On Course Financial Planning

Facing the Future with Optimism and Courage

December 2024

Vectors

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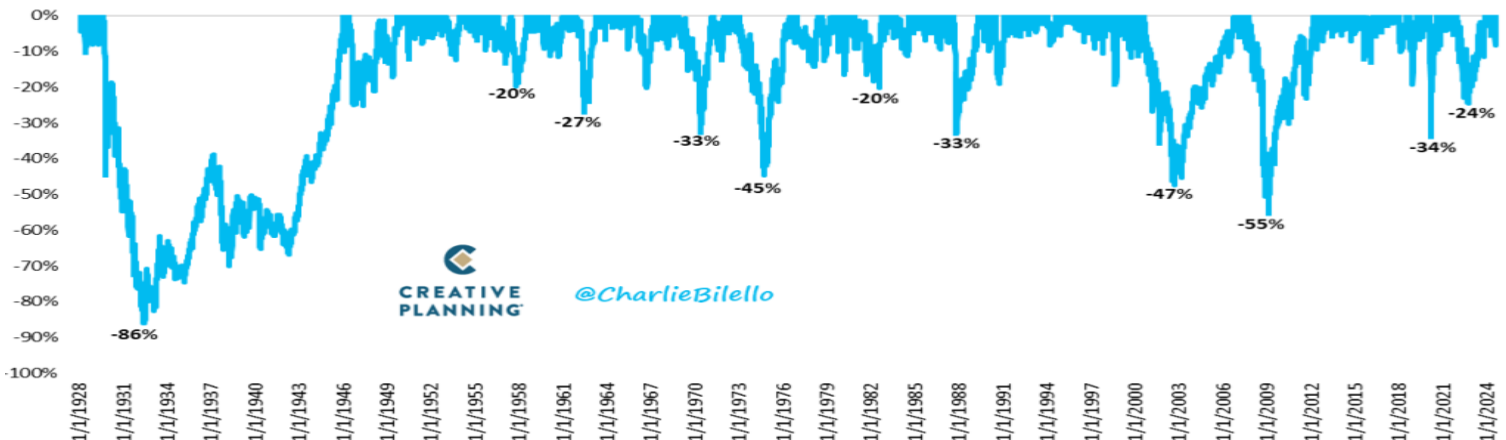
## A Picture Worth 1,000 Words




This chart shows the performance of the S&P 500 index since 1928. The blue line hit the 0% line at the top of the chart whenever the S&P 500 finished the day at an all-time high. If we say that the index was in a drawdown on any day on which the S&P 500 finished lower than its last all-time high, it has been in a drawdown (blue) in more than 90% of the days in the past 97 years. Assuming that the stock market was open 250 days each year, that means the S&P 500 was at a level that was below its last all-time high on about 21,825 days. The chart notes eleven extremely unpleasant drawdowns, including the 24% decline in 2022 – a year in which the high for the S&P occurred on Jan. 3, followed by 362 days in drawdown blue. So far, nothing to get too excited about. But on the other hand, if it hit an all-time high on 10% of the days, then it did so approximately 2,425 times (including 57 times this year through December 6). New all-time highs on about one day in ten created the oft-noted 10% annualized average return for the index for the past century. Now that's something to get excited about.

The greatest loss that a stock can experience is 100% but there is no upside limit to its potential gain. In 2017, Hendrik Bessembinder, a professor at Arizona State University, published a paper titled "Do Stocks Outperform Treasury Bills?" His finding: between 1926 and 2016, just 4% of stocks accounted for all of the net gains in the U.S. stock market above the return of Treasury bills. In other words, the other 96% of stocks, as a group, did no better than Treasurys, which delivered about 2% a year. The relatively few companies that yielded gains many times greater than 100% have been responsible for that 10% return – despite all the drawdowns along the way. The unfortunate reality is that few investors have the patience and fortitude to withstand the inevitable drawdowns, to stay the course and maintain an optimistic view of the future. Bessembinder's study revealed the risk of not owning the market's best performers. One reason it is so hard for active managers to outperform index funds is that the few super-performing stocks are unknowable in advance. Fortunately for investors today, there is no easier or less expensive way to own tomorrow's great performers than to own a total stock market index fund.

There has never been a better time to be an investor, but to be a successful investor you must learn to deal with those "blue" days of drawdowns and short-term losses. Unfortunately, no one has yet to discover a way to receive the return of the stock market while avoiding the drawdowns. All strategies that attempt to limit drawdowns will also limit the upside. Anyone telling you otherwise is lying – trust me on this. Fortunately, all drawdowns in the S&P 500 have been temporary and made irrelevant by the next all-time high. It would be nice if the gain was in a straight upward line, rising 10% each year, but such has not been, nor will it ever be the case.

