On Course Financial Planning
Facing the Future with Optimism and Courage
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Desert Musings

My wife and I are relaxing in the Arizona sun and it's time for my annual desert musings.

It's ironic that Robinhood, which exists to help the little guy gain easy access to the stock market, has seen its brand tarnished by client overtrading. Robinhood has faced criticism in the past for allowing unsophisticated investors to trade stocks as often as they change their minds. Many users of its app suffered large losses in the recent GameStop mania which saw the stock of the money losing company rise from $20 on January 11th to $468 on January 28th and back to $53 on February 4th. By "gamifying" investing, the Robinhood app encourages the type of behavior that leads to losses and lower returns. It lures naïve investors by offering a free app and commission-free trades. So how does it make money? It sells its orders to high-speed trading firms, the market makers and institutional customers who process trades. These invisible middlemen exist between Robinhood's app and the stock exchanges and they skim money off every trade. Robinhood's users don't see these costs which are hidden in behind-the-scenes fees and bid-ask spreads.

Every generation provides a new group of gullible, foolish investors who try to get rich quickly by turning investing into gambling, treating Wall Street like a casino. They have not learned that instant gratification and investing are mutually exclusive concepts. Thus, we have millions of people today who believe they can get rich by trading stocks based on internet chatter. Like the dotcom mania of the late 1990s, investors are purchasing financial assets with little or no value simply because the price has been rising. How else can you explain the gains in the price of Bitcoin, an intangible asset which has yet to demonstrate any use or value to non-criminals. These "investors" will soon learn the hard way that it is perfectly legal for Wall Street to sell you garbage if you are advised of the risks in a prospectus. But nobody reads prospectuses.

To the extent that GameStop stock buyers were organized and coordinated, they may have engaged in illegal "market manipulation", defined in the US Securities Exchange Act of 1934 as *"transactions which create an artificial price or maintain an artificial price for a tradable security"*. SEC investigators are reviewing online media posts for evidence that fraud played a part in the trading frenzy that triggered extreme volatility in GameStop stock. Much of the reporting about the GameStop story has been idiotic, celebrating a supposed "democratization" of financial gambling and a populist rebellion that will punish Wall Street hedge fund bigwigs. When Sesame Street kids play on Wall Street, guess who comes away with all the cash?

Too much financial advice promotes budgeting as the cure for all financial ills. I disagree. If you are funding your retirement accounts at an appropriate level and avoiding expensive consumer debt, then I don't care how you spend the rest of your income each month. It's a waste of time and energy tracking every expense. You should know how much you spend each month, an amount less than your take-home pay, but not necessarily where each dollar goes.

Financial planning is an ongoing process consisting of a series of educated guesses. But reality doesn't give a hoot about your financial plan's assumptions. Therefore, flexibility is an essential ingredient of good financial planning. Annually reviewing your financial plan is the best way to track your progress. Comparing actual results with projected results will reveal if you need to make changes in your plan. A plan also helps keep you goal focused instead of market focused. Expect your financial plan to bring success over years, not months.

I can't predict when the next bear market will begin but since emotions play such a large part in our investment decisions, it's easy to predict how investors will react.

Every trading day, financial commentators create stories to explain why stocks went up or down. They know that their audience prefers a comforting story – even if false - to the uncomfortable truth that on most days no one knows why stocks went up or down. The uncertainty inherent in investing is one reason why economic and market forecasters find such a large audience – even though, deep down inside, we know that most of them are just blowing self-promoting smoke.

The financial media exists to entertain you and sell advertising. Fox Business and CNBC have mastered the art of talking endlessly, even after nothing else needs to be said. The financial media pumped enough hot air into the dotcom bubble to inflate the Hindenburg. A common mistake that investors make is confusing information with profitable insight, not realizing that all current information is already factored into asset prices. Thus, nothing you learn from the financial media can give you an edge in the market. Most of what we think are our unique insights are just run-of-the-mill facts that are known to all other investors.

