of prior generations and why bubbles, panics and crashes have been with us for 500 years.

Financial professionals who offer a market beating value proposition will never admit that they are on a stress and anxiety merry-go-round of stock picking and/or market timing that they can't escape. Their value proposition attracts performance maniacs -- the worst clients imaginable. They have no loyalty and will switch advisors if promised a 1% higher rate of return. This adds client replacement to the to-do list of these continually stressed advisors.

Speculation seeks quick profits and rejects the virtues of thrift, deferred gratification and hard work. It has attained respectability, sitting comfortably at the table with legitimate investing. I've come to hate speculation and pity speculators. Financial markets are dominated by institutional investors who earn a fortune speculating with other people's money. Their upside potential is almost unlimited while they assume almost no personal risk.

Too much financial advice is being offered by people who are too young, inexperienced and historically challenged to be in the advice-giving business. Common sense and perspective can't be taught in school, they come from living life, making mistakes and learning from them. For those financial advisors just beginning their journey I offer this advice. The best way to thrive in this business is to be good to people, always tell the truth, never pretend to know more than you do and always recommend what's best for your clients. Emphasize strategies and the big picture, use fewer numbers and round them off as much as possible. Place the success of your clients ahead of your own. If you follow this simple advice, you'll never have to worry about how to gather more assets under management.

The cost of good financial advice is a fraction of the money that will be lost without it; it's worth more than its weight in gold. Bad financial advice is worth less than its weight in sand. This is probably the simplest, most valuable truth for investors that I've written in the past 13 years.

Well, another year has flown by. There's only one thing more to say in 2017 – Merry Christmas to all and to all a good night.