On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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## A Parable

Every night after dinner, Johnny takes Fido for a walk. After leaving home, Johnny and Fido turn north and head to a schoolyard a mile away. Johnny walks at a leisurely, steady pace of 3 mph. Fido is on a long leash and has a lot of freedom to go left or right, forward or back. Fido moves in a seemingly random and unpredictable manner. A team of renowned scientists have been given the task of developing a mathematical equation that can predict Fido's movements. After months of daily observations, they admit that they are unable to predict Fido's movements with an accuracy greater than random guessing. While concentrating on Fido's every move, the observers have failed to see the big picture. Fido is traveling north at 3 mph and will arrive at the schoolyard in exactly 20 minutes. Fido's erratic movements cannot overcome his leash and Johnny's steady pace.

- Johnny – the US economy, growing at a real (inflation adjusted) long-term rate of about 3% per year.
- Fido – the US stock market. Unpredictable in its short-term movements yet moving forward at a long-term real growth rate of about 3% per year. Add 3% for inflation and the historical dividend yield of about 4% and you get the S&P 500's 10% annualized return over the last 90+ years. Dividends have declined to a level of just under 2% today and real economic growth has hovered between 2% and 3%. The Federal Reserve is targeting a 2% rate of inflation in the years ahead. You can do the math. To expect large company domestic stocks to return more than about 7% – let's say between 6% and 8% - in the years ahead is to be more optimistic than what the current data is leading us to believe.
- The leash – The inevitable reality that the stock market's long-term return will be determined primarily by inflation, the growth in corporate earnings and dividends.
- The scientists – market timers, active money managers and investment gurus who attempt to predict short term market movements. Wealth and stardom are the rewards for any fund manager who can "beat the market" and consistently outperform a comparable index fund. Proponents of active management point to recently outperforming active funds as evidence that active managers provide value. But this proves nothing because there must be top decile (10%) funds in every time period. To provide value, a fund must outperform year after year. The historical record reveals that few funds have been able to do so.

Most studies compare the performance of active funds against their benchmark index – which has no fees or expenses. Morningstar's Active/Passive Barometer solves this problem by comparing the performance of actively managed mutual funds to the performance of the average index fund in its asset class. In its mid-year 2020 Barometer report, Morningstar noted, *"The coronavirus sell-off and subsequent rebound tested the narrative that active funds are generally better able to navigate market volatility than their index peers. Active funds' performance through the first half of 2020 shows that there's little merit to this notion. Across all 20 categories we examined, 51% of active funds both survived and outperformed their average index peer during the first half of the year...In general, actively managed funds have failed to survive and beat their benchmarks, especially over longer time horizons; only 24% of active funds topped the average of their passive rivals over the 10-year period ended June 2020."*

Morningstar's methodology favors active funds because it compares an active fund's performance to the average performance of all index funds in its asset class, not the largest index funds which typically have lower fees and higher returns. Investors seem to be getting the message. For the 12 months ending Sept 30, index mutual funds and ETFs reported net inflows totaling $385 billion, compared to net outflows totaling $258 billion for actively managed funds. The fact that most actively managed stock funds have failed to outperform a comparable index fund provides strong evidence that capital markets do a good job of pricing securities.

## Stop Worrying

My grandmother was a worrier. When I started taking flying lessons, it just about put her over the edge. Her advice to me was to fly low. To her way of thinking, if you had to fly, it was safer to be closer to the earth. When she was about 90, I asked her, "Did it ever do any good to worry?" "No" she said. I would love to be able to say that I have followed my grandmother's advice in the intervening 30 years, but it would be a lie. And if you're like me, you worry mostly about things over which you have no control. Here are just a few worrisome topics that we've been pondering in 2020 that are beyond our control – a contested election, Covid-19, a vaccine for Covid-19, low interest rates, budget deficits, the Federal debt, unemployment, judicial appointments, riots, racial tensions, wildfires, hurricanes, political scandals and how to open up schools and the economy. And that's a list for just the last month. Let's take Grandma's advice and stop worrying about things we cannot control. Instead, let's look at six things important to your future prosperity over which you have complete control.

