On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Desert Musings

I'm taking a break from golf during our Arizona getaway to write down some musings about financial planning, investing and some items in the news.

Why do people who spend $50k on a luxury automobile waste time by going out of their way to wait in line at a Costco gas station to save $5 on a fill-up?

The financial media gives a microphone to stock market forecasters because forecasts, especially frightening ones, attract attention. Before subscribing to someone's forecasting newsletter, heed this warning from Warren Buffett - *"Short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children."*

The unemployment rate was 9.7% in January 2010 and steadily decreased to 3.5% by the end of 2019. Today, there are 0.7 job seekers for every job opening, meaning there are currently more available jobs than job seekers.

The performance of commodities over the past decade has been atrocious, which explains why you don't hear much about investing in commodity funds these days.

If you're looking for a risk-free investment, be advised that its inflation adjusted rate of return will likely be zero.

The financial media can only tell us what has happened, not what will happen. Therefore, the Weather Channel provides more value to viewers than CNBC. Ignore the news and study history; you'll be learning, not just listening and it'll make you a better investor.

Many investors have been enticed by market timing strategies that promise to have them in the stock market when it's going up and out when it's going down. Many advisors fear that they'll lose business if they tell clients that market timing is a fool's errand, that it's kryptonite and their portfolio is Superman. Its danger lies, not so much in the fact that it can't be done over the long-term but that it can seem to work just long enough to entrap you. If a successful market timing strategy existed, it would have to be kept secret. It's like the attempts of medieval alchemists to find a way to turn common metals into gold. If someone succeeded, he could never let the secret out. If he did, gold would soon be as common as stones and worth as much. You don't need to engage in market timing. You need a strategy that keeps an appropriate percentage of your portfolio permanently invested in stocks. This way, you'll be invested during those unforeseeable time periods that make stock investing profitable in the long run. Short-term market returns can be disheartening; there's a lot of "two steps forward, one step back". Take a long-term view, diversify broadly, use low cost, tax efficient index funds, rebalance your portfolio annually and let time take care of the rest.

A few years ago, a popular book for retirement planning was *The Number*. It supposedly explained to readers how to calculate the size of the nest egg they'll need to retire comfortably. It was long on ideas and short on specifics because inflation, longevity, health care expenses, taxes, market returns and personal spending are impossible to predict, and you can't compute the "number" without knowing what they will be.

I believe that optimism makes you a better investor. In the short-term optimists often seem to be wrong, probably because bad news travels faster and "sticks" so much longer than good news. Historically, optimism has paid off in the long run. Perhaps that's because most people wake up each morning attempting to make their life better tomorrow than it is today.

Optimism isn't the same as overconfidence, but they're closely related. Overconfident investors tend to engage in excessive portfolio tinkering. One cause of overconfidence is "self-attribution bias". We tend to credit our profitable trades to talent and skill, which enhances our confidence. We blame losing trades on bad luck, so our confidence doesn't suffer. Overconfidence surges during bull markets, even if personal returns are no better than market averages.

I don't entertain hypotheticals; life is vexing enough already. You cannot develop an investment strategy out of, "what if?" There will always be enough bad news on any given day to give the fainthearted investor a reason to avoid the stock market – even when stock indexes are at all-time highs. There's never been a time in history when things were "normal". Uncertainty is our constant companion – it's what's left over after we think that we've thought of everything.

A quote from economist Thomas Sowell – *"Politics allows people to vote for the impossible, which may be one reason why politicians are often more popular than economists, who keep reminding people that there is no free lunch and that there are no 'solutions' but only trade-offs."*

You don't need an investment outlook. You need an investment philosophy. I am a proponent of a passive investment philosophy – a buy, hold and rebalance strategy using index funds. These funds don't try to outperform the market, they're designed to capture the long-term return of a stock or bond index. They are low-cost, tax efficient and have outperformed most actively managed funds over the long-term. Investors seem to be getting the message. According to Morningstar, inflows into index mutual funds and exchange traded funds (ETFs) in 2019 totaled $476 billion, compared to net outflows of $61 billion from actively managed funds

Investing is an activity in which working harder doesn't produce better results. This is counter intuitive. We assume that capable, intelligent fund managers should be able to outperform "dumb" index funds. But intelligence is not a rare trait among fund managers. Many smart, capable fund managers with similar educations and access to the same data, are searching for mispriced stocks. There are too many smart, profit seeking competitors for any one manager to consistently outperform. This "paradox of skill" is one reason why few active funds outperform on an ongoing basis.

Wall Street makes a fortune selling clients what they want instead of what they need. The growing number of ESG (environmental, social and corporate governance) funds is the latest example. The hype behind ESG funds is the idea that some profit-seeking firms are more "virtuous" than others, and that their virtue will produce outperformance. Virtue signaling is popular these days, but a consensus definition of corporate virtue doesn't exist. ESG funds are relatively expensive actively managed funds that have little or no impact on the companies they buy or shun. The initial performance of ESG funds has been disappointing. A much better idea is to invest in index funds, earn the market's return and use your gains to fund the virtuous activities of your choice.

Too often a sales pitch is presented as investment advice. When getting financial advice, it's important to know if you're dealing with someone trained as an investment advisor or someone trained to sell securities. Be skeptical, a collection of investment products is no substitute for a financial plan.

Half of us will live longer than the average life expectancy for our current age. Half of today's 65-year-old men will live past age 85 and half of today's 65-year-old women will live past age 88. The joint life expectancy of today's 65-year-old couple is 27 years. This means that in half of these couples the husband or wife will still be alive at age 92. It is prudent for a married couple to plan living to at least their joint life expectancy and for a single person to plan to live to an age beyond current life expectancy.

