On Course Financial Planning
Facing the Future with Optimism and Courage
February 2022 Vectors
geo@oncoursefp.com 425-861-9997

In the News

Almost every year, the stock market goes through a period of volatility that occurs without warning. We should know this by now, yet it always comes as a surprise to many investors. The financial media will overhype every market decline. Ignoring the media and calmly accepting unpleasant volatility is a trait of all successful investors. In January, the stock market experienced its latest episode of heightened volatility as traders, computer algorithms, novice investors, speculators, and other such fools bought and sold stocks in anticipation of what they believe will happen when the Fed raises interest rates from zero to practically nothing. Once again, too many investors focused on the stock market's short-term volatility instead of its long term upward trend line. The intra-day volatility of stocks always has, and always will be, irrelevant to investors with a financial plan and a well-diversified portfolio that reflects their goals, time horizon and risk tolerance.

A correction is defined as a drawdown of 10% or more from a stock market index's most recent peak. The S&P 500 Index ended 2021 at 4,766. On January 24th it hit the low point for the month - 4,223, a drop of 11.4%, making January the ninth month since 1950 in which the S&P 500 experienced an intra-month decline of 10% or more. True to form, the financial media did their best to give the impression that, at this rate, the S&P 500 would be zero by the end of October. Even though stock market corrections are common occurrences, many people overreacted and fled to the sidelines. Peter Lynch, the legendary manager of the Fidelity Magellan Fund during its heyday has famously said *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves…No one can predict with any certainty which way the next 1,000 points will be. Market fluctuations, while no means comfortable, are normal."*

The previous eight times that the S&P 500 fell at least 10% during a month, the average decline was 13.7%. Yet over the following 12 months in those eight years, the S&P 500 yielded an average return of 26.6%. Most investors who flee stocks during corrections miss the rebound because they have no way of knowing when it is "safe" to get back in. Market timing is hazardous to your wealth because you must be right twice, getting out before the decline and then getting back in before the rebound. Good luck with that.

Stock Market Losses: 1928-2021

Losses	% of Years
5% or Worse	95%
10% or Worse	63%
20% or Worse	26%
30% or Worse	10%
40% or Worse	5%

To give some perspective on January's 11.4% drawdown, here's a chart from Ben Carlson's blog noting the frequency of intra-year drawdowns in the S&P 500 in the 94 years since 1928.

In 89 years, there was a drawdown of at least 5%.
In 59 years, there was a drawdown of at least 10%.
In 24 years, there was a drawdown of at least 20%.
In 9 years, there was a drawdown of at least 30%.
In 5 years, there was a drawdown of at least 40%.

The annualized average return of the S&P 500 since 1928 has been just over 10%. However, annual returns have varied from -43% (1931) to +54% (1933). Thus, that 10% average annual return number that you often hear is deceptive, it is the average of widely dissimilar outcomes. Don't be fooled, normal is a word with no meaning when it comes to annual stock returns. The only certainty is uncertainty, and you should always expect the unexpected.

As has been the case for several years, inflows into mutual funds and exchange traded funds (ETFs) continued to favor index funds in 2021. Index mutual funds and ETFs reported estimated net inflows totaling $958 billion, compared to estimated net inflows totaling $250 billion for actively managed funds.

The Justice Department has accused Steven Gallagher of perpetuating a "pump-and-dump" scheme that earned him more than $1,000,000. He is accused of recommending the 70,000 followers of his "Alex DeLarge" Twitter account to purchase stocks that he owned and planned to sell. Once his Twitter followers began buying the recommended stocks, their prices rose, and he sold the shares he owned for a profit. Same old scam made easier with new technology.

Desert Musings

Stocks go up most of the time but sometimes they go down. If you want the long-term return that stocks have historically provided, you have to accept the inevitable drawdowns along the way. Almost a century ago, economist John Maynard Keynes made this observation: *"It is from time to time the duty of the serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself."* If you can't take the heat, get out of the kitchen. Stop complaining about red numbers. Eventually, they'll turn green. If you don't believe this, put all your money in the credit union and pray for deflation.

