On Course Financial Planning

Facing the Future with Optimism and Courage

January 2017

Vectors

geo@oncoursefp.com

425-861-9997

2016 In Review

The year began with what was proclaimed throughout the financial media as the worst first six weeks in stock market history. By the end of the second week in February, the S&P 500 Index had fallen 11% and the small company Russell 2000 Index had fallen 27%. One year later, most of us can't remember the reasons for the decline but it doesn't matter – it's always something. The comparisons to 2008 were too numerous to count.

Following the financial crisis, many people swore off the stock market – believing it to be a casino where the odds are stacked against them. But markets and economies are cyclical and downturns are more common than most do-it-yourself investors realize. From 1926 through 2016, the S&P 500 Index fell 10% or more 152 times and 20% or more 39 times, yet the average annualized return over those 91 years was 10%. Since 1980, the average intra-year decline in the S&P 500 Index has been just over 14%, making last year's 11% decline unusually rapid but not uncommon. Despite the regularity of intra-year double-digit losses since 1980, annual returns have been positive in 28 of those 37 years.

It's an old Wall Street adage that as January goes, so goes the rest of the year. There's no convincing evidence to support this rule of thumb but it persists nonetheless. There's no slate that is wiped clean on January 1st. Life is a series of old months rolling into new months and the arrival of another January is meaningless to your long-term financial plan.

Stock market volatility creates temporary market declines that do not represent a permanent loss of capital. Despite what is claimed by many commentators, volatility is not synonymous with risk. Risk is the possibility of experiencing a permanent loss of capital. Investors who own individual stocks experience volatility and risk a permanent loss of capital. Investors who own index funds that hold hundreds of stocks experience volatility but assume little or no risk of a permanent loss of capital – if they remain invested for the long haul. Stock market volatility is the trade-off that investors must accept if they want to earn the higher return that stocks have yielded over less volatile government bonds (known as the equity premium). You'll rarely hear a Wall Street talking head mention that the best remedy for market volatility is simply the passage of time. If you bought the Vanguard Total Stock Market Index ETF (VTI) at its pre-financial crisis/market crash peak in October, 2007 and held on, you earned a 6.8% average annualized rate of return through the end of 2016. All you had to do to capture these gains was stay calm and carry on. We got another reminder of the benefit of keeping calm and carrying on in June following the Brexit vote. Domestic stocks declined nearly 6% over the next day and a half but recovered the loss in less than a week.

Many investors suffer from an irrational fear of stock market declines because of "availability bias". Our minds give more weight to recent information instead of the lessons of history. Even though we've experienced two stock market crashes in the first decade of this century, stock market crashes are rare historical events. Unfortunately, the financial media's relentless negativity gives the impression that market crashes are common and that the next one lurks just around the corner. No wonder then that so many investors sell during times of volatility and reenter the market when it seems safe – a sell low, buy high merry-go-round that is likely to yield a long-term rate of return that barely keeps up with inflation.

A written financial plan is the foundation of a multigenerational wealth building strategy. During times of market volatility, a financial plan helps to still your emotions and guide your actions. If you have faith in your plan's long-term efficacy, you'll stick with it and continue funding your retirement accounts regardless of what's happening in the stock market. Without a plan, your investment decisions will likely be driven by emotional responses to the headlines and the fads or fears of the day.

For investors who were able to withstand market volatility, ignore the headlines and maintain a long-term perspective, 2016 was a profitable year. The S&P 500 Index produced a positive return for the eighth consecutive year. This is quite a turnaround from the first decade of the 21st century when it lost an annualized 0.9% from 2000 through 2009. This eight-year winning streak is one shy of the record of nine consecutive years which occurred from 1991 through 1999. Another piece of good news you might have missed was that Americans now own $56 trillion in private financial assets, 8 million households own more than $1 million in financial assets and, according to Boston Consulting Group, an average of 1,700 of your fellow citizens became new millionaires each day in 2016. If we could go back to January, 2009 and tell everyone that today the Dow is near 20,000, unemployment is under 5% and gas is $2.50 a gallon, they would think we entered the Millennium. Instead, we're complaining about almost everything and everyone.