• Your financial plan. Without a plan, designed for your goals, time horizon and risk tolerance, it will be difficult to attain financial independence – which I define as being able to afford to do what you want, when you want, with whom you want, for as long as you want. A financial plan should include an analysis of your investments, insurance coverage, employee benefits, funding for major expenses, estate planning and taxes. Most people will find it necessary to seek professional help to do the job properly. There is no perfect financial plan because unexpected economic and geopolitical events are permanent features of the future. As John Bogle, the founder of Vanguard Group said, *"The greatest enemy of a good plan is the dream of a perfect plan."* The peace of mind that results from having a financial plan that you understand and can commit to is worth a multiple of its cost.

• Your asset allocation. Your financial plan should contain a proposed asset allocation that identifies the type of funds that belong in your portfolio and in what proportion. Grandma knew that you shouldn't put all your eggs in one basket. In investment-speak we say that your portfolio should consist of diversified, "non-correlated" assets. In other words, assets that do not move up and down in lock step with one another. When some assets in your portfolio are declining, others will be rising. If you do not know how to create this type of portfolio, or don't want to dedicate the time and energy learning how to do it, find a financial planner who can help you.

• How much you save every year. Your most important task in a world of disappearing pensions and uncertain Social Security benefits is to maximize your savings. The adage of saving 10% of income is probably obsolete, a relic of a prior world in which corporations provided defined benefit pensions. Today, Social Security and portfolio withdrawals are the primary sources of income for most retirees. How much you save and invest today will determine your retirement lifestyle. For most workers, a 401(k) or 403(b) salary deferral plan is the centerpiece of their retirement portfolio. Funding these plans to the maximum extent possible is essential.

• The cost you pay to access financial markets. You should understand the fees and costs associated with your investments. Fortunately, you can create a diversified portfolio of index funds at little or no cost with annual expense ratios approaching 0%.

• Your emotional response to the daily market noise. Once a well-designed financial plan is in place, you'll be goal focused, not market focused and the market's daily volatility becomes insignificant noise. Let your friends and neighbors fixate on the red and green numbers each day on their stock market app. During your annual review, your financial advisor will let you know if you have achieved your annual growth target in the past year and if you're still on course to achieving your long-term financial goals. If your financial plan reveals that a 6% average annualized return will allow you to achieve your financial goals, then any year in which your portfolio rises 6% is a great year.

• Tax planning. Worrying about how Congress will tinker with the tax code is a waste of time. However, you should take advantage of available options to reduce your taxes. For example, in taxable accounts, offset sales that yield capital gains with sales that produce capital losses, which can also be used to offset up to $3,000 in ordinary income. You can make a tax-deductible contribution up to $6,000 into a traditional IRA; $7,000 if you are 50 or older. Non-working spouses can make deductible IRA contributions if adjusted gross income is less than $196,000. If you are over 70½, you can make a tax-free Qualified Charitable Distribution of up to $100,000 from your IRA to a charity.

Stop worrying. The U.S. is the world's largest economy; it has the deepest and most transparent capital markets, and innovation isn't going to end anytime soon. We will face challenges in the days and years ahead, just like always. But we are resilient and will continue to make most of today's worries mere notches on a timeline of things long forgotten.

## Ponzi Centennial

*The Securities Exchange Company, for and in consideration of the sum of exactly $1,000 of which receipt is hereby acknowledged, agree to pay to the order of ___________, upon presentation of this voucher at ninety days from date, the sum of exactly $1,500 at the company's office, 27 School Street, Room 227, or at any bank.*

*The Securities Exchange Company, Per Charles Ponzi*

In the Italian section of Boston, the almost penniless Charles Ponzi established The Securities Exchange Company for the purpose of trading postal reply coupons. As shown above, he promised his investors a 50% return in 90 days. Postal reply coupons were used to facilitate sending mail between countries whereby the sender could prepay return postage in the country of origin. Ponzi claimed that because of currency devaluations in Europe after World War I, he could buy these coupons for a penny in Europe and exchange them in the US for four cents worth of US postage stamps. He accused banks of making similar profits but only returning 5% to depositors and keeping the rest for themselves. There is nothing like a little class envy to sucker people into a scam.

