On Course Financial Planning
Facing the Future with Optimism and Courage
October 2021
Vectors
geo@oncoursefp.com
425-861-9997

The Investor Gap

Mutual fund performance is reported 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. But few dollars in a fund are invested this way. A better 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 approximate the return realized by the average dollar in the fund. Each year in its Mind the Gap study, Morningstar calculates and compares the asset-weighted return of mutual funds to the reported time-weighted performance of each fund. Any difference is called the "investor gap". Numerous studies reveal that portfolio turnover and portfolio return are inversely correlated. Many investors are more active than prudence would dictate and the more you tinker with your portfolio, the larger your investor gap is likely to be. Combine a limited understanding of financial concepts with the lack of a financial plan to help avoid behavioral mistakes and, voilà, you get the investor gap.

In its Mind the Gap 2021 update, Morningstar reports that for the ten years ending December 31, 2020, the average annual investor gap in stock and bond funds was 1.1%. Morningstar found that a fund's investor gap is directly related to its volatility. This isn't surprising since funds with volatile performance tend to attract performance chasing, short term investors. Sector equity funds are popular with "tactical" investors who invest in sectors with strong recent performance, and then leave when performance falls. The Mind the Gap report noted that investors in sector funds experienced a 4% annual investor gap. Making "tactical" strategic changes to your portfolio is an impulse, and almost always a counterproductive one. In the end, investor behavior, not fund performance, creates the investor gap. Investors' actions should be guided by a financial plan, not speculative, "tactical" bets.

In summary Morningstar noted, *"The endless drumbeat of market and economic news can make it tempting - even for professional investors and financial advisors - to feel like they should be doing something to respond to shifting market conditions. But for the most part, the time and energy that investors spend on trading decisions is wasted effort - and often counterproductive. Our study found that areas with the most volatile cashflows often suffered the widest gaps in investor returns. Investors can improve their results by setting a rational asset allocation, buying low-cost funds, and just sticking with their plan. It also makes sense to set a strict schedule for rebalancing…Whether they invest in a lump sum upfront or follow a dollar cost averaging system, investors who follow a consistent investment approach and avoid chasing performance will likely reap rewards over time."*

In the News

The Effective Reproduction Number (Rt) measures the average number of people who will become infected by a person with COVID. If the number is greater than 1, the number of infected persons will increase, if less than 1 it will decrease. As of Sept. 29, 38 states had a Rt less than 1 and the national average was 0.9. COVID cases have declined 33% nationally since the middle of September. Funny, the lack of large font headlines proclaiming this good news.

In 2020, Social Security paid retirement, survivor and disability benefits totaling $1.1 trillion to more than 64 million beneficiaries. The latest Social Security Trustees' report reveals that the Old-Age and Survivors Insurance Trust Fund (OASI), which pays benefits to retirees, is now projected to be depleted by 2033, one year earlier than reported in 2020. The report projects that the Disability Insurance Trust Fund can pay benefits until 2057, eight years sooner than last year's report. These earlier projections are due to the job losses and resulting reduction in payroll tax collections caused by the pandemic. In addition, involuntary retirements of older workers may have prompted them to claim Social Security benefits earlier than what previous Trustees' reports had assumed.

These numbers are still better than what was feared during the height of the pandemic when some pundits predicted that OASI funds could be depleted by 2029. Although fewer payroll taxes were collected in 2020, there was an increase in mortality among Social Security recipients, largely cancelling each other out. Once the trust funds are depleted, Social Security should be able to pay 76% of scheduled retirement benefits and 91% of scheduled disability benefits.

The report noted that the Hospital Insurance Trust Fund, (Medicare Part A), which helps pay for inpatient hospital care, can pay benefits until 2026, the same as reported last year. Once depleted, program income will be sufficient to pay 91% of total scheduled benefits. The Supplemental Medical Insurance Trust Fund covers Medicare Part B (physician and

outpatient services) and Part D (prescription drug benefits). The trustees noted that these are “*adequately financed into the indefinite future”* because they are financed from general revenue and beneficiary premiums.

There's nothing new in the latest Trustees' report. Returning Social Security to solid funding will require a combination of higher taxes, raising the full retirement age for younger workers, and moderating inflation assumptions. Politicians will likely wait as long as possible before making the hard choices. The longer they wait, the bigger the changes will be.

