On Course Financial Planning

Facing the Future with Optimism and Courage

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Lessons Learned in 2020

If you received Divine Revelation on New Year's Day 2020 that the world was about to be hit by a global pandemic that would lead to massive government imposed shutdowns of businesses, a sudden recession and the largest single quarter decline in economic activity since the Great Depression, what would you have done? Most of us, if we are honest, would admit that we would have sold our stock investments and hid in cash until things "settled down", a phrase with no definition or date on the calendar. To the dismay of those investors who fled stocks during this tumultuous year, the Vanguard Total Stock Market Index ETF (VTI) was up more than 17% through the first week of December, not including dividends. Fortunately for most buy and hold investors, our inability to see the future prevented us from making short-term decisions that would have done long-term harm to our portfolios. Investors who were able to tune out the noise of 2020 and stick with their plan have reaped the rewards of the time-tested strategy of staying the course.

Knowing what lies ahead does not guarantee investing success. In a speech in June 2007 Robert Rodriguez, manager of the FPA Capital fund, said that housing, stock, bond, private equity and hedge fund markets were in a speculative bubble. In December of 2007, he stated his belief that a credit crisis would lead to a severe recession in 2008 and went to a large cash position in his fund. Yet in 2008 his fund declined 35% - just 2% better than the S&P 500 - despite his astute prediction.

Market timing is a gamble, no matter how you cut it. When someone gambles and wins, we don't consider the gambler a genius - we call him lucky. Despite making a perceptive economic call and holding a large cash position entering 2008, Mr. Rodriguez re-entered the market too soon and bought stocks whose prices continued to decline. Although he avoided financial stocks, he was heavily invested in energy related companies, whose stock prices plummeted as commodity prices collapsed. He also had a large allocation to Circuit City – which went bankrupt. Successful market timing requires more than just seeing the big picture, you must also decipher the small details hidden in the cracks inside your crystal ball.

History tells us that the stock market has most of its significant gains in a small number of days, often for no apparent reason. For those investors who decided to stay on the sidelines until the election was settled and a Covid vaccine was approved, November provided a stock market slap in the face. For those investors who were determined to stay the course, come what may, November provided an early Christmas gift. November was the best month for the Dow Jones Industrial Average since January 1987 (up 11.9%), the best month ever for the small-cap Russell 2000 Index (up 18.3%) and the second-best November for the S&P 500 Index (up 10.8%). Don't feel too bad if this dramatic rebound took you by surprise. According to BofA data, only 14% of actively managed large-cap core funds beat the Russell 1000 Index in November, the third-worse index lagging monthly performance since 1991. The performance shortfall was partly attributable to fund managers overweighting growth stocks and underweighting value stocks, which rebounded strongly in November. As of the end of November, only 20% of active domestic stock funds have outperformed their benchmark index in 2020. The notion that a portfolio must be in the sure and steady hands of an active manager during times of market volatility has once again been shown to be an assertion unsupported by the facts.

