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Facing the Future with Optimism and Courage
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There's No Such Thing

There's no such thing as a maximum "safe" withdrawal rate. Many academic papers have been written attempting to determine the maximum "safe" percentage a retiree can withdraw from a portfolio each year, with annual increases for inflation, and maintain a reasonable expectation that it won't be depleted in a 30-year retirement. Most studies, whether using past performance data or projections of future returns, come up with a number in the 3% to 5% range for a portfolio evenly divided between stocks and bonds. That's a reasonable range but even if a maximum "safe" withdrawal rate worked in the past, there's no guarantee that it will remain "safe" in the future. No one can predict the "big three" components of investment performance – asset class returns, tax rates and inflation - with any degree of accuracy. Additionally, these academic studies ignore investor behavior. Many retirees will panic and flee to cash during the inevitable bear markets that occur during retirement. So, despite what you might read or hear in the financial media, there is no one-size-fits-all maximum "safe" withdrawal rate. Your "safe" withdrawal rate is likely to vary from one year the next – depending upon the above-mentioned unpredictable factors. This is why I'm a proponent of annual reviews in which investment returns, inflation, taxes, investor behavior and a retiree's changing needs and goals are analyzed. Once this analysis is complete, an appropriate withdrawal rate for the upcoming year can be calculated.

There's no such thing as the "best" asset allocation. There are portfolio allocation software programs that use past performance data to calculate, to the nearest percentile, the precise allocation that would have yielded the highest annual return with the lowest volatility for a conservative, moderate or aggressive investor. Any financial advisor can create a portfolio allocation that would have performed heroically over any multi-year period in the past. Unfortunately, you cannot invest in the past and no program can tell investors what the best asset allocation will be in the future.

There's no such thing as the "best" mutual fund. All hot funds eventually go cold, usually after they've attracted billions of investors' dollars. This explains why a mutual fund's dollar-weighted return (the return that the average fund investor receives) is usually less than its time-weighted return (the annualized return that appears in a fund's prospectus). Twice each year, S&P issues its Persistence Scorecard which tracks the ability of actively managed funds to consistently deliver above average returns. Of the 371 domestic stock funds that were top quartile (top 25%) performers for the five years ending September 2012, only 25% remained top quartile performers over the next five years - exactly what we expect from random chance alone. As the latest Scorecard states – *"demonstrating the ability to outperform peers repeatedly is the only way to differentiate a manager's luck from skill."* What's even more disheartening is that 34% of the top quartile performers in September 2012 were either merged, liquidated or became bottom quartile performers over the next five years. There are numerous reasons for the falloff in fund performance. Some top performing fund managers leave for higher paying opportunities. Others suffer from their own success – managing more money than their investment strategy can successfully employ. And there's no way to measure what impact personal problems at home can have on an investment manager's performance. There are many reasons why mutual fund performance doesn't persist, easily summarized in five words - all fund managers are human.

There's no such thing as unemotional investing. The keys to successful investing are easy to explain and understand, but successful investing requires more emotional control than most investors realize. Technology will never change human behavior. We want immediate results. When we don't get them, we often make emotional decisions that can have a drastic impact on our portfolio's performance. An article in the *Journal of Accountancy* noted the results of a recent Harris Poll. Almost half (48%) of respondents believe that stock market volatility offers opportunities to turn a quick profit through short-term buying and selling. Short-term buying and selling also offers opportunities to lose a lot of money. Impulsiveness is a cute characteristic in children. In investors it's not cute – it's foolhardy.

There's no such thing as a single economic indicator that can predict what's ahead for the economy or stock market. Today, the big worry is a "yield curve inversion". The yield curve is a graph showing the yield of Treasury securities with different maturities. The curve is usually upward-sloping because longer-term Treasury securities typically have higher yields than shorter-term Treasuries because they have more interest rate risk. The yield curve becomes "inverted" when the yield on long-term Treasuries is less than the yield on short-term Treasuries. Today the yield on the 10-year Treasury note is barely above that of the 2-year note, leading to much hand-wringing among financial pundits. Several factors have contributed to the recent "flattening" of the yield curve. The Federal Reserve has raised the Fed Funds rate twice so far this year, which has driven the short end of the yield curve higher. Yet the yield on longer term Treasuries, which are determined by bond traders, have barely budged.

