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

An Eavesdrop Revisited

In December 2013, I wrote an article for MarketWatch that recounted a conversation that I overheard at my local Starbucks. I noted that I was an eyewitness to a mugging -- but not the traditional kind. No weapons were involved, no one was hurt, and no valuables were stolen. I noticed a financial advisor at a table with a client reviewing her new financial plan. Ignoring my mother's advice about minding my own beeswax, I decided to eavesdrop on their conversation. Unfortunately, after forty years of working in near proximity to jet noise, eavesdropping is not as easy as it used to be. So, I sat down at the table right next to them.

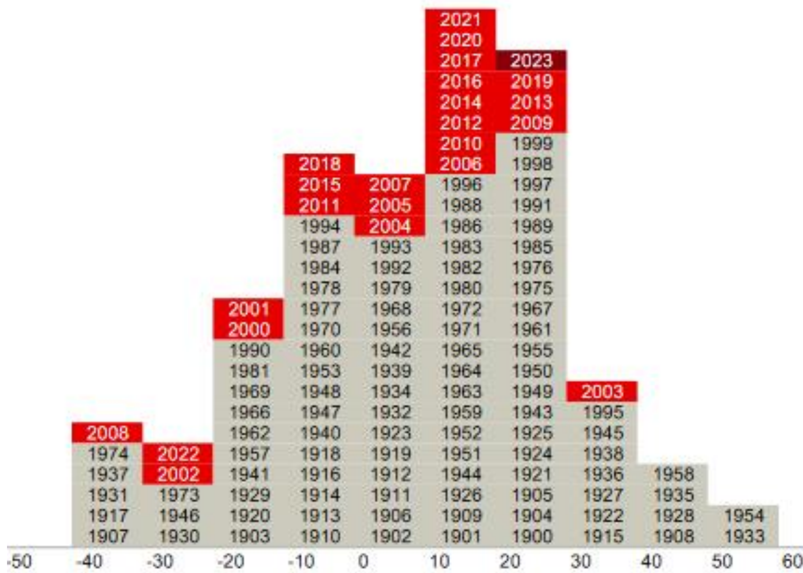
The advisor was describing the benefits of contributing to a 401(k) and the differences between a Roth IRA and a traditional IRA. He also discussed some life and disability insurance options. So far, so good. The client appeared to be about 30 years old and was seeking professional advice as she began her multiple decade investment journey. I was surprised when the advisor completed his presentation by recommending that she invest in just one mutual fund. Of the 6,000+ mutual funds that were available in 2013, he recommended the MFS Moderate Allocation Fund. This fund is a "fund of funds". Instead of owning individual securities its portfolio contains 23 actively managed MFS mutual funds. The fund has an allocation of approximately 55% stocks, 40% bonds and 5% cash, according to Morningstar. In theory, the fund gives an investor with limited funds a well-diversified portfolio but let's be realistic. If there is such a thing as over diversification, this is it. Since most active funds underperform their benchmark index, the more active funds you own, the less likely it becomes that your portfolio will outperform a portfolio of similarly allocated index funds. Additionally, the MFS fund's allocation is inappropriate for a young person just starting to invest. The bond allocation is too high, and its stock allocation is too low. It is my opinion that anyone under 40 years old should have their portfolio invested in a globally diversified, 100% stock portfolio. Fund it every year to your maximum ability and ignore the daily ups and downs of the stock market. When you are 40 years old, you can start thinking about owning some bond funds.

I will assume that the advisor recommended the B shares of the MFS fund (MMABX) to spare his client the A shares' 5.75% commission. Although there is no front-end load, MMABX has a confiscatory annual expense ratio of 1.65%, according to Morningstar. A mutual fund that gives clients the choice of paying a 5.75% commission and a 0.9% annual expense ratio or avoiding the commission by accepting a 1.65% annual expense ratio should have, by now, gone the way of the dinosaurs. But amazingly, the fund has $6.7 billion in assets. After 20 years in this business, I have to say that little has changed. The client still remains a chicken to be plucked by financial professionals who are trained to exploit their clients' lack of financial literacy and natural inclination to trust their fellow man. (Note – this trust in fellow man does not apply to anyone born in Brooklyn, buy I digress.) Unfortunately, transaction-based engagements between an advisor and client contain an unavoidable conflict of interest since the compensation of the advisor is directly related to the expenses of the insurance and investment products paid by the client.