Wall Street isn't exactly basking in glory at the present time. One reason is that it employs more scoundrels than is necessary. Wall Street firms are self-serving and, despite what they say in their ads, are not looking out for your interests. Since the financial crisis, Wall Street's big firms have proceeded with business as usual, exploiting the knowledge gap between its representatives and their clients. Individual investors would benefit by becoming more skeptical and less gullible. Accept the notion that the future is unknowable, that anything that sounds too good to be true is a lie and that nobody on Wall Street is giving out free money.

Successful investing requires a few simple actions; diversify your portfolio, focus on the long-term, keep costs low and periodically rebalance your portfolio. But simplicity is not what Wall Street emphasizes. It offers free trades, active stock funds, stock picking, market timing, complex, illiquid financial products and "safe" fixed income investments that pay double or triple what high quality bonds are yielding. Caveat emptor.

This is your annual reminder that your financial advisor has no control over your portfolio's return. Advisors who attempt to do so have two options. They can respond to what has already happened (net value to you = 0) or they can try to pre-empt events by market timing. Since no one has a clear crystal ball, you should not expect better than a 50 - 50 success rate for market timing (net value to you = 0). For the sake of their clients, I wish that every time an advisor has a new market beating idea, he would go into a dark room, lie down and not get up until the urge passes.

It's hard to comprehend the logarithmic acceleration of technical progress that is occurring all around us. My granddaughters can stream an HD movie on their Surface tablet. When I was their age, the upper limit of my technological life was listening to the Yankee game on a 9-volt transistor radio.

Try to make sure that your financial life does not serve as a warning to others.

Having a globally diversified portfolio of stock index funds makes you the owner of a small share of the global economy. Buying, holding and rebalancing this type of portfolio is one of the best, if not the best, long-term investment strategies. The ending value of a continuously funded, globally diversified portfolio of index funds over an investing lifetime will be greater than most investors can imagine. Unfortunately, many investors own a few individual domestic stocks instead of the global stock market. This is a much riskier and entirely different strategy. The retail brokerage industry has no financial incentive to advise clients to adopt an indexed buy, hold and rebalance strategy -- and they never will.

Patience may be the most important characteristic of the successful investor. Investors love the long-term return of stocks, but they hate short-term volatility. When volatility spikes many become impatient, focusing on short-term issues and engaging in counterproductive portfolio tinkering. Here are some of the consequences of investing your long-term capital with a short-term mindset:

- You will have no strategy directing your actions.
- You will find yourself constantly chasing past performance.
- If you have a financial plan, it will be shredded, replaced by financial forecasts.
- Your decisions will be reactive instead of proactive.
- You will incur higher costs, fees and taxes.
- You will not experience the long-term benefits that come from diversification, rebalancing and mean reversion.

Research conducted by Arizona State University's Hendrik Bessembinder on 80 years of US stock market history showed that, over their lifetimes, most stocks produced a negative return. Every year, many stocks underperform the stock market averages, because the averages are skewed higher by a minority of stocks with huge gains – all of which are owned by index funds. So even though owning market-cap based index funds means that you will own the most popular, expensive stocks, if they fall out of favor you will also own the stocks that replace them. Bessembinder's research provides more evidence why indexing is increasing in popularity each year. After sixteen years in this business, I am more convinced than ever that the liquidity, low cost, tax efficiency, transparency and diversification offered by index funds are essential ingredients of any well-constructed portfolio.

After suffering through a severe market calamity, such as the financial crisis, investors tend to spend the following years worrying if it will happen again and how to avoid the consequences of a repeat occurrence. Thus, we are unprepared for the next crisis – such as a global pandemic.

After the financial crisis of 2008/2009, some well-known financial prognosticators claimed that a “new normal” had arrived and that we should expect slower economic growth and lower stock returns in the future. Since the stock market bottomed in March of 2009, the S&P 500 Index, with dividends reinvested, is up an annualized 14% through the end of 2020. So far, I like the “new normal”.