An inverted yield curve is seen as a forerunner of an economic slowdown for two main reasons. Banks rely on short-term deposits to fund longer-term loans, profiting from the difference in interest rates. With an inverted curve, banks might cut back on making loans, thus hurting businesses. Additionally, the yield curve has sometimes become inverted because the Fed drove short-term rates too high and its tight monetary policy led to a recession. Historically, inverted yield curves have preceded bear markets by 20-30 months; leading some pundits to predict a recession in 2020. But I remain skeptical. Predicting the economy 20 – 30 months from now is a fool's errand and no one knows when the next recession will arrive. Inflation, credit policy, monetary policy, and corporate earnings are more important factors in determining the future direction of the economy and stock market than the shape of the yield curve.

The recent focus has been on the small difference in yields between the 2-year and 10-year notes. But a better indicator of short-term rates is the yield of the 90-day Treasury bill. Today, the difference in yields between the 90-day bill and the 10-year note is about 0.8% - lower than the average from 1950 to the present but similar to what existed in the low-interest rate and low-inflation environment of the 1950s and 1960s. As Prof. Jeremy Siegel of the University of Pennsylvania's Wharton Business School noted in a recent interview – "*People are jumping the gun a little bit too fast on this and worrying about it. They're comparing it to the average spread that we saw in the 1970s, 1980s and 1990s, which was a much higher-inflation period and a much higher-interest rate period.*"

One explanation for the flattening yield curve is the possibility that the 10-year Treasury note is overvalued – making its yield too low for current economic conditions. At some point, if investors begin selling 10-year Treasury notes, its yield will rise, and the yield curve will steepen.

There's no such thing as achieving better returns by working harder. The financial media promotes this fallacy by giving investors the impression that hard work, research, and ongoing portfolio tinkering are the keys to successful investing. But just the opposite is true. Investors who trade too much, chase past performance or try to time the market usually underperform. If working harder produces superior results, then why do most money managers fail to beat the market? It's because of the "paradox of skill". Their competitors are working just as hard; making it unlikely that a manager can consistently find mispriced securities ahead of the competition.

According to a recent article in *Bloomberg,* senior executives at Allianz Global Investors (AGI) are touring the firm's 14 global offices and handing out white running shoes. The campaign is part of a marketing and branding effort by the firm to emphasize its role as an active asset manager and to combat the growing belief that stock pickers don't add value. AGI recently lowered the management fee on some of its funds to 0.2% to retain investors who might be tempted to invest in low-cost index ETF's. But it also added an additional performance fee (20% of the fund's outperformance) that will kick in if a fund outperforms its benchmark. So, in a year in which a fund underperforms its benchmark index, the investor absorbs 100% of the shortfall but if it outperforms its benchmark, the investor keeps only 80% of the outperformance. The untold secret in the fund business is that the average fund that outperforms does so by a smaller margin than the average fund that underperforms. So, over the long-term, the losses in the losing years will likely be greater than the gains in the winning years. For active fund investors, the costs of trading are a drag on fund performance. Investors in index ETFs don't pay those costs or take "manager risk" – the risk that a manager's stock selections or timing decisions might be faulty. They also have another cost advantage over investors in AGI funds. They're not buying sneakers for strangers.

There's no such thing as an investment that yields high returns with little risk. Be wary of investments that promise riches or offer returns that are too good to be true – a common characteristic of most investment frauds. Many scams promote the idea that you can invest in some form of secret strategy that's only known and used by the rich. Sorry, but there are no secret investments that are exclusively available to wealthy people. But scammers often hype supposedly secret strategies that promise to multiply your small investment in short order. Such claims should be viewed with a healthy level of suspicion. If these strategies worked, every institutional investor would be using them.

In the News

Apparently, many American workers are not taking their earned vacation days. A survey of 1,200 full-time employees revealed that 47% did not take their full vacation time last year and 21% left more than five of their earned vacation days on the table. Some of the reasons identified in the survey were:

- Having too much work to complete to take time off (27%).
- Feeling pressured by an employer or manager not to take time off (19%).
- Fearing there will be too much work to do after returning from vacation (13%).
- Believing that not taking vacation days will be good for their careers (14%).

Even those who take vacation days are having problems unplugging from work. Almost half said they check in on work while on vacation -- 19% said they did so every day and 29% said that they did so periodically. Employers are not likely to benefit by this disturbing trend. Past research indicates that employees who take most or all their vacation time each year perform better and are more productive than those who do not.

