On Course Financial Planning

Facing the Future with Optimism and Courage

September 2019 Vectors

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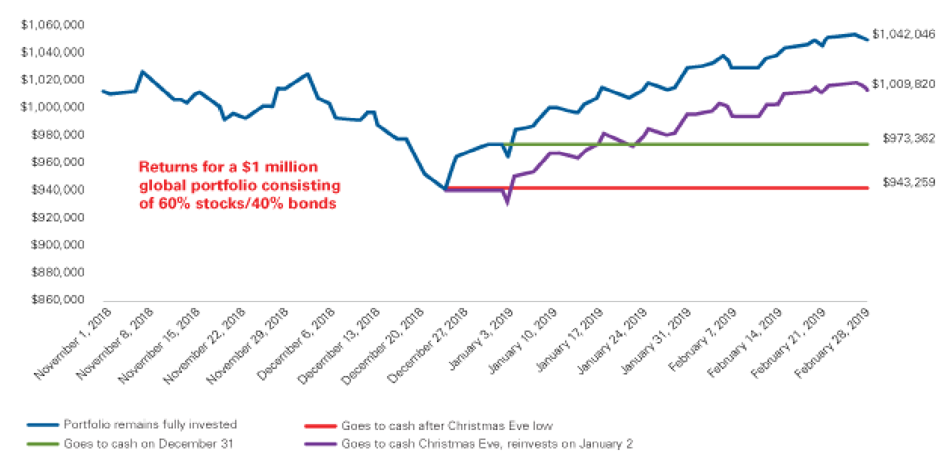
Staying the Course

Your portfolio needs time to grow and all long-term investors must get used to periods of uncomfortable volatility. Vanguard has issued a report showing how a hypothetical 60% stock/40% bond portfolio that stood at $1 million on November 1, 2018 would have varied in value by the end of February 2019 under four different scenarios. The portfolio would have declined 5.7%, to $943,000, by Christmas Eve – the low point of last year's fourth quarter market decline. Had our fictional investor fled to cash, even briefly, it would have cost tens of thousands of dollars over the next two months versus just staying invested and ignoring the noise.



In this chart, the blue line represents the performance of the portfolio if an investor remained fully invested from November 1, 2018 through February 28, 2019. Despite the decline in November and December, the portfolio would have grown to $1,042,046 by the end of February - a 10.5% gain in just over two months. The purple line shows the performance of the portfolio had the investor sold out to cash on Christmas Eve, and reinvested to the 60/40 allocation on the first trading day of 2019. Missing just four trading days led to a $32,000 shortfall. The green line shows the performance of the portfolio had the investor cashed out on December 31st and remained in cash through February. The red line shows the performance of the portfolio for an investor who panicked at the bottom and remained on the sidelines – a counterproductive decision that cost almost $100,000. If the red line investor reinvested to the 60/40 portfolio on March 1st and we assume an annualized average return of 6%, his portfolio will be worth $240,000 less than the blue line investor's portfolio 15 years from now.

Every bout of market volatility causes widespread investor anxiety. Whenever stocks fall more than just a little, you can be sure that glum voices in the financial media will shout that they're about to fall a lot more. But this rarely happens. For long-term investors, emotional reactions that lead to portfolio tinkering are likely to do more harm than good. There will always be something to worry about—interest rates, market valuations, political unrest, geopolitics etc. and media pundits and naysayers can be counted on to provide reasonable sounding explanations why fleeing the stock market is the smart thing to do, **right now**! I must agree with what Pascal said, *"All of humanity's problems stem from man's inability to sit quietly in a room alone."*

Volatility gets a bad rap in the financial media. It's always portrayed as a villain; a synonym for a sharp downward movement in stock prices that causes investors to lose money. The unspoken assumption is that lower volatility is preferable to higher volatility. But volatility is not a one-way street, it's a measure of the rate at which stock prices rise or fall over a short time period when compared to long-term averages. Correctly understood, it isn't a synonym for price declines. In the example provided by Vanguard, volatility was high from November through February.

From 1979 through 2018, the largest intrayear decline in the Russell 3000 total stock market index has averaged about 14%. Yet in 33 of those 40 years, the index yielded a positive return. A substantial portion of the long-term return of stocks comes from just a handful of days; none of which can be known in advance. Just as in the four months of the Vanguard analysis, the best days in the market have often been close to some of the worst days in the market. The only way for the panicked red line investor to catch up to the buy-and-hold blue line investor is to dramatically increase his portfolio's stock allocation – a strategy that is likely to be emotionally untenable. Negative events, both foreseen and unforeseen, occur with a high degree of regularity and most of the time the correct response to the latest financial news, whether good or bad, is to ignore the noise and stay invested.