In the 13 years since the end of the financial crisis, there have been ten quarters with a negative total return in the S&P 500. Ten out of 52 quarters – an average of less than one per year. Even better, there have not been two consecutive negative quarters. If you had money to invest over the last 13 years, and you stayed invested in the stock market, you enjoyed one of the great bull markets of the last century. Conversely, if you stayed out of the market for whatever reasons that seemed logical at the time, you committed one of the great investing mistakes of all time.

The S&P 500 ended January down 5.3%. There's an old wall Street adage that "As goes January, so goes the year.". But is this true? According to data from Larry Swedroe, since 1950, there have been 28 years in which the S&P 500 declined in January, with an average loss of 3.6% for the month. During the remaining months of those 28 years, the average return was 5.4%. By now, the silly idea of a "January effect" should have been put to rest. But it lingers.

What is the stock market going to do? Nobody knows, so don't ask. Should you care? Maybe yes and maybe no -

- Yes, if you have a large portion of your portfolio invested in highly speculative investments or "investments" with no intrinsic value, or stocks purchased just because of recent good performance.
- No, if you are reinvesting stock fund dividends, thereby buying shares at lower prices during market declines. Once the market recovers, the stock portion of your portfolio will rebound quicker than the market because you will own more shares than before the decline began.
- Yes, if you're a young investor in the accumulating phase of life. You should be hoping for an extended period of falling stock prices so you can buy shares on the cheap. The longer the bear market, the better.
- No, if you are retired and making withdrawals only from the fixed income side of your portfolio. You have the luxury of ignoring the ongoing up and down variations of the stock funds in your portfolio.
- No, if you realize that your investment decisions should be governed by your goals, not current market activity. Successful investors act according to a plan. Failed investors react to current events.

You don't make money in the stock market by buying and selling. You make money in the stock market by buying and waiting. Wealth creation from equities comes from compounding growth over time and it's important not to interrupt the compounding unnecessarily. Tuning out the day-to-day noise that often leads to impulsive decisions is a wise strategy. Too many people believe that to be successful investors, they must follow the market's daily ups and downs. But there is no evidence that this provides any edge. In investing, unlike other endeavors, being smart and working extra hard doesn't result in better outcomes, usually just the opposite. Warren Buffett said the most important trait to have as an investor isn't intelligence, it's temperament: *"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."*

The main product of the financial services industry should be perspective, but it isn't. It's hype accompanied by too many numbers and too many decimal points. It's always promoting complex solutions, but simple solutions are almost always better for investors. Isaac Newton said it best: "*Truth is ever to be found in simplicity, and not in the multiplicity and confusion of things."* Clients would be much better off if financial advisors avoided the ever-present temptation to be clever. Your financial advisor should be simplifying your financial affairs, which helps you understand issues and focus on what's really important. When you're being pitched a new, complex investment, ask yourself, "Can this be done simpler?" If you don't know the answer, seek advice from a financial professional who has no financial interest in the matter. Very often, you'll find out that it can — and at a lower cost.

The most important investing decision you need to make is finding the proper portfolio allocation to meet your financial goals. This is not an easy undertaking. Investors are regularly encouraged to improve performance by stock selection or market timing strategies, which have proven to be counterproductive, more often than not. Your allocation must reflect your risk tolerance, risk capacity and should be broadly diversified with low-cost funds. The good news is that the investments available to accomplish this task are more numerous and less expensive than ever.

The "age in bonds" rule of thumb says that your bond allocation should equal your age. This silly idea refuses to go away and is especially irrelevant to seasoned seniors. At 80 years old, for instance, your risk profile can become more aggressive if the assets in your portfolio are likely to be spent by your heirs. The assets they are likely to inherit should be invested in a manner that reflects their longer investment time horizon.