S&P 500: 1926-2020

Time Frame	Positive	Negative
Daily	56%	44%
1 Year	75%	25%
5 Years	88%	12%
10 Years	95%	5%
20 Years	100%	0%

Source: Dimensional Fund Advisors

The stock market has been unrivaled when it comes to growing wealth over the long term. As can be seen in this chart, the daily market action has split 56% up and 44% down over the past 95 years. You should ignore the first 3 rows of the chart, which are erased by the last two rows. Let the professional money managers, whose jobs depend on short-term performance, drive themselves crazy trying to figure out what will happen in the next five years. If you have a decade or more before retirement and are out of the stock market, you are not being conservative – you are being irrational.

Retirement can be defined as the time of life when you use your investment capital instead of your human capital to fund your living expenses. Retirees are often advised to withdraw no more than 4% of their portfolio's principal in the first year of retirement. This drawdown rate was calculated by William Bengen using historical data in an article published in the October 1994 issue of the *Journal of Financial Planning*. Bengen concluded that a retiree could begin with a 4% withdrawal, annually increase the withdrawal by the rate of inflation and have a 90% chance of not running out of money in a 30-year retirement -- assuming a portfolio allocation of 60% large company domestic stocks and 40% U.S. Treasury bonds. Many studies have been done on portfolio withdrawal rates in recent years using different asset allocations, updated databases and Monte Carlo simulations and the 4% rule has been found to be reasonable. Personally, I am happier with a 3% initial withdrawal rate and a rate of less than 3% is cause for celebration.

	Dollar Weighted Average Annual Returns	Dollars Invested	Ending Balance
Worst Timing	8.31%	$ 20,000.00	$ 48,563.92
Best Timing	10.61%	$ 20,000.00	$ 65,014.75
Buying Monthly	11.15%	$ 20,000.00	$ 68,989.16

Consider three people who invested $1,000 each year from 2001 to 2020 in the Vanguard Total Stock Market Index Fund (VITSX). Curly, with the worst possible market timing, invested $1,000 at the fund's highest price each year. Larry, the perfect market timer, invested at the lowest price each year. Moe invested $83.33 on the 15th of every month. All dividends were reinvested. This chart, from the *beyond-wealth.com* blog shows the annualized average return and the ending balance for each option. No surprise that Curly experienced the worst results but it is surprising that perfect market timing underperformed the once-a-month strategy. Charlie Munger, Warren Buffet’s longtime investing partner, has said, *“The first rule of compounding: Never interrupt it unnecessarily.”* Moe's once a month strategy – dollar cost averaging - outperformed the best timing because his dollars spent more time in the market, growing and earning dividends, confirming the adage that time in the market is more important than timing the market.

Stock prices do not rise in a straight line. Investors are going to encounter volatility along the way. From 2008 through 2020, the S&P 500 Index declined in 50 of the 156 months, approximately 32% of the time. Yet over that same period, the index posted an average annualized total return of 9.8%. In 2020, there were five down months in the S&P 500 and the 12.4% decline in March was the largest monthly drop since 2008. Yet despite producing losses in five months, the index posted a total return of 18.4% for the year. Investors often equate the S&P 500 with "the stock market". But it only tracks 500 large-cap domestic stocks and has no small company stock exposure. If your portfolio's stock allocation is globally diversified and includes a tilt toward value and small-cap stocks, then its performance likely trailed the S&P 500 in 2020. This is no cause for alarm. Diversification is for downside protection and guarantees that you will always underperform the best performing asset class of the year.

Optimists are often criticized for being oblivious to risks. Pessimists claim to be prescient in seeing dangers that lie ahead. But obsessing over "What if?" isn't a sign of wisdom. Optimists understand that things can get ugly, that we will have recessions, bear markets, wars, panics, and pandemics. But they are prepared to withstand the downside because they believe that recovery and progress are inevitable. To the pessimist a bad event is the end of the story. To the optimist it is a disappointing chapter in an otherwise excellent book. It may be raining but the sky isn't falling. The difference between an optimist and a pessimist often comes down to time horizon, attitude and patience.