There are really only two types of investments - those in which you are an owner and those in which you are a lender. You are an owner when you invest in stocks, and you are a lender when you invest in bonds. These two asset classes have nothing in common. When you invest in stocks you put money at risk with no promise of a return. Your hope is that the

investment will reward you with dividends and/or an increase in share price. When you buy a bond, you are in a completely different relationship. It is a lower risk, defensive act in which you lend money to an entity that is contractually obligated to make periodic interest payments and return your initial investment after a stated period of time.

Risk and reward are inseparable. If you want your portfolio's return to keep up with or beat the rate of inflation, you have to put your capital at risk – and that means investing in stocks. You do not own bonds to grow your capital, they are defensive assets designed to preserve capital and lower portfolio volatility. Thus, you cannot have a portfolio allocation that maximizes growth and safety at the same time. This is a fundamental, inescapable truth about investing that too few investors understand. Let me put it another way – you can't get high returns with low risk. Repeat after me, "Anyone pitching me an investment promising a high return with low risk is lying". Deciding how much of your portfolio to place in risk assets and how much to place in defensive assets is the most crucial decision in portfolio construction. A higher expected return is always accompanied by the potential for greater losses, more volatility, and more uncertainty. More dependable returns will be accompanied by less volatility but also less upside potential. Each investor must decide a proper allocation of the two types of investments based on their goals, time horizon, and need and ability to take financial risk.

Sticking with your plan and portfolio in tough economic environments isn't easy, which is why there are so few successful investors. My guess is that a survey of successful investors would reveal that they have the emotional makeup to, in the words of John Bogle, *"Don't just do something, stand there"* during bear market panics and bull market manias. Each new episode of market volatility will be accompanied by claims that, "This time it's different!". But, so far, it has never been different in the long run.

## In the News

After a great 2023, in which the S&P 500 yielded a 26% total return, few market prognosticators expected the good times to continue in 2024. In late 2023, a possible economic slowdown was the big worry for many economists and market pundits. And while geopolitics was a constant worry, neither an escalating conflict in the Middle East, nor the ongoing war in Ukraine or the US presidential election slowed the stock market advance this year. Bolstered by steady economic growth, rising corporate earnings, declining inflation, stronger than expected consumer spending, and the Federal Reserve's decision to start lowering interest rates, the S&P 500 is just weeks away from delivering two consecutive years of 20%+ gains for the first time since 1997 and 1998.

The S&P 500 finished the week ending December 6 at a record high – 6,090 - up 28% for the year and 26% above the average target of the year-end 2024 forecasts from 20 financial firms queried by Bloomberg in December 2023. It was also 13% more than the highest forecast (5400) by Yardeni Research. The most bearish forecast came from JPMorgan, the biggest bank in the world, which employs some of the smartest people and has unlimited access to data and information. JP Morgan kept its target for the S&P 500 at 4,200 for the past two years under the assumption that a recession was just around the corner. One has to wonder how many investors, in an attempt to protect their wealth, fled stocks due to this and numerous other recession forecasts and are still sitting in the" safety" of 5% CDs. Meanwhile, the Vanguard Total Stock Market Index ETF (VTI) has risen 55% over the past 24 months. If you change your portfolio when your goals haven't changed, you're probably making a mistake. And if you make the change in an anxious manner in response to someone's forecast, social media post or YouTube video, you're probably making a big mistake.

With the S&P 500 45% higher than its embarrassing forecasts of the past two years, JP Morgan has replaced its former seer with a new "expert" who is predicting a year-end 2025 target of 6,500 for the S&P 500. This is higher than the 6,300 average forecast of the strategists tracked by Bloomberg this month, a clear example of the old adage that if you can't beat them, you might as well join them.

Yardeni Research is still leading the pack in its 2025 year-end forecast – 7,000 – which is 15% above its December 6 level. That would be nice, but no one can predict what stocks will do in the short term, and one year is the shortest of short terms. Why anyone pays attention to this annual end-of-year forecasting nonsense is beyond me. If you have a financial plan and a portfolio that's well suited to that plan, tune out the financial media. They're in business to promote their sponsors and amplify the daily noise of the markets to attract more eyeballs, ears and clicks. Helping you attain your financial goals is the last thing they're concerned about.