Investors have always been seduced by claims that are too good to be true. Claims in social media of making a killing in the market (if true) are likely the result of a once-in-a-lifetime trade. And, to state the obvious, there’s a huge difference between a once-in-a-lifetime lucky guess and a viable investment strategy. The recommendations that have stood the test of time - don’t chase yield, don’t speculate, don’t invest in something you don’t understand, don’t invest in something that has no intrinsic value and don’t expect to get rich quickly – are out of favor among some "investors" today. Has social media changed the rules of successful investing? Time will tell but put me in the camp of the unconvinced.

A 30-year, fixed rate mortgage at today's low rates is a great inflation hedge. Let’s assume that you take out a 3.0%, 30-year, $300,000 mortgage. The monthly principal and interest payment is $1,265. Debt-phobic commentators will note that over the life of the loan, without any early principal repayments, you will pay about $155,000 in interest. But if you are in the 24% marginal tax bracket and itemize deductions, the net-of-tax interest over the life of the loan will be $118,000 – an average of about $330/month. Inflation "lowers" the real (inflation adjusted) mortgage payment over time. If inflation averages the Fed's ideal 2% for the next 30 years, your real borrowing costs will decline 2% annually. After 10 years, your monthly payment, in today's dollars, will be $1,035. After 20 years, it will be $847 and $695 in year 30. If inflation matches its historical, long term 3% average, the real payments 10, 20 and 30 years from now will be $937, $695 and $515/mo. respectively. This is a good example of why debt holders love inflation and why a fixed rate mortgage with a miniscule after-tax, real interest rate is a financial asset, not a liability.

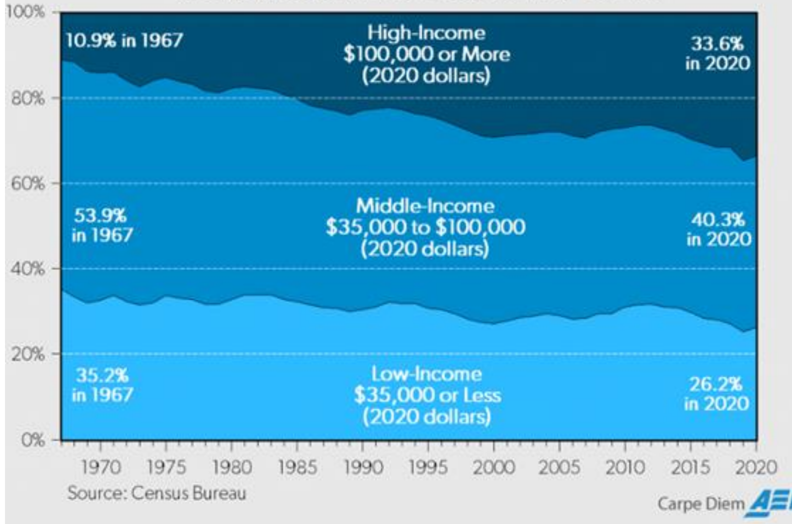
Investing has never been easier or less expensive, yet the investment world is full of complex products that the average investor has little chance of understanding. Fund firms continue to promote clever sounding, faddish investments to gather more assets from a gullible, investing public. The latest evidence that there is no limit to the foolish ideas promoted by Wall Street is the Advisorshares Poseidon Dynamic Cannabis ETF (PSDN). This is an actively managed fund that plans to invest in marijuana stocks with borrowed money. Its prospectus states –

The Fund is an actively managed exchange-traded fund (“ETF”) that seeks to achieve its investment objective by investing, under normal circumstances, at least 80% of its net assets (plus any borrowings for investment purposes) in (i) securities of companies that derive at least 50% of their net revenue directly from the marijuana and hemp business or from providing services, products or technology to the marijuana and hemp business, and (ii) derivatives that have economic characteristics similar to such securities…the Fund’s investment sub-advisor, may, at its discretion, dynamically adjust the Fund’s overall market exposure to marijuana and hemp companies through leverage of up to one and a half times (1.5x), or 150% of, the Fund’s assets…The loss on a leveraged investment may far exceed the Fund’s principal amount invested. Leverage can magnify the Fund’s gains and losses and, therefore, increase its volatility…The Fund cannot guarantee that the use of leverage will produce a high return on an investment... The use of leverage may result in the Fund having to liquidate holdings when it may not be advantageous to do so.

In England in the Middle Ages, the phrase "*you'll see a black swan before....*" was used to describe a highly improbable event. As far as anyone knew, all swans were white. Then, in the 17th century, black swans were discovered in Australia and the phrase “black swan" has come to refer to an unpredicted event that occurs unexpectedly. Contrary to the way the term is used today, there are good and bad black swans. The internet, smart phones, FedEx and the personal computer were black swans. So were World War I, the sinking of the Titanic and 9/11. A black swan event has these three characteristics –

1. **Rarity -- I**t was unpredictable, outside the realm of expectation, because nothing beforehand signaled its occurrence.
2. **Extreme impact** -- Its occurrence has massive consequences for the future.
3. **Hindsight bias -** After the fact, we can concoct a plausible explanation that makes the unexpected event appear less random and more predictable than it was.

