On Course Financial Planning
Facing the Future with Optimism and Courage
August 2024
Vectors
geo@oncoursefp.com
425-861-9997

News From the Mutual Fund World

In all mutual fund advertising, the disclaimer "past performance is no guarantee of future returns" is a mandated warning to investors that the advertised performance is unlikely to continue. Standard & Poor's publishes the *S&P Persistence Scorecard* twice a year which tracks the consistency of top performing mutual funds over consecutive multiyear periods. The latest scorecard, published in June, noted "*As readers of our SPIVA Scorecards know, active management is challenging. But identifying outstanding managers can be equally, if not more, challenging.*"

The latest Persistence Scorecard analyzes the subsequent performance of the 529 actively managed domestic stock mutual funds that were top quartile (top 25%) performers in their asset class in 2019. In 2020, 300 of the funds remained top quartile performers. Only 15 remained top quartile performers in both 2020 and 2021 and none remained top quartile performers in each of the years 2020, 2021 and 2022. By random chance alone, eight should have been able to do so.

Perhaps more disappointing for proponents of active management is the fact that among the 1060 domestic stock funds that produced top half performance in their asset class in 2019, only 42 were able to maintain top half performance in 2020, 2021 and 2022. By random chance alone, 132 should have been able to do so. If the number of winners is less than what we would expect from random chance, there is no reason to believe that the winners did so through skill rather than luck. The semiannual publication of the *S&P Persistence Scorecard* provides a periodic reminder of just how difficult it is for top performing managers to repeat their success in subsequent years.

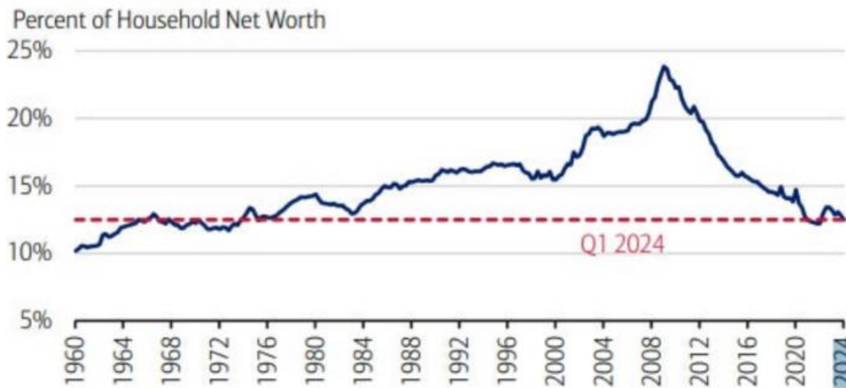
Dr. Hendrik Bessembinder is a professor at Arizona State University, and he recently published a report that analyzed the long-term returns of all 29,078 publicly listed common stocks from December 1925 to December 2023. The majority (51.6%) had negative returns over their lifetime. The median stock (half performed better, half performed worse) yielded a cumulative loss of 7.4%. The performance of the domestic stock market since 1926 was driven by relatively few stocks. Seventeen stocks delivered cumulative returns greater than five million percent ($50,000 per dollar initially invested), with the highest cumulative return of 265 million percent ($2.65 million per dollar initially invested) accruing to very long-term investors in Altria Group (formerly known as Phillip Morris). The annualized compound return of these 17 top performers averaged less than one might expect, 13.5%, thereby reinforcing the importance of having a long-term perspective.

This report helps explain why most active funds, which typically have concentrated, non-diversified portfolios, so often underperform index funds. Bessembinder noted – *"The results here focus attention on the fact that poorly diversified portfolios may underperform because they omit the relatively few stocks that generate large positive returns."*

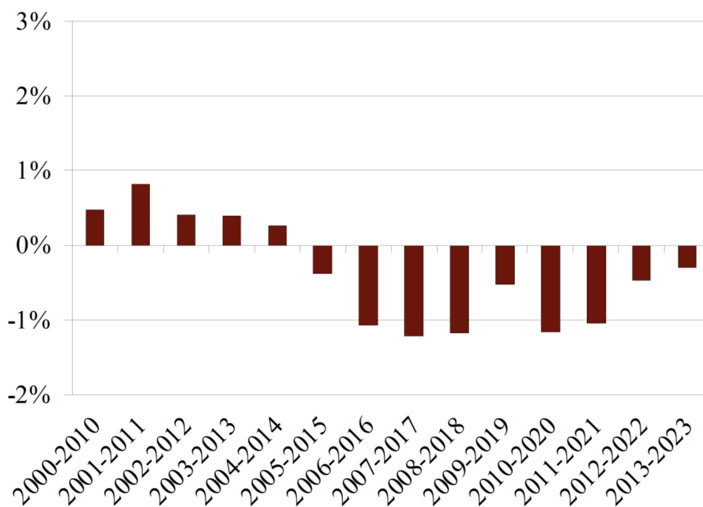
According to First Trust, index mutual funds and ETFs saw inflows of $652 billion compared to outflows of $358 billion for active funds over the trailing 12-month period ended June 30, 2024. The significant growth of passive investing in recent years has led to claims that the ongoing flow of money into index funds is behind the large share price increases of the so-called "Magnificent Seven" stocks (Apple, Microsoft, Alphabet (Google's parent company), Amazon, Meta Platforms (formerly Facebook), Tesla and Nvidia). But index funds have no impact on the relative demand for stocks. Index funds are "price takers," not "price setters." Money coming into index funds does not drive some stocks higher relative to other stocks in the index. Although larger companies have a higher dollar allocation than smaller companies in an index fund, the ownership fraction of each company in the fund is the same as in the index itself. Stock prices change due to the buying and selling of active investors, not index funds. Despite their growing popularity, index mutual