Investors are often told to maintain a long-term focus because the longer the holding period, the more likely it has been that you'd receive a positive return in the stock market. But exactly how is this done? To my way of thinking, it doesn't mean buy and hold forever. It means having a plan and sticking to it; a plan that doesn't change based upon what's happening today, this week, this month or this year in the economy or the stock market. A good financial plan evolves as a client's goals change or are achieved; which may provide a good reason to make portfolio changes. Put no faith in forecasts and remember that periodic rebalancing is an essential part of long-term investing.

The Persistence Scorecard

The disclaimer *"past performance is no guarantee of future returns"* appears in mutual fund ads to warn investors that the advertised past performance is unlikely to continue. Unfortunately, despite this well-known disclaimer, I doubt that past performance will ever lose its place as the predominant factor that investors consider when selecting mutual funds.

Twice each year, Standard & Poor's publishes the S&P Persistence Scorecard which tracks the performance of top ranked actively managed mutual funds over consecutive multiyear periods. The latest scorecard, published in July, analyzed the subsequent performance of the 996 domestic stock mutual funds that produced top-half performance for the five years ending March 2014. Random chance leads us to believe that 50% (498) of the funds would remain top-half performers for the next five years. Yet S&P reported that only 38% (380) managed to retain top-half status.

The Persistence Scorecard also tracked top quartile (top 25%) funds for the five years ending in March 2014. One might assume that the 498 funds that produced this level of peer outperformance are under the guidance of skilled managers. We would expect 25% of these funds (124) to remain in the top 25% for the next five years by random chance alone. Yet only 16% (80) were able to do so. Even more disheartening for proponents of active management is that more than half of all top quartile funds became bottom half funds over the next five years with 32% moving to the bottom quartile. As noted by S&P: *"This suggests that market participants may wish to be careful when using past performance as a guide for future results."* Additionally, to the dismay of successful fund managers, their stock picking strategy will soon be adopted by competing funds, thus eliminating any edge they may have once had.

It appears that there is an aspect of past performance that can provide a warning about future returns. Those funds that rank in the bottom quartile tend to remain poor performers in subsequent time periods. Of the 498 funds ranked in the bottom 25% in five-year performance as of March 2014, 132 (27%) were liquidated or merged into better performing funds by March 2019; forever erasing their pitiful performance from the record book. Another 75 (15%) managed to survive and stayed mired in the bottom quartile.

In investment speak we say that the stock market is "efficient". By this we mean that a stock's price reflects all available information about a company and will adjust instantly to new information. I love the frantic trading of active managers. The more they trade in response to every market hiccup, every squiggle in their favorite chart, every piece of corporate news, and every Trump tweet, the more "efficient" the stock market becomes. There is an ongoing debate about stock market efficiency. If the stock market is 100% efficient, it would be impossible for any fund manager to consistently outperform his benchmark index. Proponents of active management insist that there is enough pricing inefficiency in the stock market to enable active managers to find and profit from mispriced securities. But if, as the Persistence Scorecard reveals, the number of repeat winners is less than what we would expect from random chance, it is hard to argue that the stock market's inefficiency is large enough to be exploited by skilled fund managers.

Passive, index investors believe that even if the stock market is not 100% efficient, the current price of any stock represents the collective wisdom of all investors -- a pricing mechanism that's hard to beat. We never seek to buy undervalued stocks or sell overpriced stocks. We are content to take advantage of the market's pricing efficiency and buy or sell at current prices. The costs of creating an efficient market are borne by investors who pay for active management. On behalf of all passive, index investors I offer active investors a heartfelt thank you!

The S&P Persistence Scorecard provides a periodic reminder of how difficult it is for top performing managers to repeat their success in subsequent years. Rather than looking for outperforming funds, investors should focus on identifying a proper long-term asset allocation for their portfolio. Owning a globally diversified, low cost, low turnover portfolio of index funds will maximize your share of the stock market's return and eliminate the risk of manager underperformance.

Despite all the evidence that chasing past performance is a losing strategy; investors and (sadly) many financial advisors continue to use past performance as their primary screening filter when selecting mutual funds. By doing so they combine two losing strategies -- active management and performance chasing -- and hope for the best. Good luck to them all.

