On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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2018 in Review

The outlook for domestic stocks was favorable as the year began and most forecasters were predicting high single digit gains. The January 2018 Forecast Issue of *Kiplinger's Personal Finance* magazine predicted that global economic growth and rising corporate earnings would lead to an 8% rise in domestic stocks. In 2018, earnings of companies in the S&P 500 reached an all-time high; 28% higher than in 2017. Unemployment fell to 3.7% - the lowest rate in 50 years. Real (inflation-adjusted) GDP grew by 3% – the highest annual rate since the financial crisis. Oil prices declined and inflation and interest rates remained low. Domestic and international stocks performed well through September but suffered steep declines in the fourth quarter; leading to annual losses.

The Russell 3000 Total Stock Market Index declined 5.2% last year; its first calendar year loss since 2008. The Russell 1000 Large-Cap Index fell 4.8% and the Russell 2000 Small-Cap index fell 11.0%. The Dow Jones US REIT index declined 4.2%. International stock indexes fared worse due to a slowing global economy, trade war fears and a strong US dollar. The MSCI All-World Ex-US Index fell 14.2% and the MSCI Emerging Markets Index fell 14.6% for the year.

I often refer to the Lazy Golfer Portfolio that I use as a performance benchmark. It 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). Lazy golfers are advised to rebalance their portfolio annually to its original allocation. In 2018, the Lazy Golfer Portfolio declined 5.7% – disappointing but not the end of the world. To put some perspective on last year, it might help to revisit what I wrote in last January's issue of this newsletter-

"One would be hard pressed to find anything not to like about the performance of global capital markets in 2017. A portfolio of domestic and international stocks, REITs, investment grade corporate and US government bonds produced excellent returns last year with unusually low volatility. According to data from LPL Research, the biggest drawdown in the S&P 500 last year was just 3% - the smallest intra-year drawdown since 1995. Since 1946, the average intra-year pullback for the S&P 500 has been just under 14%. Every equity index fund that I use in client portfolios had a positive return in 2017. This is a rare gift from on high for which thoughtful men and women must pause and give thanks."

At its low point in December, the S&P 500 Index was 19.8% below its September all-time high. This is more than the 14% average intra-year drawdown in the S&P 500 since 1946, but not an unexpected event. In 2018 there were 32 days in which the S&P 500 Index declined 1% or more and 37 days in which it rose 1% or more. I can't prove it, but my guess is that the 32 bad days and the 19.8% drawdown received more media coverage than the 37 good days or the fact that the index decline only 4.4% for the year; which shouldn't be too surprising after its 21.8% return in 2017.

Double digit declines unnerve investors. So, it comes as no surprise that market timing, a thoroughly discredited strategy, attracts new adherents after every significant market drop. Its appeal is compelling. For example, if you avoided the ten days with the biggest declines in the S&P 500 Index from 1998-2017, your annualized return would have increased from 7.2% to 11.3%. Conversely, if you were sitting in cash during the ten best days, your annualized return would have fallen to just 3.5%. Most of the best days occurred in close proximity to the worst days; during times of high volatility. So, if you were lucky enough to have missed most of the bad days, you also probably missed most of the good days. The same thing happened last year. The S&P 500 Index declined 7% in the week before Christmas; generating many large font headlines containing the word **plunge!** On Wednesday of the following week, the Index rose 5% - its largest daily gain in almost ten years and it finished Christmas week up 6%. Such rapid reversals in stock prices – down 2% today, up 3% tomorrow, down 2% the next day make it nearly impossible for anyone, amateur or professional, to formulate a useful market timing strategy.

The stock market rises over time. Not every day, not every week, not every month or year. Unpleasant short-term losses are a feature of the stock market. Without them there would be no volatility, no risk of loss and no equity risk premium - the additional long-term return that stocks have provided over bonds and cash. Patience is required, whether we like it or not, and most of us don't like it. The historical record shows us that the longer the time horizon, the higher the probability of seeing gains. While all market declines create angst, it's important to understand that last year's disappointing performance wasn't unique or unusual and shouldn't cause panic. Investor anxiety would disappear if the stock market generated its historical 10% annualized average return every year. But with no volatility or risk of loss, the long-term return for stocks would soon fall to that of a 1-year CD.