funds and ETFs held only 18% of the outstanding shares of U.S. stocks as of the end of 2023. The remaining 82% of shares were held by active investors of one form or another.

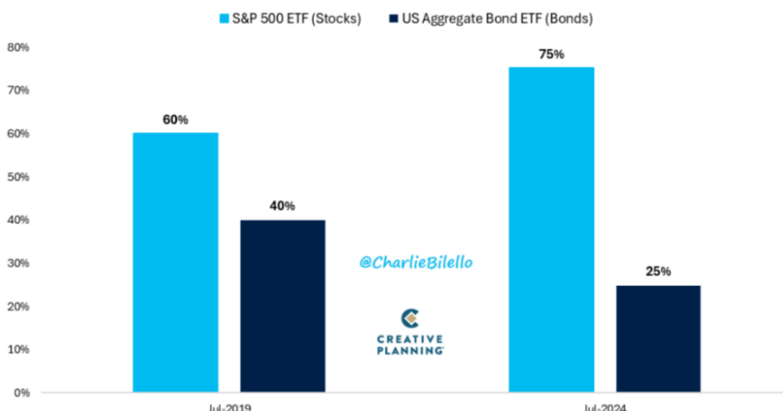
Charts and Graphs



One of my pet peeves is seeing numbers that should be presented as numerators that are presented without the denominator. A good example of the "hide the denominator" game is the apparently alarming fact that, according to JP Morgan, Americans had $20.6 trillion in debt as of 3/31/24. But this tells us nothing about our collective financial health. We need to know the denominator - that assets were $181.4 trillion. Thus, household debt as a percentage of household net worth was just about 12% - the same as it was in the year that I graduated high school. Once again, we are reminded that figures don't lie, but…….



Every financial adviser's email inbox receives numerous pitches from fund companies for alternative investments. After all, everyone knows that index funds are for amateurs, and that the "smart money" invests in alternative assets such as real estate, hedge funds, private equity, commodities, private debt, venture capital and farmland. Public pension plans have increased their allocation to alternative investments since 2000, but the results have not lived up to the promises. This chart notes the difference between the 10-year average annualized returns of pension funds and a simple 60% stock/40% bond index portfolio since 2000. Prior to the Global Financial Crisis, pension funds outperformed, but they fell short thereafter and their annualized aggregate returns since 2000 have been virtually identical to a plain vanilla, "dumb money" 60/40 index portfolio. The main reason that public plans have not netted higher long-term returns from a complex active approach is that any gains received from alternative investments have been erased by their higher costs and management fees.



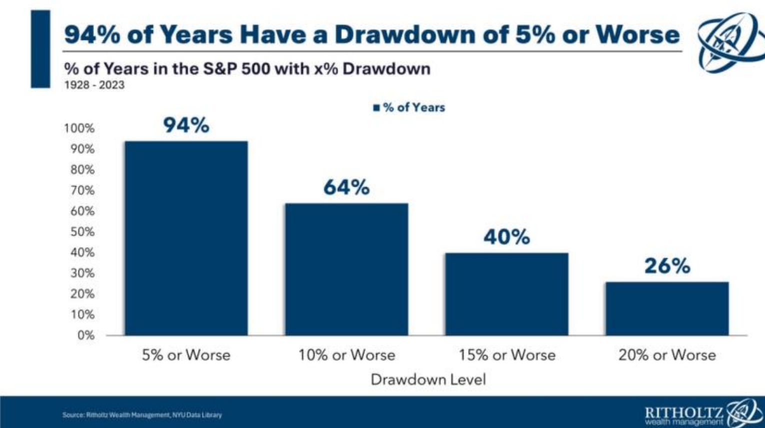
This chart shows why it is important to periodically rebalance your portfolio. In just five short years, the non-rebalanced, moderate allocation 60% stocks/40% bond portfolio morphed into a much more aggressive 75% stock/25% bond allocation. There are various opinions about how often you should rebalance. A Vanguard study several years ago concluded that it was not the frequency of rebalancing that was important, just be sure to rebalance periodically. I am a proponent of annual rebalancing. It is easy to remember and doing so more frequently increases the chances of rebalancing in reaction to short-term volatility.