Starting in 2025, businesses adopting new 401(k) or 403(b) plans will be required to automatically enroll new employees at a contribution rate of between 3% and 10% of compensation. They will also be required to increase the contribution rate by 1% annually, to a maximum of at least 10% but no more than 15% of compensation. Employees who don't want to participate will have to opt out of the automatic plan. Businesses with ten or fewer employees and businesses less than three years old are exempt from this requirement.

The maximum amount workers can put in a 401(k) or similar employer retirement plan is adjusted each year for inflation, as is the extra "catch-up" contribution available to anyone 50 and older. The standard deferral limit rises $500 to $23,500 in 2025. The standard "catch-up" contribution remains $7,500 for 2025. But starting in 2025, the catch-up contribution limit will be higher for people in their early 60s, as part of the SECURE 2.0 tax law passed in 2022. Workers who turn 60, 61, 62 or 63 next year can make a "super catch-up" contribution of up to $11,250 which means that they can contribute up to $34,750 to their workplace retirement account. For reasons unknown to mere mortals, this enhanced catch-up benefit does not apply to anyone who will turn age 64 or older next year. I can't make this stuff up.

Social Security beneficiaries will receive a 2.5% cost of living increase in 2025. The amount of income on which workers will pay Social Security taxes is also going up next year. Employees pay 6.2% in Social Security payroll taxes while employers pay an additional 6.2% for a total Social Security payroll tax of 12.4%. This tax will be withheld on income up to $176,100 for workers in 2025, up from 168,600 in 2024.

The SECURE Act of 2019 created the 10-year rule, requiring most non-spouse beneficiaries who inherit an IRA after January 1, 2020, to deplete the account within ten years of the IRA owner's death. Thus, inheritors of IRAs could no longer stretch distributions out over their entire lifetime. However, ever since the original SECURE Act was passed, advisors and tax professionals have been unsure if annual required minimum distributions (RMD) would be required during the 10 years. In July, the IRS confirmed that annual RMDs are required for most non-spouse beneficiaries who inherit an IRA after the owner began taking RMDs and that the account must be completely depleted by the end of the $10^{th}$ year. Due to the confusion, the IRS waived penalties for failing to take RMDs from inherited IRAs in the years 2021 through 2024. Heirs who inherited a Roth IRA after January 1, 2020, are not required to take annual RMDs, but they also must deplete the account within 10 years. If the decedent was not yet taking RMDs at the time of death, a non-spouse beneficiary is exempt from taking annual RMDs, but the 10-year depletion rule still applies. In all cases, year one of the 10-year rule is the year after the year of death.

Perhaps the most common financial advice this time of year is to do some tax loss harvesting. Even in the best of times, not every investment performs as expected. Tax loss harvesting refers to selling shares of a fund or stock in a taxable brokerage account that are worth less than their purchase price. The loss can be used to offset a capital gain or taken as a tax deduction of up to $3,000. Losses of more than $3,000 can be carried forward to future years. It's a logical strategy. If you have realized any capital gains this year you can avoid paying taxes on some or all of the gain by selling a security with a loss.

Unfortunately, there's a fly in the ointment. After taking a tax loss by selling shares of a mutual fund or ETF, you must wait 30 days before you can repurchase shares in the same fund or a "similar" security – this is known as the wash sale rule. If you sell a security at a loss and buy the same or a "substantially identical" security within 30 calendar days **before or after** the sale, you won't be able to take a loss on your tax return. To make things more interesting, if the fund pays a dividend 30 days before or after the sale date, and you have the fund set up to automatically reinvest dividends, this will trigger the wash sale rule – even if the remaining fund shares are in an IRA! The decision to employ tax loss harvesting should be made as part of a comprehensive investment and tax planning strategy. Consulting with a financial advisor or tax professional can help ensure that tax loss harvesting is appropriate and implemented correctly.

A less popular strategy is capital gain harvesting. In 2024, single filers with a taxable income of $47,025 or less, and joint filers with a taxable income of $94,050 or less, pay no federal tax on long-term capital gains that keep income below those limits. Let's assume you've owned a stock fund for more than one year that has a gain. If you sell shares with a capital gain and your taxable income remains in the 0% capital gains bracket, you can immediately repurchase the same number of shares in the fund which will raise the cost basis of your fund shares with no tax consequences.

Well, another year has come and gone. Hopefully, you have found some value in these newsletters. There's only one thing left to say for 2024 – Merry Christmas to all and to all a good night.

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