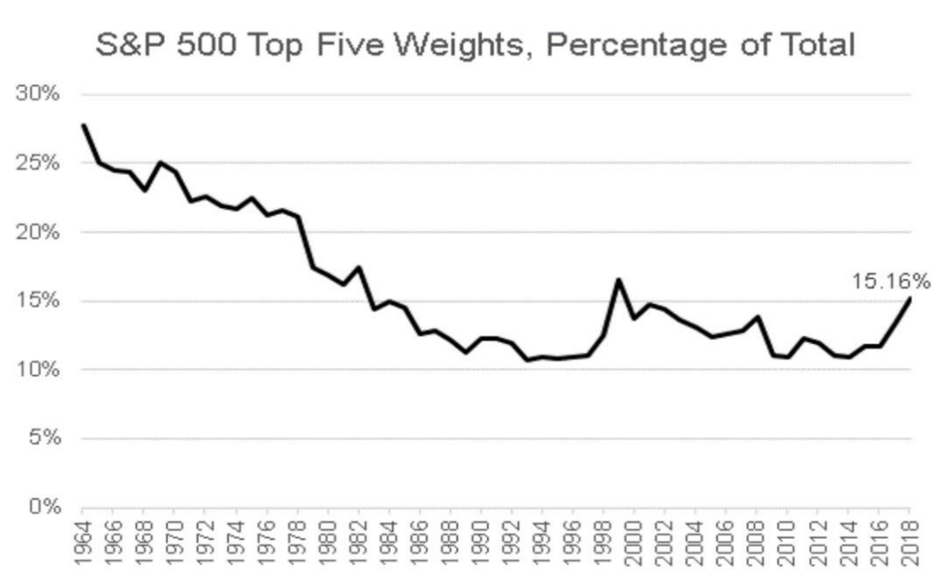
This month's example that figures don't lie but liars figure comes from an article about the increasing debt burden of American families – *"U.S. household debt, which declined between 2008 and 2013, has rebounded sharply. By the first quarter of 2018, it was at an all-time high of $13.2 trillion…we've been better able to manage our obligations, thanks in substantial part to an extended period of low interest rates. But the crisis did not teach us a lesson about the perils of borrowing too much."*

Sounds frightening until you learn what wasn't mentioned in the article – that household net worth reached an all-time high of $100 trillion in the first quarter of 2018 – 50% higher than its peak before the financial crisis. Therefore, although consumer debt is higher than ever, household debt as a percentage of total household assets – a much more useful and precise measure of the household debt burden – is about 13% - the lowest since 1987. Choosing to highlight consumer debt while failing to note consumer net worth, makes for a frightening headline that, while true, isn't the whole truth. When it comes to fake news, the financial media is light years ahead of whoever is in second place.

Something Else to Worry About?

CNBC recently noted that 3 stocks — Amazon, Netflix and Microsoft —made up more than 70% of the approximate 6% gain in the S&P 500, year-to-date. The worry is that if these stocks falter, which they must inevitably do, watch out below. Of course, there's no mention of what might happen if the other 497 stocks in the index get in gear and start performing.

Despite claims that the rising popularity of index funds is creating a misallocation of capital and a distortion in the price of the largest stocks, it isn't unusual for most of the gain in the S&P 500 Index to come from a small number of companies. In a market capitalization weighted index, the largest stocks will have a bigger impact on returns than the smaller stocks in the index. Data from a paper published by Prof. Hendrik Bessembinder showed that from 1926 to 2015, over half the wealth created in the stock market came from the 86 top-performing stocks, around 0.3% of the total. This doesn't mean other stocks didn't do well, just that most of the gain came from the best performing stocks. This chart from Ben Carlson's blog, shows that the largest stocks in the S&P 500 Index have always had a large share of the assets in the index.



Contrary to popular opinion, the current bull market that began in March 2009 has not been dominated by the biggest companies. From March 2009 through June 2018, the S&P 500 Index has yielded an 18.6% average annualized return. The S&P 500 Equal Weighted Index, which holds an equal allocation to all 500 stocks in the index – has yielded a 21.2% average annualized return.

The current bull market is one in which every capitalization size has taken part. Small-cap stocks are outperforming large-cap stocks this year. The S&P 500 Index of large company stocks is up 6.2% year-to-date through the first week in August while the S&P 600 Index of small company stocks is up 12.5%.

It's common for a few high performing stocks to yield most of the market's return in any given year. Unfortunately, no one knows who these outperformers will be in advance. So, the only way to guarantee that you'll own the stocks that grow the most is to have a diversified portfolio of index funds, which effectively hedges your bets by keeping you invested in every stock.