In the News

July provided a splendid example of the risk of owning individual stocks. A computer system disruption swept the globe on July 19, grounding flights, stopping trains, and bringing businesses to a halt. The outage was traced to a security update made by CrowdStrike (CRWD), a cybersecurity firm that reportedly serves 29,000 customers, including nearly 300 members of the Fortune 500. The CrowdStrike update contained flaws that prevented Microsoft Windows systems from starting. The resulting "blue screens of death" disrupted businesses across the world. CRWD stock reached $391 per share after it was added to the S&P 500 in June. But the stock lost half of its value by the end of July as reports surfaced about potential legal action from Delta Air Lines, which claims that the computer outage cost the company $500 million. It is likely that more companies will sue CrowdStrike for losses resulting from the outage in the days ahead. The great benefit of a diversified portfolio is that it minimizes individual stock risk so that a unique or unforeseeable situation in a particular company or sector will not have a substantial impact on the entire portfolio. Some of your friends, neighbors, relatives, or coworkers may have made big profits by investing in individual stocks. Most will attribute their success to skill when, almost certainly, it was nothing more than luck. Successful stock picking is more difficult than most people imagine, and the odds of success are heavily stacked against you.

New York City Comptroller Brad Lander reported that New York City's five pension plans saw investment returns of 10% in the fiscal year ending June 30th, exceeding their target of 7%, thanks to a strong stock market. My Lazy Golfer Portfolio consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSAX), 20% to the Total International Stock Index Fund (VTIAX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBTLX) and 10% to the REIT Index Fund (VGSLX). It has an annual expense ratio of 0.10%. Note to Mr. Lander - the Lazy Golfer Portfolio returned 12.6% for the 12 months ending June 30th, according to Morningstar.

In December 1989, Gallup pollsters asked working adults, "Do you think the Social Security system will be able to pay you a benefit when you retire?" The poll's result was 49% Yes, 47% No, and 4% No Opinion. Not only have Social Security benefits continued unabated, but they have increased on a real (inflation adjusted) basis. Current beliefs about Social Security's future are similar, with a 2023 poll eliciting a response of 50% Yes, 47% No, and 3% No Opinion. Once again, there's nothing new under the sun.



The first week in August saw a level of stock market volatility that we haven't seen for a while. This was accompanied by a torrent of explanations and predictions from pundits in the financial media who pretend to know what the future holds. But it's important to put things in perspective. Intrayear drawdowns are a normal part of investing, and we should expect a high single digit to low double digit decline every year. Since 1980, the average intra-year decline in the S&P 500 has been -14.3%, according to JP Morgan. As this chart shows, 94% of the years since 1928 experienced a pullback of at least 5% in the S&P 500. In almost two out of three years there was a drawdown of 10% or more, two out of five years have seen drawdowns of 15% or more and one out of four years have seen drawdowns in excess of 20%. Big up and down days tend to occur close to each other, in times of high volatility. Just in this month's first seven trading days the S&P 500 returned -1.4%, -1.8%, -3.0%, +1.0%, -0.8%, +2.3% and +0.5%. A 3.0% down day and a 2.3% up day three days later. Not to be outdone, Japanese stocks fell 12% on August 8th and rose 10% the next day. This is the latest example that if you try to miss the worst days, you will likely miss the best days also. The good news is that when the S&P 500 notched its most recent all-time high on July 16th, it turned every previous drawdown into a temporary interruption in the ongoing increase in equity values. Stocks are volatile because people are emotional. The issue that troubles many investors – and ultimately hurts them – is attempting to time the market to avoid periods of unpleasant volatility. Properly constructed investment plans do not warrant an emotional reaction to perfectly normal volatility and drawdowns. John Bogle has famously said, *"The stock market is a giant distraction from the business of investing."*

Disclaimer - The information in this newsletter is educational in nature and should not be considered as personal investment, tax, or legal advice. Each reader must determine how its content should be applied to their investment portfolio. This newsletter is not a solicitation to sell investment advisory services where such an offer would not be legal. Investing in stocks and mutual funds involves risk and the potential loss of principal. Historical data has been obtained from sources believed to be reliable. Past performance is not an indication of future returns. The calculations or other information in this newsletter regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are shown for illustrative purposes only. Unless otherwise noted, rates of return reflect historical annual compounded total returns including the reinvestment of dividends but do not include taxes, fees, or operating expenses. If included, these additional costs would materially reduce the results. Index performance is provided as a benchmark and is not illustrative of any particular investment. It is not possible to invest directly in an index. All expressions of opinion are subject to change. OCFP accepts no responsibility for losses arising from the use of the information contained herein.