On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Happy Birthday!

Forty-five years ago, this past August 31st, the first index mutual fund -- the Vanguard 500 Index Fund -- completed its initial public offering. The Vanguard Group, under the stewardship of John Bogle, was just 16 months old at the time. Bogle believed that most actively managed mutual funds would under perform a comparable index fund once management fees, operating expenses, sales commissions, and portfolio transaction costs were subtracted from returns. His goal was to offer a well-diversified fund at minimal cost. During its initial public offering the fund brought in only $11.3 million. This wasn't enough to purchase all 500 stocks in the S&P 500 Index and Bogle was advised to forget the idea. Vanguard's competitors began calling the fund "Bogle's Folly". Despite all the derision thrown his way, August 31, 1976 was the day that Bogle changed the course of the mutual fund industry. In September 2019, the assets in index mutual funds and ETFs surpassed the assets in active funds for the first time. New money flows continue to favor index funds over actively managed funds. For the 12-month period ended June 30, 2021, index mutual funds and ETFs reported net inflows totaling $765 billion, compared to net inflows totaling $281 billion for actively managed funds.

Mutual funds give investors the opportunity to participate in global financial markets by pooling the assets of many investors. The first stock mutual fund was the Massachusetts Investors Trust which began operating in 1924 and still exists as an actively managed large-cap fund (MITTX). For the first time, individual investors could own a portfolio of broadly diversified securities at a lower cost than if they bought the stocks on their own. From 1924 until the appearance of "Bogle's Folly" in 1976, all stock funds were actively managed, but they had no need to beat the market. Their mission was to select good securities that paid reasonable dividends, to secure profits without undue speculation and to conserve investors' principal. It was a win-win situation for fund companies and investors.

Index funds offer investors broad diversification and due to their miniscule management fees, they yield market equaling returns. According to Morningstar, the average annual management fee paid by investors in domestic stock index funds in 2020 was 0.1%, compared to 0.7% for the average active stock fund investor. No longer can active managers just offer a diversified portfolio of securities. Their emphasis is now on performance, not stewardship, in the hope of outperforming index funds and validating their higher fees. Any honest observer must conclude that they have not been able to do so.

The latest evidence is the year-end 2020 Standard & Poor's Indexes Versus Active (SPIVA) Scorecard, which compares the performance of active mutual funds to their benchmark index. This SPIVA report contains data for the three-year period January 2018 through December 2020, which included the COVID-19 bear market - a perfect opportunity for active managers to provide value. But over these three years, 70% of actively managed large-cap domestic stock funds underperformed the S&P 500 Index. 72% of actively managed domestic mid-cap funds underperformed the S&P Mid-Cap 400 Index and 72% of domestic actively managed small-cap funds underperformed the S&P Small Cap 600 Index.

These results are in line with a more in-depth analysis of the performance of active funds during the COVID-19 bear market - *Mutual Fund Performance and Flows During the COVID-19 Crisis* - by Lubos Pastor and M. Blair Vorsatz of the University of Chicago Booth School of Business. The S&P 500 Index experienced its sharpest decline in history, losing 34% of its value between February 19 and March 23, 2020, before bouncing back by over 30% by the end of April. This ten-week period was roughly evenly split between the crash and recovery and active investors were depending on their fund managers to protect their assets during this crisis. Yet their analysis of 3,626 active funds reveals that 58% of the funds underperformed their benchmark index during those ten weeks.

When an actively managed fund underperforms its peers or benchmark index for a few years, it hemorrhages assets as performance chasing shareholders run for the exits. Soon thereafter, like Jimmy Hoffa, the fund disappears and is never seen or heard from again. Of the 2,364 domestic stock funds available to investors in January 2016, the SPIVA Scorecard notes that only 1,827 were still in business at the end of 2020 -- a 23% fatality rate in just five years.

Intelligence is overrated in the fund management business. There are so many smart fund managers that being intelligent doesn't guarantee success. Lady Luck is a likely silent partner in any market beating performance. Fund managers are competing in a zero-sum game of trying to guess better than the competition what the competition will do next. This ultimately becomes a losers' game once costs are subtracted from return. Nothing makes smart, talented fund managers angrier than the success of "dumb" index funds.

Forecasts

Essentially, there are only two types of forecasts. The first type are those that are in-line with the consensus forecast of other pundits. Thus, they reveal nothing new and have no value. The second type are those that differ significantly from the consensus of other pundits. These are likely to be wrong, making them even less valuable than consensus forecasts.