In May 1920, he opened an account with the Hanover Trust Co. -- the bank which was to become the financial hub and willing accomplice of his scheme. He used investors' money to purchase almost 40% of the bank's common stock. Bank officers knew that he was not buying postal reply coupons and that current investors were being paid from the deposits of new investors. By mid-summer of 1920, news of investors' 50% return spread like wildfire. Ponzi's operation expanded throughout New England, New York and New Jersey. By July of 1920 it is estimated that he was receiving new deposits of $1 million per week, equivalent to $12.9 million today. In less than a year he went from being a penniless immigrant to a wealthy man who lived in a mansion on banker's row. Crowds followed him wherever he went, proclaiming him "the greatest Italian of them all." In all modesty, Ponzi is reported to have admitted to being only in third place -- behind Columbus and Marconi.

Government officials were suspicious of Ponzi's activities because the aggregate postal coupon volume did not support the size of his purported activity. But there was no evidence of illegality since all investors had been fully paid in a timely manner. The Massachusetts district attorney met with Ponzi to discuss his business. Surprisingly, Ponzi agreed to stop accepting new deposits starting on Monday, July 26 until an auditor could verify the soundness of his operation.


When news of the audit was announced, frightened investors rushed to withdraw their money. Ponzi set up a temporary office in Boston's Bell in Hand Tavern – the oldest tavern in America - where, over the next four days, he refunded the money of all investors who wanted out. Investors were paid in full - an estimated $2 million - $25.8 million in 2020 dollars. The next week a Boston newspaper published an article in which a former employee claimed that Ponzi was insolvent and that his assets were insufficient to cover claims. A second run of redemptions began. Ponzi assured investors that "Mountains of money are available to pay all claims." He continued to pay claims with no apparent difficulty. Public opinion was shifting towards Ponzi and away from his critics and inquiries from prospective investors continued to pour in. But behind the scenes he used fictitious names to borrow $255,000 from the Hanover Trust Co. to cover the second round of redemptions.

Eventually, bank examiners brought Ponzi down. By August 7, he had just over $13,000 on deposit at the Hanover Trust Co. They insisted that the bank stop honoring Ponzi's checks if his account became overdrawn. Three days later the account was overdrawn by more than $400,000 and the bank was seized by state regulators. On August 12,1920, Ponzi was arrested and charged with mail fraud. Initially, he claimed that he had millions of dollars in overseas assets and would be able to pay off all creditors. But two weeks later he admitted that he was bankrupt. Although the total extent of the fraud will never be known, it is estimated that Ponzi had taken in more than $10 million and paid out just under $8 million. Ponzi's scheme was so notorious that his name has become associated with this type of swindle - in which interest paid to initial investors comes from the capital provided by new investors.

A century after Ponzi, people are still being conned by schemes offering "safe" returns greater than what bank CDs and high-quality bonds are offering. Beam Financial was launched in 2019 promoting itself as the "first mobile high interest bank account". Its ads on Facebook and Instagram promised savers a minimum annual percentage yield of 1.7% with 24/7 access to their money and no monthly withdrawal limits. By inviting friends to open accounts via the Beam app, investors could earn a base rate of 4% and temporarily boost their annual percentage rate up to 7% for one day. Beam never explained how it can offer interest rates so much higher than what traditional banks offer. Beam promised savers that their money was FDIC insured through banks listed on its website. CNBC contacted all the banks listed on the site. The 17 that responded said that they had no partnership or relationship with Beam. Beam is not a bank and FDIC insurance insures depositors against bank failure, not investment fraud. This year, customers have complained about encountering delays or an inability to access their funds, the app has stopped working and they can't reach anyone at the company by phone. To find their money, customers need to know the name of the bank and under whose name their funds have been deposited – information that is not provided by Beam. Beam has told customers that the fund transfer delays are due to its bank partners limiting daily withdrawals, problems with its app provider, technical errors and, of course, Covid-19. Huntington Bank, the only bank known to be working with Beam, has said it is not currently in possession of any Beam funds nor has it withheld any funds. The Federal Trade Commission has opened an investigation to see "*whether Beam has engaged in deceptive or unfair practices related to its financial products or services, including the accessibility of consumer funds, the advertised rates of return and interest, and the functionality of the company's mobile apps."*

A century after Ponzi, people still invest their hard-earned dollars in investments they don't understand, with promised returns too good to be true, on the advice of people they barely know, while hoping that they won't be cheated.