Even though domestic stocks have historically risen three years out of four, many investors remain fearful of low probability, bad, black swan events. They're always worrying about money, asking themselves endless "What if?" questions even when they have more than enough to meet their needs. Nothing is easier, or more common in the investment business, than scaring gun-shy investors into buying products that promise to hedge against inflation, deflation, stagflation, bear markets, volatility, or anything else that frightening headlines and YouTube videos claim are about to bring down our economy. It's an age-old way of doing business and it will be with us until we find a way to punish people who falsely claim to be able to get you stock-like returns with little or no volatility. Hedging out every risk imaginable will leave you with a portfolio of expensive, complex, opaque products that, in aggregate, have almost no chance of providing a long-term rate of return that will allow you to achieve your financial goals.



This chart from the American Enterprise Institute shows the total income shares of US households for three income categories - low-income (earning $35,000 or less), middle-income (earning between $35,000 and $100,000) and high-income (earning $100,000 or more) in inflation-adjusted 2020 dollars.

We repeatedly hear from some politicians that the "middle-class is disappearing", and it's true – but it's because middle-income households are gradually moving up to the higher-income group, not down into the lower-income group.

In 1967, only 10.9% of US households were in the high-income category. Last year, 33.6% were in the high-income category – three times the 1967 percentage. The share of middle-income households has decreased over time, from 53.9% in 1967 to only 40.3% in 2020. The share of low-income households has decreased from 35.2% in 1967 to only 26.2% of households last year

Donor Advised Funds

A donor advised fund (DAF) is a fund into which you make irrevocable donations of cash or appreciated assets. Donations yield a tax deduction of up to 60% of your adjusted gross income in the year of the contribution. You retain control over how assets in a donor advised fund are invested until gifted. Any investment gain in fund assets before they are gifted are tax-free to you, the DAF and the charity that receives the grant. Contributions to a donor advised fund cannot be used for anything other than charitable grants to IRS approved charities and non-profits. A donor advised fund allows naming a successor trustee, such as a child or spouse, who can make grants from the fund after your death. Alternatively, you can direct the DAF administrator to continue making grants to charities of your choice after your death.

Fidelity, Schwab, and Vanguard are the three largest administrators of donor advised funds and close to $150 billion is currently invested in donor advised funds. There is no minimum initial contribution or additional contribution amount to a donor advised fund at Fidelity or Schwab. The minimum initial contribution to a Vanguard DAF is $25,000 and additional contributions must be $5,000 or more. Administrators of donor advised funds make certain that grants from the fund are to IRS approved charities and eligible for an income tax deduction. Donors are charged annual administrative costs and management fees for the underlying investment funds used in the DAF. A donor advised fund can be a powerful tool for maximizing charitable impact if you are charitably inclined and-

- You'd like to get a tax deduction for your donation, but you don't itemize deductions. If combining several years' worth of planned giving into a single DAF contribution causes you to exceed the standard deduction, you'll be able to get a tax deduction for your charitable gifts. Even if grant requests are made over several years, you will still get the tax deduction in the year you contribute to the donor advised fund.
- You would like to donate a highly appreciated asset. There's no need to determine the cost basis of the asset, which may be difficult to do if it has been held for many years. The donor advised fund will sell the appreciated asset and there is no tax on the embedded capital gain to report by the fund or the donor. The charity will receive more money than if you sold the asset and then gifted the after-tax proceeds. Using a donor advised fund in this way allows gifting to charities and non-profits that are not set up to handle gifts of appreciated assets.
- You have an unusually high-income year and are charitably inclined. Now may be a good time to consider opening a donor advised fund. Typically, in high-income years, your marginal tax rate is higher and you'll get a greater tax benefit from charitable donations than in lower-income years. Clumping future donations into a high-income year and making grants over time from a donor advised fund is a good way to maximize your tax benefit.
- You prefer to make anonymous gifts. While some people like to maintain a close relationship with the charities they support, others may find the resulting volume of solicitations undesirable. Grants from a donor advised fund can be made on an anonymous basis.

Disclaimer - The information in this article is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how the content of this newsletter 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 is from sources believed to be reliable. Past performance is not a guarantee of future returns.