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Facing the Future with Optimism and Courage
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In the News

Jobs Data Leave Markets on Unsure Footing
Recovery Doubts Drive Broad Decline
Poor U.S. Data Pull Yields Down
Crude Settles at 3-Week Low
Weak Data From China Push Europe, Asia Lower
30-Year Mortgage Hits Another Record Low
Asia Falls on Recovery Doubts
Underwriting Tumbles to Crisis Levels

Strategas Research compiled these news headlines for the month of July. Financial journalism is fundamentally an exercise in fear mongering; thus, the headlines never change. They emanate from the financial media's Bag of Scary Stuff and are withdrawn as needed to attract eyeballs, ears and clicks. When stocks are declining, few investors can sit quietly and ignore fear generating headlines. Fearing permanent loss, we engage in emotional, counterproductive portfolio tinkering and flee from stocks. It does little good to make an intellectual case against panic selling - because it's not an intellectual problem or due to a lack of information. It's panic in the absence of faith, patience, and discipline - the successful investor's most valuable assets.

But wait just a minute – these aren't last month's headlines; they are from July 2010. Perhaps the biggest clue is that there's no mention of the July price collapse in bitcoin. There will always be the fear du jour that is sure to undermine the economy and stock market. This month, it's the fear of the COVID-19 Delta variant. Last month it was the fear of a resurgence of inflation. Next month it will likely be the political circus surrounding raising the debt ceiling. All market declines - no matter how brief, shallow, or meaningless will be attributed to investors' increasing worry about the current fear and all market rises, no matter how small, will be attributed to an easing of that fear. This type of inane market commentary occurs on an ongoing basis. It's easy to attract attention by shouting that the world is about to come to an end. And too many unrepentant, incorrigible forecasters have made a good living by doing so.

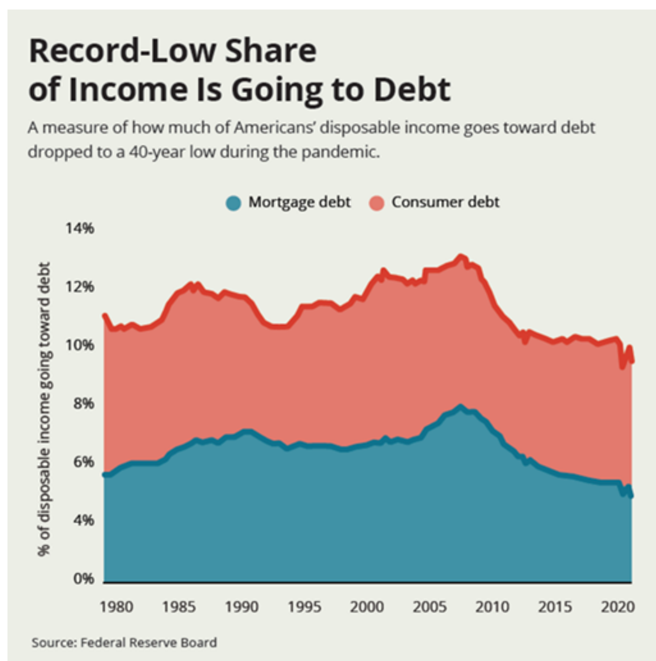
Let's crank up Mr. Peabody's Wayback Machine and look at a July 2010 article from the *Wall Street Journal* – "Small Investors Flee Stocks, Changing Market Dynamics". It profiled Karen and Roger Potyk, a retired couple in San Antonio, Texas. Mr. Potyk, 68, and his wife, 63, were invested in a conservative 50% stock and 50% fixed-income portfolio. They continued to own stock mutual funds despite their anxiety following the financial crisis of 2008. But in May 2010, they finally sold their stock funds because they could no longer bear the stress of stock ownership. *"We just didn't want to put up with it anymore."* They reinvested the proceeds in bonds, certificates of deposit and annuities.