Thus, ergo and Q.E.D, all forecasts are worthless. Yet they never go away. The predictive "batting average" of forecasters is never mentioned by their enablers in the financial media. The welcome mat is always out because forecasters attract eyeballs, ears and clicks. But it's pure folly to listen to people vain enough to believe that they can see the future.

How refreshing it would be if these pundits would truthfully answer the question, "What do you think is going to happen in the market?" by answering, "I couldn't possibly know." The logical follow-up question would be, "Then what should I do?" The answer is, "Invest as if you don't know what will happen and own an opinion-neutral portfolio." Identify a target mix of stocks, bonds, and cash reserves that is likely to yield a rate of return sufficient to achieve your financial goals with a level of volatility that won't give you sleepless nights. This allocation decision will be the primary factor that determines your long-term rate of return. Diversify broadly in each of the asset classes in your portfolio so that you're not overexposed to any one company, country, or industry sector. Rebalance back to the original target allocation on an annual basis. Then don't allow anyone's predictions about the future cause you to abandon your strategy. In other words, put your eggs in many baskets, ignore the news, and stick with your financial plan.

In the News

Year	New All-Time Highs
2013	45
2014	53
2015	10
2016	18
2017	62
2018	18
2019	35
2020	32
2021	48

"Look out, the market is at an all-time high!" is perhaps the most deceptive, useless, repetitive warning heard by investors. The worry is that good times cannot last and much like climbing a ladder, each step higher means there's farther to fall. But every closing price in the S&P 500 prior to today was, once, its "all-time high." Valuation is never a predictive or timing indicator. This chart, from Ben Carlson's blog, shows the number of all-time closing highs for the S&P 500 from January 1, 2013 – when the index stood at 1480 – to August 15,2021 when the index stood at 4,400. There have been 320 all-time highs since January 1, 2013, an average of one every 10 days. The S&P has tripled in price, excluding dividends over that time. But don't put all your money into an S&P 500 Index fund just yet. There wasn't a single new high from October 2007 through late summer 2013.

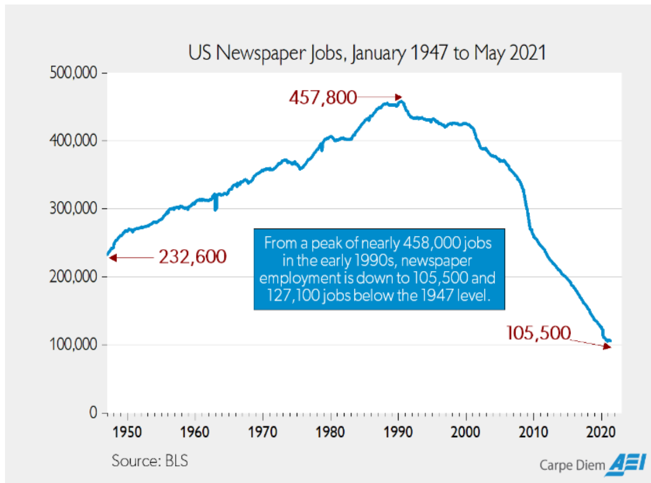
Last year, the Social Security Administration received over 718,000 reports of Social Security related telephone scams. Victims who lost money reported an average loss of $5,800. In March, the Commissioner of Social Security urged Americans to be very cautious of calls claiming to be from Social Security that -

- Threaten arrest or legal action against you unless you immediately send money.
- Promise to increase your benefits or resolve identity theft if you pay a fee or move money into a protected account.
- Require payment with a retail gift card, wire transfer, cryptocurrency, or cash.

Social Security will not text or email you messages containing your personal information. If you owe money to Social Security, the agency will mail you a letter with payment options and appeal rights. It will not suspend your Social Security number or demand secrecy from you in resolving a problem. Visit www.ssa.gov/scam.