Despite the endless media hand wringing over the US and global economies in 2016, a portfolio of domestic and international stocks, REITs, investment-grade corporate and US government bonds outperformed almost everyone's expectations. Every asset class index fund that I use in client portfolios produced a positive rate of return last year, led by the 30% return of domestic small cap value stocks. This happy and rare occurrence is a gift from on high for which thoughtful men and women must pause and give thanks.

Small cap domestic stocks were the star performers last year. After suffering a 27% decline in the first six weeks of the year, the Russell 2000 Index of small company stocks rebounded more than 40% and finished the year with a 21.6% gain. The poorest performing stock asset class was large cap international stocks – a combination of slow economic growth overseas and a strong dollar. This leads me to my first fearless prediction for 2017. Many investors will sell their international stock funds and buy small-cap domestic stock funds. This short-cited performance chasing will often be done following the recommendation of a financial advisor. Wise investors will do just the opposite, rebalancing their portfolio by selling small-cap stocks and buying international stocks.

For several years now, domestic stocks have outperformed international stocks, leading some commentators to claim that you don't need to own international stocks. But the relative performance of domestic and international stocks has always been cyclical and no one knows when the current trend will reverse or what part of the world will be this year's outperformer. It's never comfortable investing where the best bargains are found because attractive asset valuations are usually accompanied by bad news and poor fundamentals.

Readers of this newsletter have often heard me refer to the Lazy Golfer Portfolio that I use as a performance benchmark. The Lazy Golfer Portfolio holds five Vanguard index mutual funds allocated 40% in the Total Stock Market Index Fund (VTSMX), 20% in the Total International Stock Index Fund (VGTSX), 20% in the Inflation Protected Securities Index Fund (VIPSX), 10% in the Total Bond Market Index Fund (VBMFX) and 10% in the REIT Index Fund (VGSIX). I instruct my lazy golfer to forgo golfing one day a year, perhaps on his birthday, and rebalance his portfolio to its original allocation. In 2016, the Lazy Golfer Portfolio gained 8.1% -- well above my 6.5% estimate for the portfolio's long-term average annual return. Not too bad if I do say so myself.

My two favorite predictions for 2016 came in January. The manager of the largest bond mutual fund, Jeffrey Gundlach, predicted: *"if you're going to do something in emerging market equities, my recommendation is to short them. They may fall a further 40%."* Why anyone would take stock picking advice from a bond trader is a mystery to me. The Vanguard Emerging Markets Index Fund ETF (VWO) gained 12.2% last year. The Royal Bank of Scotland advised its clients to brace for a "cataclysmic year" which would include a global deflationary crisis, a 20% global stock market decline and oil selling for $16 per barrel. The bank recommended that its clients *"sell everything except high-quality bonds."* This led to the most frightening, attention grabbing financial headline of the year: *RBS Warns: Sell Everything*. But in the end, the first six weeks of 2016 proved to be a classic "bear trap". It gave pessimistic, stock averse investors an excuse to flee to cash and then suffer the consequences of missing the rebound. By year's end, the Vanguard Total Stock Market Index Fund (VTSMX) was up 12.5% (including dividends).

Like the flu, economic and market forecasts occur throughout the year but are widespread in January. Every brokerage firm, big bank and mutual fund company in the Financial Industrial Complex plays the New Year Forecast Guessing Game. I'll let you in on a little secret. They don't make these forecasts for your benefit. Their purpose is to encourage investors to play the "outsmart the market" game and engage in short-term portfolio tinkering that generates revenue for these firms. They give lip service to the tried and true strategy of buying and holding equities for the long-term but they have no use for people who trade infrequently. These forecasts should come with a disclaimer that investors would be better off ignoring them and sticking with their long-term plan. Many brilliant investors and pundits have been dead wrong about the market since the financial crisis - to the detriment of those who have listened to them.

I've read many economic forecasts for 2017. They bore me. All too often they serve only to promote a product or bring attention to the forecaster. To have any value, they must satisfy two criteria. The first -- the forecast must be correct. The second -- it must not already be priced into the market. It's highly unlikely that any forecast you hear will satisfy both criteria. What's worse, with a new president about take office, many forecasts will be tainted by the commentator's political beliefs – a poor foundation for investment decisions. My recommendation is that you treat all forecasts like Superman treated kryptonite.