Justifying the Potyk's decision, the article noted these frightening facts – "*The Standard & Poor's 500 stock Index has fallen at an annualized rate of 3% a year over the past 10 years, including dividends and controlling for inflation. Long-term Treasury bonds show a gain of 5% a year during that same period, after inflation. Gold is up 10% a year and real-estate investment trusts 8% a year. The S&P 500 Index itself, without adjusting for inflation and dividends, is stuck today at a level it first reached 12 years ago, meaning it has gone nowhere in more than a decade, scaring a legion of people in the process."*

There's no doubt that the "lost decade" from January 2000 through December 2009 was a difficult time for domestic stock investors. The annualized return of the S&P 500 Index was a loss of 0.95%. However, unknown to the Potyks, the "lost decade" provided one of the greatest buying opportunities of their lifetime. Since this article was published, the S&P 500 has risen from 1,100 to 4,430, a 13.5% annualized return, not including dividends. Inflation has averaged 1.7%, turning the purchasing power of $10,000 into $8,300. $10,000 invested in the Vanguard Aggregate Bond Index ETF (BND) would be worth $15,600 today. $10,000 invested in the Vanguard Total Stock Market ETF (VTI) would be worth $52,000 today. It would be interesting to see a follow-up story asking the Potyks how they feel about their decision to sell their stock funds. It's a classic example of the danger of recency bias – the belief that what happened yesterday is a precursor to what will happen tomorrow.

To counter recency bias, the disclaimer, *"Past performance is no guarantee of future results"*, appears in every mutual fund ad. Yet, fund flow data indicates that this disclaimer is universally ignored. Funds with recent high performance attract the lion's share of new money. It's almost as if investors think, "Maybe not a guarantee, but close enough for me." Cathie Wood is the newest member of the Active Managers Superstar Club. Her ARK Innovation ETF (ARKK), gained 152% in 2020, placing it in the top 1% of mid-cap growth funds according to Morningstar. Was this the result of luck or manager skill? Her one million Twitter followers hope it's skill, but the jury is still out. So far this year, ARKK has been outperformed by 99% of mid-cap growth funds. I wonder. Is there an Active Managers Reversion to The Mean Club?

This is the best time in history to be an investor. Many people fail to distinguish between speculating (buying an asset, regardless of fundamentals, for the purpose of selling a short time later at a higher price) and investing (buying an asset that is expected to grow in value over the long term). Just like placing a bet in a casino, speculating can be fun for a while, especially during a bull market. Eventually, the speculator's losses will outpace the gains, and the disappointed "investor" will join a long list of those who have been punished by the market. A word of warning if you seek investing advice from social media – no billionaire's advice is relevant to you. Their lifestyles, needs, goals, risk tolerance and financial ability to absorb losses is completely different from yours.



U.S. household liabilities as a percentage of household assets have been declining since 2008. Likewise, the percentage of monthly disposable income going to debt service is now 8.2% - lower than at any time since 1980.

Predictably, financial journalism was quick to attribute the drop entirely to government transfer payments, ignoring the fact that the ratio has been in steady decline since 2008.

Two primary factors behind this bit of good news are the growing economy and the ongoing trend of households to pay down debt - especially credit card debt. Total outstanding US credit card debt has declined 18% since the beginning of 2020. Although the total dollar amount of credit card purchases in the first quarter increased 3% from last year, card balances are down 14% from one year ago, according to JP Morgan Chase.

Mortgages make up almost 70% of household debt. Many homeowners have refinanced their mortgages at today's low rates, thus lowering their debt service for years to come. This is sure to create an ongoing tailwind for our consumer-driven economy.

Rebalancing

The robust economic recovery, which few analysts had predicted during the lockdowns and shelter-in-place orders last year, has driven corporate profits higher, and in turn, fueled a doubling of the stock market in just 15 months. Many investors are reluctant to invest more money into the stock market with valuations at or near all-time highs. With 50 new all-time highs in the S&P 500 this year, many pundits have been asserting that a market decline lurks just around the corner. But valuation has never been a useful market timing mechanism. If new all-time highs are precursors to market declines, the stock market would never achieve another all-time high. So, considering current valuations, what's an investor to do?

We have two options. The first is to stay invested. If the stock market suffers an interim decline that causes its performance to revert to its long-term average, so be it - what else is new? The foundation of successful stock investing is long-term compounding and long-term investors will suffer no real harm.

The second option is to follow the example of the Potyks and sell your stock funds. Reinvest the proceeds into fixed income assets and accept inflation lagging returns until prices drop "enough" (whatever that means) to reenter the stock market. This is pure market timing. It opens the door to "decision risk"— the possibility that your timing decision will turn out to be wrong. Few professional investors, if any, can successfully time the market, because it requires two correct predictions: when to exit the stock market and when to get back in. The chances that you can do so are nil. Many frightened investors are still sitting in cash with no compounding of their capital and no real gain in their investable assets since the financial crisis more than a decade ago, a financial planning disaster that few will be able to overcome.

