On Course Financial Planning

Facing the Future with Optimism and Courage

May 2017 Vectors

geo@oncoursefp.com 425-861-9997

Quiz Time

Many of the 10,000 baby boomers who are turning 65 each day are looking forward to retirement. But how many of them have the financial savvy to manage their finances well enough to avoid running out of money in retirement? I've always thought the answer is "few, if any" and now there's some evidence to support my belief.

The American College of Financial Services is a 90-year-old institution that claims to be the nation's largest nonprofit educational institution devoted to financial services. It created the Financial Income Literacy Quiz which contains 38 multiple-choice questions covering financial subjects that retirees need to understand if they are to successfully manage their finances. Earlier this year, the quiz was given to 1,244 people between the ages of 60 and 75 who have at least $100,000 in financial assets. Here's a link to the quiz. Be forewarned – unlike most financial literacy quizzes I've seen, this one requires you to know a thing or two. You must score above 60% (23 correct out of 38) to pass the quiz.

How did you do? The average score (mean and median) for the respondents was 47% and 74% failed the quiz. Only 5% scored 80% or higher. Of those respondents with more than $1 million of financial assets, only half passed the quiz. Among the 61% of respondents who consider themselves to be "very" or "extremely" knowledgeable about retirement income planning, only one out of three received a passing grade.

In its summary, the report noted – "*Americans have a particularly low knowledge about preserving assets and sustaining income in retirement*." Some of the areas of concern noted in the report were –

- Only three out of ten know that actively managed mutual funds have higher fees than index funds.
- What percentage of a portfolio should be invested in stocks if it must finance a 30-year retirement? More than one third answered "don't know".
- Only one in three understand that the price of a bond will fall if interest rates rise.
- Only one in four understand that higher bond yields are associated with higher default risk.
- Only one in four know that employees won't lose their 401(k) if their employer files for bankruptcy.

Successfully managing retirement income requires specialized knowledge that goes beyond the basic financial principles that you can learn from reading a few books or scouring the financial media. It isn't surprising to discover that most Americans nearing or entering retirement have no business managing their own portfolio. What's disheartening is that almost two thirds of them apparently think that they're up to the task. This can't end well.

Active Managers' Report Card

I've often mentioned S&P's SPIVA Scorecard – its semiannual grading of the performance of actively managed mutual funds versus their S&P benchmark index. The Scorecard provides ongoing evidence of the inability of active fund managers to provide risk-adjusted outperformance. The year-end 2016 SPIVA Scorecard was released last month and is the first Scorecard covering a 15-year time horizon. As the time horizon increases, the number of funds that outperform their benchmark index declines because of the performance drag resulting from the compounding effect of the higher expenses of active funds. This is a permanent, fatal flaw of active management that will not change until managers dramatically lower their fees. For the 15 years ending December 2016, 92% of large-cap, 95% of mid-cap and 93% of small-cap domestic stock fund managers underperformed their respective S&P benchmark index. Additionally, 89% of international stock fund managers underperformed the S&P International 700 Index.

The Scorecard also tracks the longevity of mutual funds. There were 2,206 domestic stock mutual funds available to investors on January 1, 2002. By January 1st of this year, only 923 (42%) were still in business. The 58% that went missing in action were either merged into other funds or liquidated because of poor performance.

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 in less efficient markets, such as small-cap stocks and emerging market stocks, active managers supposedly have an edge. But the data indicates that this assertion is a myth that can only survive in a world of uninformed investors and disingenuous financial advisors. The SPIVA Scorecard discloses that for the past 15 years, 90% of emerging market stock funds underperformed their benchmark index and 95%

of domestic small-cap core funds underperformed the S&P Small Cap 600 Index. Let's take a closer look at small-cap domestic growth stocks; an asset class in which active managers supposedly have a good chance to outperform.

Last year, 96% of small-cap growth fund managers underperformed the S&P Small Cap 600 Growth Index and 99% underperformed the index over the past 15 years. For investors who want to maintain an allocation to domestic small-cap growth stocks, one option is the iShares S&P Small-Cap 600 Growth ETF (IJT) – which tracks the index. This fund has an annual expense ratio of 0.25% and has outperformed 95% of comparable funds over the last 5, 10 and 15 year periods. Yet it is just a "dumb" index fund. In an asset class that proponents of active management consider to be "easy pickings", almost all fund managers have not only failed to provide value to their shareholders, they've subtracted value.

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, owning the right funds at the right time. Years ago, this bill of goods was an easy sell because the relative past performance data provided by the Scorecard was unavailable. Today, the evidence provided by the Scorecard is an insurmountable hurdle for active management's propagandists to overcome; one that most choose to ignore rather than refute.

Advice For New Graduates

If you are a newly minted college graduate, you probably don't have much money to invest right now. But it's important to understand that the most valuable financial asset that you own is time and the most powerful tool at your disposal is compound growth. Consider my fictional friends, Stan and Ollie, 21-year-old twin brothers just beginning their professional careers, and their sister Lucy.

Stan is the prudent brother. He knows that by starting to invest at a young age, he maximizes the chances of achieving financial independence. He starts contributing $5,000 each year to a Roth IRA. After ten years, his contributions have totaled $50,000. Ollie is a procrastinator and saves nothing during the first decade of his working years. Ollie then has a Prodigal Son moment. He realizes that he has been wasting time and squandering money long enough. So, he begins making $5,000 annual contributions to a Roth IRA. After making contributions for ten years, Stan finds that the expenses of home ownership and raising a family leave him with no money to invest. So from this point until retirement he makes no further IRA contributions.

Let us assume that both accounts yield a 7% annualized rate of return and that Stan and Ollie work for 45 years. At retirement, which brother will have the larger IRA?