Many investors "anchor" their investing emotions on their portfolio's highest value, instead of its growth over time. The S&P 500's 19.8% drawdown in last year's fourth quarter was reported throughout the financial media. But it was rarely mentioned that even after declining in 2018, the S&P 500 has yielded a 13.1% annualized average return for the past ten years. When we forget previous gains and fixate on how much our portfolio has declined since its high point, we open ourselves up to the irrational fear of **losing everything!**

Each new market decline looks like the end of the world but with 20/20 hindsight every past decline gets redefined as a great buying opportunity. Following market declines, many investors engage in portfolio tinkering – typically lowing their stock allocation – because it gives them a false sense of control and safety. Over shorter time frames, anything can happen and even a flawed strategy can produce excellent results. Most investors think that 5 years is a long-time and ten years is an eternity. So, after a few disappointing years, they're tempted to junk a perfectly good plan and portfolio and start over. Disappointing short-term performance doesn't necessarily indicate that something is wrong with your strategy or portfolio allocation. Even the best investment strategy will have periods of poor performance.

Wise investors understand the value of having a financial plan that can be reviewed annually to see if they're still on course to achieving their financial goals. They maintain a long-term outlook and continue to fund their portfolio regardless of current market gyrations. They focus their attention on things they can control, such as their behavior, tax efficient planning, and keeping investing expenses low. Foolish investors have no plan to guide them and spend their investment lifetime responding to what happened yesterday. A never-ending purgatory of woulda, coulda, shoulda. They focus their attention on things they cannot control, such as the financial markets, geopolitical events, politics and seek financial gurus and forecasts to guide them. Heaven help you if you're in this camp.

No one knows if the stock market will rebound in 2019 or if things will get worse from here. The economy's fundamentals remain healthy, yet optimism is in short supply today. No society will ever reach perfection, but it seems to me that the increase in our collective pessimism is directly correlated with the increase in our use of social media and the decrease in our collective knowledge of history. I predict that investors who remain patient and disciplined will outperform impatient and undisciplined investors who nervously check to see if today is a green day or red day for their portfolio.

The best financial plan is of no value if you put it in the shredder. A good financial advisor must always encourage clients to stay the course, ignore the noise and do the right thing. This may be the most difficult part of our job and the most important part of what we do. My investment advice hasn't changed in the 14 years that I have been advising clients. Buy, hold, rebalance and change your portfolio only when your goals change. It's goal focused and planning driven, the opposite of the market focused and current events driven advice dispensed by most of the big name Wall Street firms. It's a simple, boring strategy that has rewarded investors who exercise optimism, discipline and patience. It's easier said than done, which is why so few investors have earned the long-term returns that stocks have offered.

Forecasting Folly

Annual stock market forecasts appear in the financial media every January. You are going to read and hear forecasts for 2019 delivered with mathematical precision to the nearest decimal point and chest-pumping confidence by blush-free media guessers acting as if they've received a vision from On High. Many of these forecasts will be accompanied by charts, graphs and equations. But since the stock market's short-term activity is random, January's forecasts rarely make it through the year without modifications, which says a lot about why you should ignore them. They are no more valuable than guessing – or asking Alexa. There are no accurate crystal balls. Every forecast represents one of an infinite number of roads we might be heading down in the years ahead. Consequently, the odds that a forecaster has identified the one that we will travel on are less than slim.

Investors have a hard time coming to grips with the fact that when it comes to forecasts, nobody knows nothin'. This explains why so many fall prey to forecasting charlatans who pretend to possess insight into what's going to happen. Avoid them like Superman avoided kryptonite. The list of charlatans includes investment professionals who will never admit to their clients that they have no idea what stocks will do in 2019. I can't figure out if these folks are arrogant, nuts or a bit of both but trying to increase assets under management is probably a significant factor behind their bravado. Perhaps more distressing is the fact that there are thousands of financial advisors and brokers who will repeat the forecasts of their media favorites; pretending them to be their own insights.

A correct forecast requires two insights. First, the forecaster must predict important economic and geopolitical events before they happen. Second, the forecaster must predict how millions of investors, each with their own goals, time horizon, risk tolerance and temperament will react to these events. There are just too many variables, and no evidence suggesting that anyone can put these two insights together on a consistent basis.

Most forecasts compare current trends with past data. Unfortunately, no matter how far back we go, data provides less information than we'd like to believe. Basing forecasts on long-term averages offers a level of comfort; it seems to provide a rational basis for predicting the future. This works for many things - baseball batting averages, for example - but not for investing because of the nasty complication of randomness. No one knows how much of the long-term data is the product of random chance, and it's likely more than most investment professionals would care to admit.