In the News

It doesn't seem that long ago that you could get a 5-year CD paying 5% interest at any bank in the USA. Today, the rate is about 2.5%. With the Federal Reserve doing everything it can to debase our currency at the rate of 2% per year, the post-tax, post-inflation return of a 2.5% 5-year CD is likely to be negative. But this is nothing new. Some of us can remember 1-year CDs paying 12% in the late 1970s. But few remember that inflation hit 13% in 1979.

In some developed nations in Europe and Asia, savers are experiencing "negative" interest rates. Currently, 10-year bonds issued by Switzerland, Denmark, France, Japan and Germany offer below zero yields and at the end of August, the global volume of negative-yielding debt exceeded $17 trillion, according to Bloomberg. European Central Bank officials say that below-zero interest rates provide important support for Europe's economy, despite complaints from banks in Germany and France that the negative rates are causing harm.

How can a bond have an interest rate less than zero? Ordinarily, investors purchase a zero-coupon government bond at a discount to its par value and receive no interest payments. Upon maturity the government pays the bond's par value, netting a small gain for the investor. This gain, when annualized, yields the interest rate paid by the bond. Today, Germany might issue a 10-year zero-coupon bond with a par value of €10,000. But the bond is priced at 106.8, meaning that it costs €10,680 to buy the bond. At maturity, the German government pays the investor €10,000. Essentially, German bond investors are paying the government to hold their cash. It's a great deal for the German government but it makes little sense for the investor who will lose €680 (a 0.66% annualized loss) on the deal. The only way the investor will come out ahead is if Germany experiences deflation in the upcoming decade; making the purchasing power of €10,000 greater ten years from now than it is today. Highly unlikely, IMHO.

Several factors are contributing to the below-zero yields. Investor concerns about slowing global growth and the trade conflict with China have increased demand for government bonds around the world, causing yields to decline. Economic growth and inflation have been substandard in Europe for the past decade and there are concerns that Europe may be headed toward another recession. The European Central Bank has been much more accommodative than the Federal Reserve and cut its key interest rate by 0.1%, (to -0.5%) on Sept. 12th. Globally, there's too much nervous cash with nowhere to go and it's finding a home in investment grade government bonds.

Below-zero yields in other countries have led foreign investors to seek positive returns in US Treasury securities. Since yields and bond prices move in opposite directions, an influx of foreign cash pushes up U.S. bond prices which lowers yields. This is one reason why the yield on the 30-year Treasury bond fell to a record low of 1.94% and the benchmark 10-year Treasury note had a yield of less than 1.5% late in August. In recent months, short-term Treasury securities have been paying higher interest than long-term bonds, creating what's known as an inverted yield curve. An inverted yield curve is not the same as a negative interest rate. An inverted yield curve is often seen as a precursor to a recession but there's an ongoing debate whether today's inverted yield curve is predicting a recession.

Today's low interest rates are bad for savers and have caused many retirees to worry about how they will be able to generate the income they need. But these low rates are good for companies with investment-grade credit ratings. On September 3rd, 21 domestic corporations that possess an investment grade credit rating issued bonds totaling about $27 billion. Most of the proceeds from these bond sales are being used to refinance existing debt with lower yielding bonds – a corporate version of home mortgage refinancing.

So, what should investors do in today's low interest rate environment? One option is to buy investment grade corporate bonds which provide a relatively safe alternative to Treasury securities and pay a slightly higher interest rate. Most importantly, investors should focus on what they can control and not worry about what might happen next with interest rates or if today's inverted yield curve is precursor of recession. Continue funding your portfolio, which should be designed with your time horizon, risk tolerance and financial goals in mind.

On April 9th, Dick Cole died in San Antonio Texas at the age of 103. He was the last surviving Doolittle raider. On the morning of April 18, 1942, he was Jimmy Doolittle's copilot and their B-25 bomber was the first to takeoff from the deck of the aircraft carrier USS Hornet. Doolittle took off first, to ensure that it could be done since he had the shortest deck run and most dangerous takeoff. After bombing their target in Japan, Doolittle, Cole and their three fellow crew members bailed out at 9,000 feet at night in rain and fog when their B-25 ran out of fuel soon after entering Chinese airspace. They eventually found each other and were rescued by Chinese Nationalist soldiers. Dick Cole, RIP.