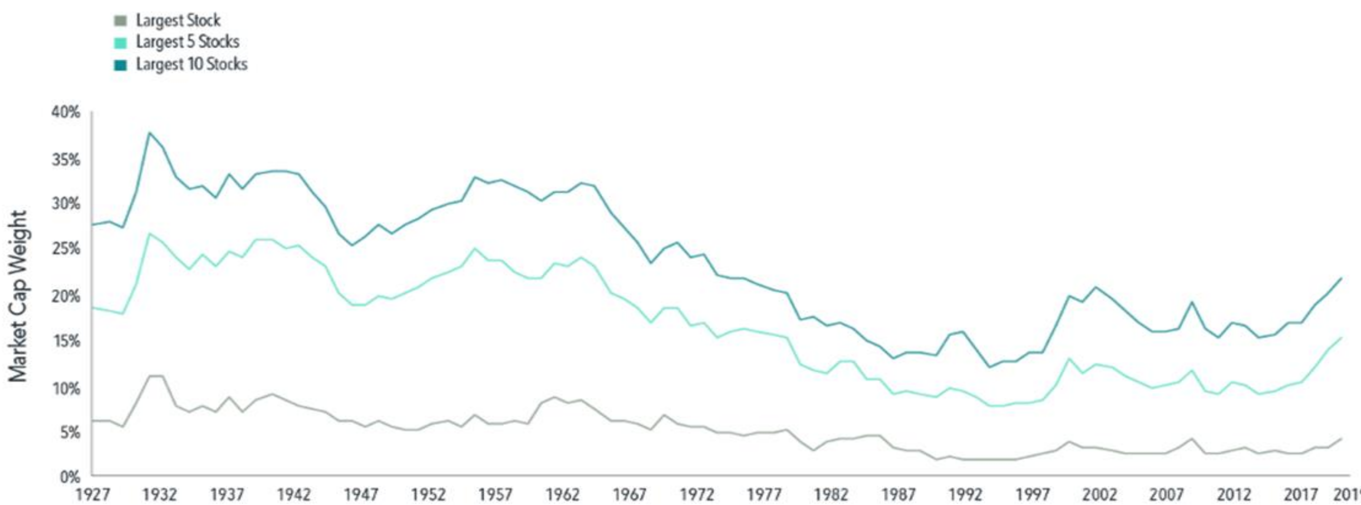
The future is synonymous with uncertainty and will always contain unexpected negative events. The stock market doesn't climb in a straight line and volatility cannot be avoided. March's decline was short, but violent. However, as we have repeatedly witnessed, bear markets eventually come to an end and market indexes recover and climb to new highs. Allowing large font, frightening headlines to scare you out of the stock market has always been a big mistake, even if it feels "safe" in the short-term. You've got to keep your emotions as far away from your investment decisions as possible. Wise investors acknowledge the risk that accompanies uncertainty, allocate their assets, rebalance periodically and press on with the information they have, incomplete as it always is. The goal is not to be right 100% of the time. The goal is to be right more than you are wrong. One of the toughest lessons for investors to learn is that stocks often fall amid positive news and rise while negatives dominate the headlines. This is because the professional investors who dominate market activity are thinking about tomorrow and what will happen, not what happened yesterday or is happening today. Success in investing requires more patience than most endeavors. Fortunately, it does not require you to know the future. But you need to face the future with optimism and courage and maintain the belief that, even if it takes a while, things will work out and that prudent risk-taking will be rewarded.

An Index Fund Bubble?

How can we determine the total value of the stock market? The answer is found by calculating the market capitalization (market-cap) of every stock (by multiplying the price of the stock by the number of outstanding shares) and then taking the sum of the market-cap of all stocks. By comparing the difference in the market-cap of a total stock market index at two different periods, we can compute the market's return during that time. For example, if we take the difference between the Russell 3000's market-cap on Monday and Tuesday and then divide the difference by Monday's market capitalization, the answer gives us Tuesday's percentage gain or loss in the value of the stock market.

All the popular market indexes are market-cap weighted and they make index funds relatively easy and inexpensive to maintain. Unless the stocks in an index change, a properly constructed cap-weighted index fund does not need to trade because the share price of the fund changes in direct proportion to the daily change in the market-cap of the index. Market-cap weighted indexes are used to measure the performance of almost all asset classes.

For most of this year, just a handful of stocks were driving the market upward. At the end of November, the five largest stocks by market-cap weighting (Apple, Microsoft, Amazon, Facebook and Google parent Alphabet) made up 22% of the S&P 500 Index. In other words, 22 cents of every dollar invested in an S&P 500 Index fund was invested in just these stocks. Critics of indexing claim that all the money flowing into S&P 500 Index funds has created a bubble in these large-cap growth stocks, which receive more than one out of every five newly invested dollars. But there is nothing unusual about a small number of stocks driving the market. This chart from Dimensional shows that from 1927 through the mid-1960s, the largest ten stocks made up more than 25% of the market cap of the S&P 500.



Researchers at Dimensional Funds examined the performance of the ten largest companies by market capitalization from 1927-2019. As might be expected, during the five and ten-year periods before reaching the top-ten, they outperformed the overall market. But after becoming top-ten stocks, they tended to underperform the market over the succeeding five and 10-year periods. The reason might be that investing in mature, profitable companies is less risky than investing in the average stock. Since risk and expected return are directly related, we should expect that the future return of today's most popular stocks will be less than the return of the broad market.

10 most valuable U.S. companies

1980	2020
1. IBM	1. Apple
2. AT&T	2. Microsoft
3. Exxon	3. Amazon
4. Standard Oil of Indiana	4. Alphabet
5. Schlumberger	5 Facebook
6. Shell Oil	6. Berkshire Hathaway
7. Mobil	7. Walmart
8. Standard Oil of CA	8. Tesla
9. Atlantic Richfield	9. Visa Inc.
10. GE	10. Johnson & Johnson

Sources: ETFDB.com and assetdash.com

This chart shows the ten most valuable domestic companies based on market capitalization in 1980 and 2020. It reveals that change is a permanent feature in the economy and how hard it is for top stocks to maintain their status. Austrian born economist Joseph Schumpeter coined the phrase "creative destruction" to describe how entrepreneurs and workers in new technologies create disequilibrium by creating new profit opportunities and businesses that replace companies committed to older technology. Recent examples of creative destruction are how Netflix put a quick end to Blockbuster and how digital film put an end to Kodak. Creative destruction is a permanent component of our capitalistic economy and is one reason why it is wiser to own the total market with a portfolio of index funds rather than just a few individual stocks or active stock funds whose portfolios contain only a subset of the total market.

