On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Looking Back

My biggest complaints about the financial media are its obsession with short-term market performance and its relentlessly negative outlook. If you want to get media attention, put on a serious face, use lots of numbers and ooze pessimism. Scare readers and viewers with impending doom and they'll hang on every word. But history reveals that it's better to be optimistic than pessimistic during times when most investors are scared to death.

There have been many articles and reports in the financial media this past month noting the tenth anniversary of the collapse of Lehman Brothers, an event that sent shockwaves throughout the global economy. Let's look back at the October 13, 2008 cover of *Time*. Fear boosts circulation and this *Time* magazine cover was as frightening as they come. If standing in a soup line isn't unpleasant enough, how about standing in a soup line in the rain in a black and white world? I will leave it to others to decide if the editors of *Time* had the upcoming Presidential election in mind when deciding what picture to put on the cover. Those intrepid souls who delved further into this issue of *Time* were treated to these New Hard Times articles -

- The End of Prosperity
- Surviving the Wall Street Storm

In October 2008 we were in the midst of a bear market that would get worse over the next five months. Six of the ten largest US bankruptcies, including the largest – Lehman Brothers – occurred in 2008 and 2009. Like all previous bear markets, it appeared to be the result of new and unforeseen events and the financial media predictably proclaimed that "This time it's different...an entirely new threat that we have never seen before...one that is beyond the control of mortal man!" The world has changed a lot in the past decade, but one thing that hasn't changed is catastrophic journalism.

Every bear market is the product of unique circumstances, but all bear markets are essentially the same. In the long run, stock prices respond to the growth of the economy and corporate profitability. During bear markets, many investors fear that the long-term upward trend in stock prices has come to an end; leading to counterproductive, emotional investment decisions. Earlier this month, the S&P 500 Index set a new all-time high, essentially making every bear market in history a mere temporary interruption in the long-term trend of rising stock prices.

Market prices reflect the consensus opinion of investment professionals, most of whom subscribe to a market timing/stock selection philosophy. They employ strategies focused on taking advantage of short-term price fluctuations that, although they'll never admit it, are impossible to predict or control. So, trading algorithms, rather than long term planning, cause most of the stock market's day to day swings.

During bull markets, investors are optimistic and are willing to pay high prices for stocks. The market rises, creating returns greater than long-term averages. Soon thereafter, investors' caution and risk aversion diminish. Stocks are purchased, not because of their intrinsic value, but because they have been going up in price. Rising price means lower value, but this is a sermon preached to empty pews. It seems so easy - buy today and sell tomorrow at a profit. This is what we saw in the US stock market in early 2000, emerging market stocks in 2007, the commodities market in 2008 and in the bitcoin mania last year. As bull market euphoria peaks, many investors - transfixed by rising prices – borrow money to leverage their upside potential because, as anyone can see, "This time it's different!

But it's never different. Prices eventually plateau and begin declining. Leveraged investors get nervous and are the first to sell. Prices continue to decline as more investors, attempting to lock in their gains, jump on the selling bandwagon. Investors begin to panic and their risk tolerance changes from high to non-existent. Lenders refuse to offer credit even to credit-worthy borrowers. The fear of continued losses leads to more selling and when the decline reaches 20%, a new bear market is born. During bear markets investors realize that they are not nearly as risk tolerant as they thought they were, and they develop a new fear of stocks that is magnified by magazine covers and 24/7 cable news. And the reason behind their newly developed loathing for stocks is always the same - "The world is ending because this time it's different!"

Eventually, the consensus opinion of institutional investors changes from "prices are too high" to "prices are too low" and they begin buying stocks. Historically, as we have experienced in the past decade, the losses in bear markets have been more than overcome in the ensuing economic expansion. Eventually time passes, and a new bull market is born – accompanied by new investment fads - and the cycle continues.

The most important lesson of the past decade is that our emotions cannot be depended upon to give clear direction in stressful times. Economically, we've recovered from the financial crisis and the major domestic stock market indexes have reached new all-time highs. But the rebound didn't help investors who fled the stock market and are still hiding in the "safety" of cash. A Fidelity study of 401(k) participants noted that 25% of plan participants who sold to cash in the last quarter of 2008 or the first quarter of 2009 were still sitting in cash at the end of 2015. In a survey last year of more than 1,000 adults by Hartford Funds, 42% said that they now avoid the stock market. Many of these folks will likely one day discover that they cannot afford to retire. The same month this issue of *Time* magazine hit the newsstands, Warren Buffett wrote this in an op-ed piece in the *New York Times* –

"I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So, if you wait for the robins, spring will be over…. Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: "I skate to where the puck is going to be, not to where it has been."

Unfortunately, many investors ignored Buffett's well publicized advice. I maintain that you cannot be a successful investor if you are afraid of the future. Fleeing to cash during a bear market may bring short-term comfort but selling during bear markets has not been a winning strategy. All investors need a goal focused, long-term perspective anchored by a prudent written financial plan. Absent a plan, most investors find it almost impossible to stay the course during bear markets. Your plan must be a function of your investment time horizon (probably longer than you think), risk tolerance (probably less than you think) and financial goals. The most reliable asset for wealth accumulation has been a diversified portfolio of domestic and international stocks bought and held for the long term.