A 2019 study by Dr. Ilia Dichev of Emory University and Dr. Xin Zheng of the University of British Columbia, "The Volatility of Investor Returns", reveals that although market timers "chase stability" – they are trying to minimize volatility - they end up doing exactly the opposite. They tend to invest in stocks after times of low volatility - just before the onset of higher volatility. The result is that they maximize their stock exposure just as volatility returns. In summary they note that "*the volatility of the actual investor experience is nearly 50% higher than the corresponding volatility of stock returns.*" Thus, market timers, on average, assume more risk and get lower returns than those who buy and hold their stock investments. Rather than engaging in market timing, it's much wiser to settle on an asset allocation that fits your ability and willingness to take risk—and then stay put.

Fortunately, there's an easy way to deal with high stock prices - rebalancing. Hopefully, your portfolio's equity exposure is globally diversified. Over the past 15 months, domestic stocks have outperformed international equities by a wide margin. Without a rebalancing strategy, it is likely that your portfolio is now overweighted to domestic equities. To return to the portfolio's original risk and return characteristics, it must be rebalanced. There are two components to this rebalancing, each with a different rationale.

The first is the rebalancing of the stock/bond mix. With domestic stocks at or near all-time highs, it is likely that your portfolio is overweighted in domestic stocks. Rebalancing back to your original stock/bond allocation will lower the future performance of your portfolio because rebalancing tends to reduce the allocation to asset classes with higher expected returns. Rebalancing to your original stock/bond allocation is for risk and volatility management purposes, not to increase portfolio return.

The second is the rebalancing among the domestic and international stock funds that represent different equity asset classes. We expect different returns in different stock asset classes. Rebalancing among a portfolio's stock funds isn't done to manage volatility. It's a sell high, buy low strategy designed to take advantage of the inevitable reversion to the mean that occurs in stock asset classes. Reversion to the mean is a mathematical term that means what has gone up will go down and what has gone down will eventually go back up. Perhaps you remember the Seinfeld episode in which Jerry explained reversion to the mean to Elaine --

Jerry: *Elaine, don't get too down. Everything will even out. See, I have two friends. You were up, he was down. Now he's up, you're down. You see how it all evens out for me?*
Kramer: (to Jerry) *You know who you are? Even Steven*.

How often should investors rebalance? A Vanguard research report looked at the annualized performance of three different rebalancing strategies on a 50% global stock/50% global bond portfolio from 1926 through 2014. The first strategy was "time only" – three different rebalancing strategies were analyzed -- monthly, quarterly, and annual. The second strategy was "threshold only"– the portfolio was rebalanced if its allocation drifted from the target asset allocation by a predetermined threshold of 1%, 5% or 10%, regardless of the time period involved. The third strategy was "time and threshold" – the portfolio was rebalanced on a scheduled basis but only if the asset allocation had also exceeded a 1%, 5% or 10% rebalancing threshold.

The report concluded that none of the rebalancing strategies provided better risk adjusted returns than another. More frequent rebalancing increases the cost of rebalancing which led Vanguard to conclude that annual or semiannual rebalancing is adequate. I am a proponent of annual rebalancing. More frequent rebalancing increases the chances that you are rebalancing in response to short-term market noise. So, when it comes to rebalancing, when you do it isn't as important as choosing a rebalancing strategy that you can stick with.

The best part of rebalancing is that it requires no knowledge of the future, only knowledge of the past. Unlike market timing strategies, no guessing is required. It's easy to know what to buy (assets that have gone down) and what to sell (assets that have gone up). Investors who follow the Potyks' emotional, guessing approach become forecast seeking speculators; trapped in a succession of "What do I do now?" cycles that will likely cause much frustration and lead to higher taxes and market trailing performance.

August and September have historically been low volatility months for the stock market - except for those years when they weren't. I don't have a short-term view of the market, and neither should you. You invest in the stock market to create wealth over the long-term to achieve your financial goals. Buying, holding, and rebalancing a globally diversified portfolio of index funds is one of the best, if not the best, long-term investment strategy that you can adopt. The retail brokerage industry has no financial incentive to advise clients to employ this strategy -- which is why they never recommend it. To make matters worse, the financial media and its talking heads promote predictions, stock selection and market timing to the benefit of their advertisers and the detriment of investors.

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