Forecast Time

The financial media is awash with noise. By noise, I mean statements of little value, often spoken or written to fill lapses in television broadcasts or blank spaces on newspaper pages. Most of what passes for financial news is nothing more than financial noise. All forecasts are noise. All "What to Buy Now" articles are noise. When the financial media asks "experts" for their opinion about how today's events will influence tomorrow's markets, they never fail to respond. Most investors walk away from all this noise in a state of confusion.

Wall Street analysts get paid to make predictions and December is the time of year when the financial media is filled with economic and stock market forecasts for the upcoming year. These predictions will find a large audience because we investors share a disturbing trait -- the more uncertainty we face, the more anxious we become. The randomness of world events frightens us, and we seek someone who can make sense of it all. Deep down inside we know that no one can predict the future. But like moths to a flame, we are attracted to “experts” who confidently claim to know what lies ahead. No one predicted what was in store for us in 2020, the latest example of why investing according to market forecasts is not likely to be a reliable strategy. This is not to say that financial analysts don't know a lot about the industries and companies they cover. But no amount of study or analysis can factor in the unexpected. The sheer number of economic and stock market forecasters is proof that no forecaster possesses the insight that investors are seeking. Forecasts are at best an educated guess, yet guesses, nonetheless. It’s easy to create a reasonable sounding story to support practically any forecast. Truth be told, most forecasts are made to enhance the reputation of the forecaster, not to enhance the financial well-being of investors.

The data used in economic forecasting models is based on surveys, estimates, sampling and good old-fashioned guessing. No surprise then that the track record of forecasters is no better than what one would expect from coin flipping. Given the large number of forecasters, a few will make accurate calls through luck alone, achieving notoriety, at least for a while. But random chance is a heartless task master. Few will repeat their success and their 15 minutes of fame will soon end. There are no economic theories whose adherents have a better forecasting ability than others. Consensus forecasts are no more reliable than the individual forecasts on which they are based. There are no specialist forecasters who have demonstrated a predictive ability regarding specific financial topics such as the stock market, interest rates or inflation. Many of the forecasts for 2021 are contradictory and you can be sure that predictions of doom and gloom will garner headlines and go viral on social media. So, what can you do?

The best strategy is to own a diversified portfolio that is diversified not only across asset classes, but within them. Continue to fund it throughout the year, periodically rebalance it and don't waste time listening to “expert” forecasters. Understand that all those opinions and forecasts you're hearing are already reflected in today’s prices, which represent the collective best estimate of future expected returns. The three most important words that investors need to be comfortable with are “I don’t know”. It's actually a relief once you realize that knowing what will happen next isn't a prerequisite to successful investing. Diversification is the best defense against the likelihood that things will not turn out exactly as most forecasters expect.

Too many financial advisers believe that their value proposition includes helping clients outperform the stock market. Thus, they recommend individual stocks and active funds that they believe (hope?) will outperform. They continue this charade even though most professionally managed mutual funds cannot beat their benchmark index. Why would anyone believe that advisors who work with a small staff (or maybe even alone) can succeed where so many better qualified money managers have failed? Beware of taking financial advice from someone whose recommendations are based on a market forecast - a good indication that your advisor believes that they can provide either a timing or selection advantage over the market. Their inevitable failure to provide outperformance, and the costs you pay attempting to do so, will likely have more impact on your financial well-being than theirs.

Exercise a good deal of skepticism when you hear or read economic and stock market outlooks for 2021. No one has been able to make accurate forecasts with any consistency because forecasters must not only predict what will happen but also how the capital markets will react to unexpected events. But their faulty predictions are of no consequence to long-term investors who can safely ignore them. There would be fewer forecasters if we held them accountable for their erroneous predictions and the financial losses of their disciples. Unfortunately, bad forecasts are soon forgotten and forecasting itself never receives the ridicule that it deserves.

Well, another year has come and gone. Good riddance to 2020. There is only one thing left to say - Merry Christmas to all and to all a goodnight.