Two things are guaranteed to accompany all bear markets. Investors will fall prey to "recency bias" and assume that the stock market's decline will continue indefinitely. And media commentators who failed to predict the bear market will offer no apologies and forecast what will happen next with great conviction. For the past ten years, economic, financial and geopolitical crisis have plagued the global economy at irregular intervals. These real and imagined crises have been so numerous that I've forgotten most of them by now and I'm sure you have also. Yet, since *Time's* October 13, 2008 issue hit the newsstands, the Vanguard Total Stock Market ETF (VTI) has yielded an annualized average return of just over 12% through the first of October. Long term reward has come to those who were able to stick with their plan, stay invested and keep their focus on ten years down the road, not ten days down the road.

Creative Destruction and Individual Stocks

Stock owners assume two types of risk – market risk (often called compensated risk), which is the risk of the stock market in general and individual company risk (often called uncompensated risk), which is risk that is unique to a company but not to the market as a whole. For example, a rainy summer would enhance the prospects of a company that makes umbrellas but be detrimental to a company that sells suntan lotion. Since the stock market contains both companies, it is free from "weather risk".

All stock investors must accept market risk - it cannot be eliminated by diversification. Stocks go up and down in response to economic events, often in a volatile manner. Investors who own individual stocks take on the additional risks unique to the companies in their portfolio. They don't understand that an efficient market won't compensate them for taking additional risk that can be easily eliminated by diversification.

The market's average annual return is not equally divided among all stocks. Each year, more stocks underperform the market's average return than outperform it. This makes stock picking a loser's game from a purely mathematical standpoint. For you calculator heads out there, I'll explain why. The rest of you can skip the following paragraph.

Let's imagine a year in which the mean average return of all stocks is 10%. If the dispersion of the annual returns was normally distributed, it would resemble a bell curve. The mean average return and median average return would both be 10%. Half of the stocks would return more than 10% and half would return less than 10%. But stock market returns are not normally distributed because every stock has an unlimited upside, but its downside is limited to 100%. Each year, a few big winners cause the mean average return to be greater than the median average return. Consequently, more than half of the stocks in any stock market index underperform the return of the index each year.

A recent analysis by J.P. Morgan noted that 320 of the 500 largest, most successful US-based companies that made up the S&P 500 Index in 1980, have since been removed from the index because they went bankrupt or suffered substantial declines in their market value and no longer qualified for inclusion in the index. The report noted –

"*the pace of distressed based deletions rises during a market crisis or recession, but there is a steady pulse of business failure during the entire business cycle.*"

The J.P. Morgan study also analyzed stocks that were members of the Russell 3000 Index, which includes small and mid-cap stocks that are not included in the S&P 500 Index. The Russell 3000 Index measures the performance of the largest 3000 domestic companies and represents 98% of the investable domestic stock market. It is reconstituted annually to ensure that new companies are added and is considered to be a total stock market index.

The report noted that 40% of the 13,000 stocks that were in the Russell 3000 Index between 1980 and 2014 suffered a "catastrophic loss"; defined as a stock price decline of 70% or more from its peak with little or no recovery. This is a subjective definition and many investors would consider smaller permanent declines as catastrophic.

Investors own individual stocks primarily because they expect them to outperform the market. As such, they are naïvely overconfident, believing that they possess insight about a company's prospects that are hidden from other market participants. But owning individual stocks is speculating, not investing, because it increases portfolio risk while offering no legitimate expectation of higher than market returns. The J.P Morgan study of the performance of stocks in the Russell 3000 Index from 1980 through the end of 2014 reveals that –

- 40% of all stocks produced a negative return during their years in the index.
- Two out of three stocks underperformed the index during the years they were included in the Russell 3000.
- Only 7% of all stocks, the "extreme winners", were responsible for most of the long-term gain in the index.

Over the long run, a minority of stocks are responsible for a disproportionate amount of the total return of the stock market. Companies such as Apple, Microsoft, Starbucks, Walt Disney, Southwest Airlines and Walmart. Yet there is a long list of companies that were once at the top of their industry, household names, that suffered a catastrophic loss or destroyed shareholder value in bankruptcy court. Companies such as RadioShack, Blockbuster, Goodyear Tire, Zenith Electronics Corporation, Subaru of America, Callaway Golf, XM Satellite Radio, Macy's, Polaroid, Barnes & Noble, Sears and United Airlines. The odds that you, or anyone you know, or anyone who is advising you can successfully identify one of tomorrow's extreme winners and avoid tomorrow's losers are so low that it would be foolish to try. To quote Burton Malkiel, from his classic investment book, *A Random Walk Down Wall Street -*

"No one can consistently predict either the direction of the stock market or the relative attractiveness of individual stocks, and thus no one can consistently obtain better overall returns than the market. And while there are undoubtedly profitable trading opportunities that occasionally appear, these are quickly wiped out once they become known. No one person or institution has yet to produce a long-term, consistent record of finding money making, risk-adjusted individual stock trading opportunities, particularly if they pay taxes and incur transaction costs."

Capital markets are efficient. That doesn't mean that stocks are always perfectly priced, it simply means that market prices are the best estimate of a stock's value. Future stock prices are unpredictable because the next piece of news about a company has an equal chance of being better or worse than expected. Most of the price change in response to any new information about a stock is realized in the first trade after the news is announced. By the time you hear the news, it's too late to profit from it.

Too many financial advisors believe they, or their firm's research team, possess an ability to identify mispriced securities. They believe they are helping their clients by making sensible, educated stock recommendations. But in efficient markets, educated recommendations are no different than speculative guesses. In most cases they result in higher costs to investors while inevitably producing market trailing performance. Motion masquerading as action is more profitable for the providers of investment advice than for the recipients of that advice.