Each January, personal finance publications bombard readers with "Stocks to Buy This Year" articles. The January issue of *Kiplinger's Personal Finance* contains its eight stock picks for 2017. The magazine admits that six of the eight stocks it recommended in its January, 2016 forecast issue lost money last year and that a portfolio equally weighted to all eight stocks lost 9% - underperforming the Vanguard Total Stock Market Index Fund by more than 21%. I can't make this stuff up. But instead of blushing and swearing off stock picking, they continue to make annual stock recommendations because they know that these articles sell magazines. Unfortunately, they'll never be held accountable for the harm done to readers who are gullible enough to follow their recommendations.

Fortunately, you don’t have to know the future to be a successful investor. Having a goals based financial plan, owning a globally diversified portfolio, funding that portfolio regardless of the headlines and implementing a disciplined rebalancing schedule eliminates the need to know what lies ahead. Successful investors are goal focused and planning driven, not market focused and performance driven. Investors who reacted to the headlines and fled stocks early last year missed a golden opportunity to make progress in achieving their long-term financial goals and suffered unnecessary emotional frustration.

In the first four months of the year, the ETF with the largest inflow of new money was a fund that few investors (including your humble scribe) have heard of – the iShares MSCI USA Minimum Volatility ETF (USMV). This fund owns large cap domestic stocks in the S&P 500 Index with lower volatility than the index itself. The fund outperformed the most popular ETF that tracks the S&P 500 Index (SPY) by 3.5% in the first four months of 2016. Outperforming the S&P 500 Index with less volatility – what's not to like? What's not to like is that it can't possibly continue. Any stock selection strategy might outperform for a few months or years. This will be accompanied by claims that it is the Holy Grail of investments. But the stock market is too efficient to allow low volatility stocks to outperform the market over the long-term because volatility and expected return go together. If this wasn't true, investors would only buy low volatility stocks. If you're presented with an investment that promises to provide stock like returns without stock market volatility, you're dealing with someone who is lying, a fraud or a fool. Little-known ETFs don't sell themselves and too many financial advisors are mere order takers - catering to every fear and whim of their clients in order to maintain assets under management. "You like stocks but don't like volatility? Here's the fund for you." From May through the end of December, USMV gained 2.4% and SPY gained 7.5%. For the year, USMV returned 10.5% versus 11.8% for SPY.

If you tried to time your way into and out of the market in response to the headlines or invested in individual stocks in an attempt to outperform the market, I have no idea if 2016 was a good or bad year for you. Your 401(k) is a dollar cost averaging accumulation vehicle designed to profit from the returns generated by the capital markets over several decades. Unfortunately, too many investors unplug this process by jumping into and out of the stock market based on fear or hunches. To my way of thinking, anyone who passed up the domestic stock market's 12.5% return in 2016 (which was available free for the asking) in an attempt to do better, was playing a loser's game.

Portfolio volatility and temporary declines are part and parcel of the investment process. There are unintended financial consequences when investors attempt to avoid volatility. Conservative investors who overweight fixed income investments may enjoy less volatility today but are likely to suffer a loss of purchasing power due to inflation. It's important that your portfolio's stock allocation is high enough to achieve your long-term financial goals and low enough that its volatility doesn't exceed your risk tolerance. Few do-it-yourself investors know how to accomplish this delicate balancing act.

As we enter 2017, our nation seems to be engulfed by a noxious mood of widespread apprehension and negativity. Many Americans, who have experienced a rising quality of life during their lifetime, seem to expect nothing but decline ahead. As I have mentioned many times in my newsletters, pessimism isn't merely wrong, it's counterintuitive. To be an American declinist, one must believe that science, technology, and the unique combination of innovative genius and entrepreneurial energy that have been hallmarks of the American character are all spent forces. There is no objectively verifiable evidence for this bizarre notion; rather all the evidence of history contradicts it.

I have one prediction for the stock market in 2017. It will continue to be unpredictable because life is unpredictable - that's why hospitals have emergency rooms. It will continue to humiliate and plunder investors who pretend otherwise. I have no idea where markets, inflation, oil prices, interest rates or the economy are headed in 2017. But neither does anyone else. One thing I'm certain of - unexpected events will create volatility in the stock market – you can bank on it.

Hopefully, you made great strides last year in accumulating the financial assets necessary to meet your long-term financial goals. Most of the headlines that caused stock market volatility in 2016 have already been forgotten. For long-term investors who didn't react to the headlines and tuned out the short-term noise, 2016 was a very good year.