There have been 14 million mortgage refinances in the last two years. The average monthly savings has been $233 in reduced mortgage payments. So, homeowners who have refinanced their mortgages in the last two years have offset some of the effects of the inflation spike we have been experiencing recently.

It is not uncommon to hear stories of speculators making quick profits. But it is less common to hear of speculators repeating their success. But if they do, the coin-flipping odds of speculation are sure to eventually punish over-confident speculators.

Stocks and real estate have proven to be the best long-term inflation hedges for the last one hundred years. But you have to accept the volatility of stocks and the illiquidity of real estate if you want to enjoy the inflation beating returns that they have provided.

The US dollar is a faith-based currency backed by nothing. But it is legal tender for paying bills, debts and taxes - thus it is money. Gold is a faith-based metal backed by nothing that cannot be used to pay bills, debts and taxes – thus it is not money. Bitcoin is nothing backed by nothing except the enthusiasm of its fan base. Its price can change by thousands of dollars in a few hours because it lacks intrinsic value. There's no way for any "expert" to determine what its future value might be—except by guessing. Crypto fanatics ignore these facts. They are betting on the greater fool strategy – as long as they believe that some fool will buy it from them at a higher price than what they paid, they're happy. And there appear to be plenty of crypto fools. Bubbles inflate when people stop thinking for themselves and copy what others are doing in an effort to get rich quickly. In all speculative bubbles, what appears to be rational behavior on an individual basis inevitably leads to collective insanity. Latecomers to this party will likely discover too late that early bitcoin speculators found a greater fool, made a fortune and re-invested their gains into real estate and other traditional assets.

With a return of 196%, Devon Energy Corp. (DVN) was the best performing stock in the S&P 500 in 2021. The tenth best performing stock was Nucor Corp. (NUE), with a return of 118%. The worst performing stock in the index, with a loss of 41%, was Penn National Gaming Inc (PENN) and the tenth worst performer was Fidelity National Information Services Inc. (FIS) which lost 22%. This wide dispersion of annual returns is typical, and it provides active managers the chance to outperform the S&P 500. Yet, year after year, the majority fail to do so. According to Morningstar, the Vanguard 500 Index ETF (VOO) returned 28.8% in 2021 – even though it owned all of the worst performing stocks. All an active fund manager had to do to outperform VOO was overweight the top performers and underweight the bottom performers in their fund. Yet, according to Morningstar, VOO outperformed 76% of active funds in its category in 2021. Instead of lowering risk, active managers add one more layer of risk to investors' portfolios.

As a general rule, it's best to assume that a publicly traded security is accurately priced. However, it's best to assume that the price of any non-traded security is nothing more than an optimistic guess made by its issuer. It may swear that it's telling the truth but, in the end, that's not much of a warranty.

Performance chasing investors are fooled by simple arithmetic. The financial media will proclaim any fund manager who outperforms the competition for five consecutive years to be a money managing superstar. If a manager is more skilled than the competition, the outperformance should continue. But according to data provided by S&P, of the 490 domestic stock funds that were top quartile performers (top 25%) for the five years ending June 2016, only 104 (21%) remained top quartile performers over the next five years. By random chance, 123 (25%) should have done so. Since top performing funds rarely repeat their success, we must conclude that for most of them, Lady Luck, not the fund manager, produced the results. You can't buy past performance, only future performance—which often experiences reversion to the mean when a popular fund receives more new money than its manager can efficiently invest.

All the evidence shows that institutional investors are no better at timing the market than individual investors. I agree that if you could time the market, you'd be much better off than those who buy and hold. But no one can successfully time the market over long time periods, so that's a silly argument, a nonstarter. The good news is that we don't have to engage in market timing. Good financial planning assumes that unpredictable financial crisis will occur periodically, and portfolios are designed accordingly. Unless you can see the future, buy, hold and rebalance remains the strategy that makes the most sense.