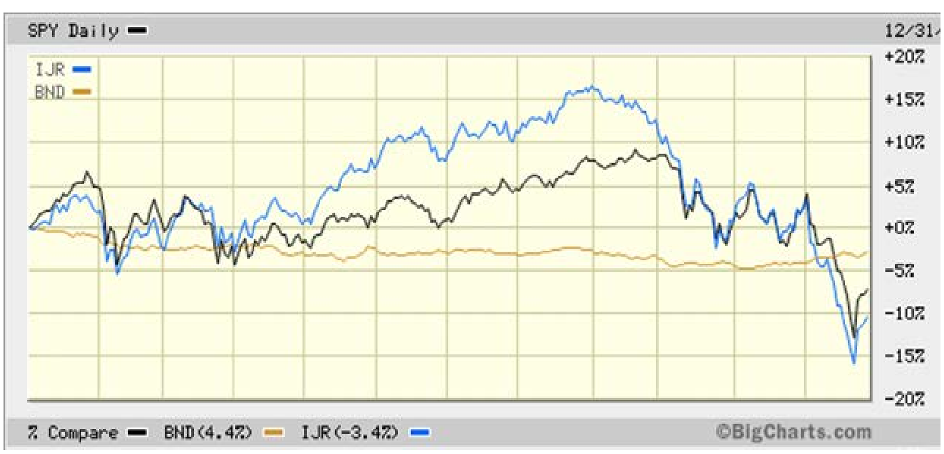
My award for the worst market forecast of 2018 goes to an article in the October 4th issue of *Wall Street Journal*: "Midterms Are a Boon for Stocks—No Matter Who Wins." The article reassured nervous investors that on average, the months of October, November and December have been the top-performing months in the past fourteen mid-term election years. Well, until last year.

Former Reagan White House Budget Director David Stockman gets my vote for the Failed Forecaster of the Decade. He has predicted market crashes in 2012, 2013, 2014, 2015, 2016, 2017, 2018, and 2019. I guess this proves that if you're famous and pessimistic, you'll have a media microphone no matter how many incorrect forecasts you've made. Despite the upward trend of the markets over time, prophets of doom attract eyeballs, ears, clicks and assets. Follow the money. Protecting the fearful from their fears, whether real or imagined, sells.

Wise investors understand that successful investing is more about setting reasonable expectations than knowing what lies ahead - because nobody knows what lies ahead. No one can predict when the next bear market will begin or how long it will last. Consequently, investors must protect themselves by owning a portfolio that is appropriate for their goals, time horizon and risk tolerance. Once again, in 2018, we saw the difficulty of predicting the performance of the capital markets, the importance of diversification and the need for discipline. Once you've given up the idea that you, or anyone else, knows what's going to happen, there are four things you should do -

- **Diversify.** Forget about trying to discover which stocks or market segments will be the best performers this year. Own them all and you're sure to own the best performers. Yes, you'll also own the worst performers. But the worst performers can only go down 100%, while the best performers have an unlimited upside - which is a big reason why index funds have outperformed most active funds.
- **Rebalance.** Prices fluctuate, and periodic rebalancing accomplishes two things. You always know what to buy (what went down) and rebalancing returns your portfolio to your financial plan's proposed allocation.
- **Keep a long-term focus.** Ten years from now is 40 quarters in the future. What happened in the final quarter of 2018 will have little, if any, impact on your portfolio's balance 40 quarters from now – if you ignore the noise and keep funding it.
- **Keep your emotions in check.** This means you ignore the crystal ball gazers who scream "SELL" every time the market declines 5% in a week. As Warren Buffett has stated, *"The most important quality for an investor is temperament, not intellect."*

The consensus forecast was that 2018 would be a bad year for bonds because the Federal Reserve was raising interest rates. Since bond prices decline (temporarily – a fact not often reported) when interest rates rise, many forecasts predicted nothing short of a bond Armageddon. Yet despite the fear mongering, the Bloomberg Barclays Aggregate Bond Index, Municipal Bond Index and US Government Bond Index all finished the year with small positive returns. It's important to note the benefits investment grade corporate and government bonds provide for a portfolio.



This chart shows the 2018 performance of three index ETF's – the large-cap S&P 500 (SPY), the small-cap S&P 600 (IJR) and the Vanguard Total Bond Market Index (BND), which holds investment grade corporate and US government bonds. High quality bonds aren't in your portfolio for capital appreciation. Their function is to limit portfolio volatility when stocks have one of their inevitable bouts of volatility. In 2018, they upheld their end of the bargain.

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