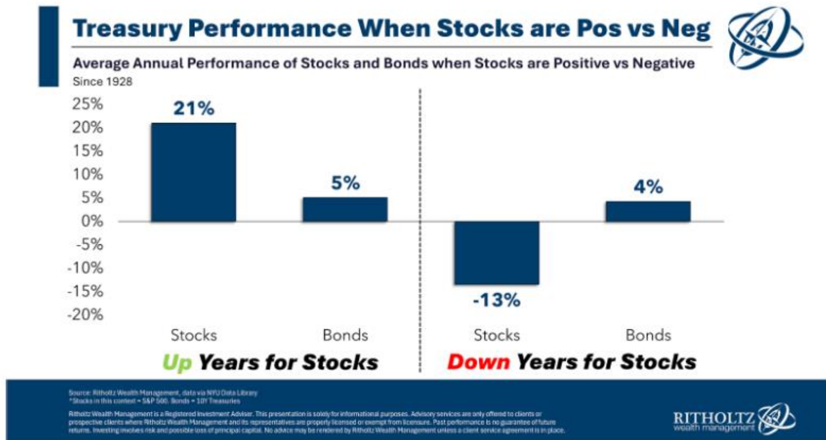
The MFS fund has a portfolio allocation similar to the Vanguard Balanced Index Fund (VBIAX). VBIAX is an index fund with approximately 60% of its assets tracking the CRSP US Total Stock Market Index and approximately 40% of its assets tracking the Bloomberg U.S. Aggregate Bond Index. It has no commission to buy and has an annual expense ratio of 0.07%. Over the ten years ending Aug 20, 2024, VBIAX has outperformed the MFS fund by 2.7% annually (8.2% vs. 5.5%), according to Morningstar. Had our novice investor invested $5,000 in each of the past 10 years into MMABX, the current value would be $64,377 vs. $73,124 if invested in the Vanguard fund. The 15-year return differential is similar - 9.6% for VBIAX and 7.1% for MMABX. The current values of annual $5,000 investments for the past 15 years would be $126,618 for the MFS fund and $159,912 for the Vanguard fund. In seven of the ten years from 2014 through 2023, the Vanguard fund was a top quartile (top 25%) performer in its Morningstar fund category. The MFS fund accomplished this feat only once. The performance differential of the funds is a perfect example of what Vanguard founder John Bogle calls the tyranny of compounding expenses and why Wall Street is rich, and you are still working.

To my way of thinking investors with limited investment funds are best served by owning a small number of broadly diversified low-cost index funds. This will maximize their net invested dollars and their long-term rate of return. Albert Einstein supposedly said that compound interest was the eighth wonder of the world. I have to add this corollary -- the tyranny of compounding expenses is the eighth deadly sin.

Charts and Graphs



This chart from the 2024 UBS Global Investment Returns Yearbook is a histogram displaying the range of real (inflation adjusted) annual returns in the US stock market since 1900. The annual return range of each year is noted on the horizontal scale and includes reinvested dividends. For example, 2023 was one of 24 years with a real return of between 20% and 30%. This followed 2022, which was one of five years with a 20% to 30% decline. The red shaded years are for the 21st century. In its first 24 years, the 21st century has the dubious honor of hosting four bear markets (declines of 20% or more). Despite all the years in negative territory, UBS notes that the average annualized real return of US stocks since 1900 has been 8.4%.



A 60% stock/40% bond allocation is considered to be the standard moderate asset allocation. Bond returns have been far more stable than stock returns and this chart compares the average annual performance of 10-year Treasuries to the S&P 500 since 1928. In years when the S&P 500 was positive, bonds had a positive return 80% of the time, averaging 5%. In years when the S&P 500 was negative, bonds had a positive return 81% of the time, averaging 4%. By offering modest, yet reliable returns, US Treasuries are considered to be one of the best assets to own to offset stock market volatility. Riskier fixed income assets, such as high yield bonds or emerging market debt, on the other hand, are poor diversifiers because they are more volatile and often decline when stocks go down. But in 19% of the years when stocks fell, bonds also fell. The last time this happened was in 2022, when the Aggregate Bond Index fell 7.6%. This led too many commentators, who should have known better, to claim that the 60/40 portfolio was dead. We can use the Vanguard Balanced Index Fund (VBIAX) as a proxy for a 60/40 portfolio. After falling 16.9% in 2022, it rebounded with a 17.6% return in 2023 and is up 12.1% this year through August 31, according to Morningstar. To paraphrase Mark Twain "The reports of the death of the 60/40 portfolio are greatly exaggerated."