August 15th marked the 50th anniversary of the day in 1971 when President Nixon ended the convertibility of U.S. dollars into gold. Until Nixon's action, foreign central banks could convert U.S. dollar holdings into gold at $35 per ounce. In theory, the convertibility of dollars into gold imposed monetary discipline on the Federal Reserve. Inflation jumped in the years following Nixon's action. The CPI rose 98% in the 1970s, turning the purchasing power of $1 in 1970 to 48 cents by 1979. Gold compounded at more than 35% per year from 1970 through January of 1980 - a total return of more than 1900%. The simultaneous increases in the price of gold and the rate of inflation led many to consider gold a good inflation hedge. But this is not supported by the data. Research by Duke University professors Campbell Harvey and Claud Erb found that only over very long periods - a century or more - has gold maintained its purchasing power. As this chart shows, over shorter periods, its real (inflation adjusted) price has fluctuated like any other asset, independent of the rate of inflation. Remembering the 1970s makes the hearts of gold bugs flutter with joy. However, from January 1980 through the end of 2020, gold is up 3.2% on an annualized basis, essentially matching

inflation. Stocks have been a better inflation hedge; the S&P 500 has risen 12.0% on an annualized basis despite an average intra-year decline of 14.3% since 1980. Gold's inconsistent correlation to both stocks and inflation makes it impossible to predict how it will perform in the future – especially when we factor in the growing popularity of cryptocurrencies as the new, high-tech inflation hedge.



Joseph Schumpeter was an Austrian economist who popularized the idea of "creative destruction". The economy changes via an ongoing cycle of new ideas, technologies and innovations that replace old ones. Upstart companies offer new products, better technology and a leaner business model, leading to the disappearance of companies whose product line or business model has become obsolescent. This month's Creative Destruction chart shows the 77% decline in US newspaper jobs over the past 30 years. The ability to receive instant news updates from the internet has led to a huge decline in demand for printed, day-old news. The switch from printed to electronic news has been painful for employees and investors of newspaper companies but good for news consumers. Creative destruction has played a key role in America's outperformance of other major economies. When terminally ill companies die and marginal players are absorbed by stronger survivors, consumers are better off, and the economy becomes stronger.

Splurge a Little

The function of financial planning is to help you retire at the time and in the lifestyle of your choosing. Most personal financial advice concerns budgeting, cutting costs and saving as much as possible each year. Some people take this advice to the extreme and neglect present enjoyment to save as much as possible. They skimp on "splurging" on things like vacations, eating out at nice restaurants, buying new clothes, going to Starbucks, etc. The important, difficult part is finding a balance between deferring gratification and enjoying life today. We don't work hard just so we can enjoy ourselves in some future day that may not arrive, we should take time to enjoy some of the fruits of our labor today.

Recommendations to forgo small present consumptions to enhance retirement finances appear regularly in the personal finance media. Yet they all suffer from two logical flaws. First, saving a dollar here and a dollar there may enhance your pocket change but rarely, if ever, will pocket change find its way into your portfolio. Secondly, these "save a buck" recommendations start with a faulty premise. They assume that it's what you spend your money on that matters. But that's not true – it's whether you can afford to spend the money that matters.

From a financial planning perspective, your monthly income can be divided into three distinct buckets. One bucket contains the money for paying taxes. The second bucket contains the money you're allocating to savings and investments. The third bucket contains what's left over – it's what you can spend each month. If you adequately fund the second bucket and don't overspend from the third bucket, you can splurge a little – it won't kill you. I'm tired of all the holier-than-thou scolders who tell you to never buy a new car, that spending money on a Starbucks latte is an irresponsible act and retiring with a mortgage is a mortal sin. This is foolish advice given by people, most of whom don't follow their own advice, and who have never sat across the table from a real client. It's a good idea to save money and take a long-term view when it comes to your finances. But life is short, and tomorrow is guaranteed to no one, so take some time today to do something you enjoy. If spending $4.00 at Starbucks is going to ruin your retirement, you've got serious financial issues that need to be addressed that have nothing to do with coffee. Practicing deferred gratification is an important component of good financial planning. But so is enjoying the present. Deferring inexpensive, affordable, current gratification is foolish, shortsighted, demoralizing, and unlikely to have any impact on your retirement lifestyle.

Money is a tool that is meant to be used. Using it properly is a learned skill; in which frugality plays a part but isn't an end unto itself. How and when to exercise frugality is a function of perspective and good advice. An occasional, self-indulgent treat shouldn't create guilt if there's still money left over at the end of the month. So, I give you permission to take that vacation with your family, or to go out to eat with your friends or go to a concert, or, heaven forbid, fly first class. The question to ask yourself isn't "How much does it cost?" but "Can I afford it?" Enjoy today, and forget about saving money, just for one day. Try it, you'll like it.

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