Stan's contributions totaled $50,000. Ollie's contributions amounted to $175,000. Upon retirement, Stan's Roth IRA will have grown to $737,000 while Ollie's will be worth $691,000. Intuitively, it seems that this cannot be true.

With a 7% rate of return, an account will double in about ten years. When Stan stops his contributions, enough years remained for his account to double three times. By the time Ollie has made $50,000 in contributions, he will be 25 years from retirement and his IRA will have time to double only twice. As we can see from this simple example, compound growth rewards early contributions more than later, more numerous ones. When growing rich slowly, it's the last doubling that takes you from "I hope I'll be OK" to "I have more than I'll need".

Lucy is a college student looking for a summer job. She is offered a position for 30 days of work. Her prospective employer gives her the following salary options. Which one would you advise her to choose?

1) Upon completion of 30 days of satisfactory employment, she will be paid $5 million.
2) She will begin employment with an initial salary of one penny a day and her salary will double each day for 30 days.

By choosing the second option, her total pay for 30 days will be $10,737,418. Even as late as day 21, her daily salary is only $10,485. On day 29 her cumulative salary finally exceeds $5 million. And her pay on day 30 will be $5,368,709. Once again, that last doubling makes a huge difference.

Successful investing is 20% intellectual and 80% temperamental. Unfortunately, our natural inclinations do not generate the required temperament. Accumulating retirement assets is a marathon journey during which emotions will be your enemy and time will be your ally. The wealth created by long term compound growth is available free of charge to anyone with the patience, discipline and long-term optimism that it requires. The most successful investors I know have maintained a long-term view and let compounding work its magic. Hopefully, these two examples of the power of compound growth will motivate you to begin investing as early as possible -- even if your initial contributions are small.

Wall Street's product pushers know that patience, discipline and long-term optimism aren't easy to sell. So rather than advising you to get rich slowly, Wall Street's High Priests will invite you to come and worship at the Altar of Immediate Gratification. Unfortunately, they're likely to do so in a very subtle manner. It is likely that someone you know – a classmate or close friend, will go to work for Edward Jones, Ameriprise, Merrill Lynch or another of the innumerable, indistinguishable product pushing firms that profit from the lack of investor knowledge clearly revealed in the above-mentioned financial quiz. Unfortunately, your acquaintance will not have been trained as a financial advisor but as a securities salesperson. To stay employed, he or she must convince enough people to buy investments, sell them shortly thereafter and then buy something else. Inevitably, your "friend" will pitch you one or more of the following lies-

- Stock market returns can be achieved without experiencing stock market volatility.
- Outperforming the market is a legitimate financial goal and it's possible to achieve this goal through stock selection and market timing.
- You can outperform the market by buying their firm's recommended actively managed mutual funds.
- You don't need a long-term strategy if you have a market forecast.
- You don't need a financial plan if you have the right investment products.
- Your portfolio should include a variable annuity or fixed index annuity.

Newly minted brokers who can promote these fictions are sure to get rich quickly; while their clients get nowhere fast.

But even if you avoid brokers and insurance salesmen and become a do-it-yourself investor, here are some mistakes that you're likely to make without the help of anyone else –

- You'll convince yourself that you have insight about a stock and its prospects that offers a great moneymaking opportunity. There's a good chance that the stock will be that of the company that employs you. You'll be blissfully unaware of the additional risks that come with owning individual stocks. No stock is likely to outperform its asset class over the long term and the outcome of your "insight" is unlikely to be any more profitable than it has been for the millions of investors who made the same mistake long before you came along.

- Wall Street's mouthpieces are experts at telling stories and at your tender age you haven't developed the ability to distinguish between insight and smart sounding, uneducated guesses. You'll hear or read a market analysis that claims that a particular market sector is about to outperform. There are hundreds of sector funds that will allow you to overweight your portfolio to market sectors that are currently popular. But don't be fooled. Employing sector rotation strategies is a form of market timing that increases portfolio risk. It's much wiser to employ a passive, index strategy and own all market sectors.

- The kissing cousin to sector funds are single country funds. Every year some country's stock market handily outperforms the US stock market. In 2016, the Russian stock market rose 80% and the iShares Russia fund (ERUS) was up 54%. It wouldn't surprise me if a Wall Street firm soon comes out with the Putin Fund. But just like speculating on individual stocks or market sectors, betting on one country's stock market increases risk without guaranteeing better long-term performance. It's much wiser to own an international stock index fund that provides global diversification.

- If you're a nervous investor you may be tempted to buy an inverse fund. These funds go up when the stock market goes down. But the S&P 500 Index has produced positive returns in 40 of the past 50 years. Maintaining a continuous bet against the long term rising trend of the stock market is unlikely to enhance your portfolio's long-term performance.

- If betting against the market is a foolish long-term strategy, is investing in funds that return two or three times the upside of the market a winning strategy? Not really. So-called "leveraged funds" seek to deliver a multiple (2x and 3X are typical) of the return of the stock index that they track. Few investors realize that these leveraged funds are designed to yield the promised multiple return only over a one day time horizon. If held for the long term, these funds will provide a multiple of the market's volatility but not an equivalent multiple of its return. Here's a link to a FINRA alert on leveraged and inverse funds.

So, as you begin your investing years, favor simplicity and low cost. It's never too early to learn that you have no friends on Wall Street. There are no expert market or economic forecasters and the future relative performance of various asset classes is random. If a financial product or strategy require more than 30 seconds of explanation, just say no. You should own several broadly diversified, low cost, tax efficient index funds. By doing so you will maximize your net invested dollars and the long-term growth of your portfolio.

Albert Einstein, no slouch when it comes to number crunching, is reported to have said that the most powerful force in the universe is compound interest. And perhaps growing rich slowly is the most unappreciated benefit of patient, disciplined, long-term investing.