In the News

This month's episode of What Were They Thinking? concerns the activities of Russell Burkhalter, the CEO of Drive Planning, who has been accused by the Securities and Exchange Commission of operating a real estate Ponzi scheme. Burkhalter and his sales agents told prospective investors that the firm would pool their money and loan it to property developers, or enter joint ventures with property developers, to raise enough profit for a "guaranteed" three month return of - get ready for it - 10%. One would think that more than a decade after Bernie Madoff, who promised only 10% annual returns, investors would be skeptical, yet from the fall of 2020 until May of this year the fund raised more than $336 million from more than 2,000 investors in 48 States and other countries, according to the SEC. The SEC claims that Burkhalter used investor funds to buy the usual necessities of a lavish lifestyle, spending $2 million on a yacht, $300,000 on clothing, jewelry, and beauty treatments, and $4.6 million on private jet charters and car services. Once again, it bears repeating that an investment that seems to be too good to be true is likely a fraud. Unfortunately, too many people are so unschooled in investing that they cannot identify the obvious red flags that fly high above every Ponzi scheme.

Mutual funds and ETFs report performance on a “time-weighted” basis that measures the return of $1 invested at the beginning of the year and held through the end of the year. Another way to report fund performance is on an "asset-weighted" basis. This is done by analyzing the flow of money into and out of a fund to calculate the annual return realized by the average dollar in the fund. In its annual Mind the Gap study, Morningstar calculates and compares the asset-weighted return of mutual funds and exchange traded funds to their time-weighted performance. Any difference is called the “investor gap,” the result of the timing of investors’ purchases and sales of fund shares. In its Mind the Gap 2024 update, Morningstar reports that the average dollar invested in stock and bond mutual funds and ETFs earned about 6.3% per year over the ten years ending December 31,2023 – 1.1% less than the annualized average, time-weighted return of the funds in the study. Sector equity funds had the largest annual gap – 2.6%. These funds are popular with “tactical" investors who tend to invest in sectors with strong recent performance, and then sell when performance sags. Allocation funds, such as VBIAX, hold a fixed balance between stocks and bonds and are rebalanced on a regular basis – making them set-it and forget-it investments. These had the smallest annual gap – 0.4% - demonstrating the benefit of minimizing portfolio tinkering. Here are some self-induced causes of the investor gap --

Investors are Unskilled. Most investors, sad to say, are financially illiterate and make emotionally driven, short-term investment decisions. A study by two Cornell University professors, *Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self Assessments* discloses that we often hold overly optimistic assessments of our abilities in subjects in which we are unskilled. We suffer what the authors call a “dual burden” -- we reach erroneous conclusions and make poor choices, but our incompetence prevents us from realizing it. This sad state of affairs needs no explaining to parents of teenagers.

Portfolio Peeking. Studies of investor behavior show that the more you look at your portfolio, the more you will trade. In a study published in 2000 in *The Journal of Finance*, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors* authors Barber and Odean reported that investors who traded the most experienced the lowest returns. Wall Street spends billions of advertising dollars to get you to do something, anything -- hurry up and download our trading app, you can beat the market! This is Wall Street's biggest lie. The more you trade, the more Wall Street makes -- which is why there are stockbrokers in every village, hamlet, and town in the USA.

Having No Plan. Investors who have a comprehensive written financial plan are less likely to be influenced by the financial media’s Apocalypse of the Week. Good financial planning requires an understanding of capital markets, tax law, employee benefits, insurance, and estate planning. Most people lack the time or interest to study these subjects and do not know how to create a financial plan. There’s no shame in asking for help. My advice – do not accept investment advice from a financial professional until they provide a written financial plan that incorporates your income, expenses, goals, time horizon and risk tolerance.

Performance Chasing. Investors are repeatedly told that past performance is no guarantee of future returns. Unfortunately, most investors disregard this warning under the naïve assumption that they can find tomorrow’s winners by analyzing past performance. Most soon find themselves learning a new lesson in reversion to the mean.

Overconfidence. Many investors with whom I speak express firm opinions about what the stock market, a particular stock or the economy will do in the near future. I wish I could be so confident. A study of investors, *Why Inexperienced Investors Do Not Learn: They Do Not Know Their Past Portfolio Performance* revealed that 70% of investors judged themselves to possess above average investing skill and overestimated their portfolios’ past returns. The study concluded that most individual investors are incompetent and overconfident -- a dangerous combination, to say the least.

Portfolio Dissecting. Your portfolio is the sum of its parts. Do not micro-manage it by obsessing over the recent performance of each holding. I know international funds have not done well in recent years – get over it. A well-diversified portfolio will always have assets that have recently underperformed expectations. Maintain the discipline of using periodic rebalancing to reinvest in your portfolio’s underperforming components.

Investor behavior creates the investor gap. We trade too much, make poor market timing decisions, and are seduced by strategies and products that promise market beating returns. Investors need prudent advice about how to receive market equaling returns – not speculative advice on how to beat the market. Is your financial advisor focusing on planning, diversification and maintaining a long-term perspective? Or do conversations with your advisor focus on short-term performance, new investment products and market forecasts? One process will minimize the investor gap the other will perpetuate it. You are forewarned. The choice is yours.

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.