A government cannot create wealth it can only redistribute wealth. Poverty can't be eliminated by redistributing wealth –- it requires the creation of more wealth. Character traits that create wealth – intelligence, natural talent, personal initiative, hard work, thrift and the willingness to take risk are unevenly distributed among people. Thus, equal opportunity won't produce equal outcomes. Is this "fair"? Nations that have decided that the inequality of outcomes is not "fair" often choose some form of socialist economy. But socialist economies also reward participants unequally, in proportion to their political connections and influence. Socialism has often been linked with an all-powerful state. When the state is the employer, planner, administrator, and grantor of favors, the ability of the average citizen to live freely is hindered. Liberty and economic growth flourish when people are free from the constraints imposed by the stifling hand of a centralized bureaucracy. Socialism limits economic growth, innovation and productivity because it ignores and opposes human nature. As Margaret Thatcher said – *"The trouble with socialism is that you eventually run out of other people's money."*

If I had to choose between living in a collectivist society where no one is free, but no one is hungry and a capitalist society where everyone is free and some are hungry, I would choose the latter. Because regardless of what anyone's utopian dreams might be, history shows us that those societies that offer the most freedom have the best fed citizens and that efforts to establish an ideal society have all too often produced tyranny.

The average American now retires at age 62 while 100 years ago, the average American died at age 51. Living standards in the US have risen by an inflation-adjusted 2% annually for the past century. This slow and steady progress hasn't been exciting enough to attract much attention and the free market economy that produced it is taken for granted by most Americans.

When JFK was the name of a president, and not the name of an airport, 60% of the world's population lived in extreme poverty. Today, that number is less than 10%. In Africa and Asia child mortality is at historical lows, famine has been virtually eliminated, while malaria, polio and heart disease are all in decline. Why isn't this headline news?

It's sad to see formerly great companies file for bankruptcy. But corporations are like people -- they grow quickly when they are young and vibrant, make a nice dollar in their adult years and eventually grow old and die. Bureaucratic lethargy eventually sets in and they lose market share to new, vibrant competitors and the cycle begins again. A sad consequence of bankruptcy is the financial damage done to employees who own company stock. When the music stops, the institutional money is long gone and stock owning employees wind up holding an empty bag. The year the S&P 500 Index turned 50 years old, only 86 of the original 500 companies were still in the index. I can't think of a better example of how individual stocks bring extra risk into a portfolio while providing no expectation of achieving better than long term market returns.

Investors always have a pro-cyclical emotional outlook. By this I mean that we usually base our predictions of long-term financial trends on recent events. This is known as recency bias -- that what is happening now is the new normal. Recency bias is strongest during times of excessive optimism or pessimism, making it difficult for investors to stick with their financial plan. It's one reason why sound, independent financial advice is so valuable.

No one can predict the unpredictable. The future is unpredictable, so no one can predict the future. So, why do we pay attention to forecasts and why are there so many forecasters? The culprit might be a module in the left side of our brain that causes us to search for cause and effect patterns in events. Unfortunately, it cannot distinguish between patterns that are random and those that are genuine. Investing is different from most activities because of the random nature of outcomes. This habit of seeking patterns is unconscious and can't be turned off. If I wanted to be nasty, I'd mention that seeing patterns that do not really exist is the foundation of chart-gazing, technical analysis. But I would never be so unkind.

This year, for the first time since 1982, Social Security's payments will exceed its income. The deficit will be covered by tapping into its reserve fund, which is projected to be depleted by 2035. Inevitably, this funding shortfall will be fixed by higher taxes, reduced benefits and an increase in Social Security's full retirement age for younger workers. Much like Medicare, which charges higher premiums for high income retirees, it wouldn't surprise me to see means testing finding its way into a retiree's Social Security benefit.

According to the Social Security Administration, two out of three retirees receive most of their income from Social Security. Yet IRS data indicates that only two in five retirees rely on Social Security for most of their income. Only 12% of retirees, according to IRS data, receive 90% or more of their income from Social Security – one third the number claimed by SSA. My guess is that the IRS numbers are closer to reality.

Over the long-term, stock prices are determined by economic fundamentals. In the short-term, unexpected news can have a big impact on stock prices, such as the coronavirus that has infected over 34,000 people through February 7th, nearly all in China. It seems unlikely that we'll see a direct health or economic impact in the U.S. So far, 12 people have tested positive in the U.S. with no deaths. That compares to 19 million who have come down with the seasonal flu, resulting in at least 10,000 deaths. This note from Schwab research puts things in perspective –

"*While it is impossible to predict the extent, a virus can spread and have greater consequences than past epidemics, history indicates that the global economy and markets have been relatively immune to the effects of past epidemics. A key reason is that global health organizations are prepared for outbreaks and effective when mobilized. Combining these efforts with widespread public awareness and adoption of effective safety measures eventually limits the spread of the virus and its economic impact."*

Of course, the initial reaction of short-term traders has been to shoot first and ask questions later. We've seen this before, and we'll see it again, because there is nothing new under the sun.

Many retirees have enough money to live a life of abundance, yet they have an underlying fear that all that they own might suddenly disappear or be taken from them. They practice ongoing frugality, living below their means, thinking that this is a healthy attitude. I call it turning deferred gratification into denied gratification.

Nobody is more susceptible to a good story than an investor with cash. Nothing will get an American to part with his hard-earned cash quicker than a good story that promises quick riches. And there are few people who can tell stories as well as fund managers and brokers with a product to sell.