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

Desert Musings

My wife and I are enjoying sunny Arizona, so that means it's time for my annual desert musings.

January was a good month for stocks. The Vanguard S&P 500 Index ETF (VOO) rose 6.3%. One of the oft-repeated maxims on Wall Street is that "As January goes, so goes the year." Historically, when the S&P 500 has been positive in January, it has finished the year with a gain almost 80% of the time. According to data from S&P Dow Jones, since 1929, there were 36 years in which the S&P 500 had a loss in January, yet it had a positive return in 16 (45%) of those years. This is coin toss territory. Stock market returns from one month to the next or one year to the next are random and unpredictable. The positive performance of most global stock asset classes in January was refreshing news but reveals nothing about what the remainder of 2023 has in store for investors. Ignore anyone telling you otherwise.

Investing involves risk. Every investment decision is a trade-off from one risk to another. In 2022, savers did OK, even in spite of low interest rates since their accounts maintained their dollar value. But after taxes and inflation, savers also had a losing year. Cash is a good short-term investment but contains inflation risk in the long-term. Stocks, on the other hand, are good inflation hedges in the long run, but can be unpleasantly volatile in the short-term. It's important to keep adequate cash reserves but fleeing to cash when the market gets scary is not an investment strategy. It's just a frightened reaction to what has already happened.

Goldman Sachs has just lowered its estimated probability of a US recession in the next 12 months from 35% to 25%. How can a respected investment firm proclaim such nonsense? If you believe that anyone at Goldman Sachs has the ability to measure a 10% change in the probability of a recession this year, you likely also believe that the Chinese balloon was just checking the weather. Every day, the financial news is full of commentary and forecasts. "Experts" rant on about the economy, the stock market, interest rates, inflation and the outlook for individual stocks. If a spaceship landed in Hoboken, there would be innumerable forecasters in the financial media the next day predicting what it means for the stock market. These suspicious experts are often very articulate, but they don't know any more about the future than you do. All forecasts are just guesses, educated guesses perhaps, but guesses, nonetheless. A recent notable example: Jerome Powell, chair of the Federal Reserve and perhaps the world's most informed economist, was wrong in his assessment that the rise in inflation in 2021 would be "transitory". There are far too many variables in our economy for forecasting to be a viable endeavor. In his book, *Expert Political Judgment: How Good Is It? How Can We Know?* Wharton's Philip Tetlock looked at 82,361 economic and political forecasts made by 284 "experts" between 1987 and 2003. These "experts" made a living analyzing and pontificating on political and economic developments. He concluded that chimpanzees throwing darts at a board full of predictions would have been more accurate than the predictions of these alleged experts.

No one has this investing stuff all figured out. Decisions are made with imperfect information and the capital markets are impacted by surprises, overreactions, underreactions and unexpected geopolitical events. Things that have never happened before, happen. That's how it has always been and how it always will be. Everyone makes mistakes, but the important thing is to learn from your mistakes and make fewer mistakes as time goes on.

If anyone knew which stocks were going to go up this year and which would suffer losses, they'd be spending their time in front of a computer screen trading stocks, not writing articles about which stocks to buy in 2023.

Mom said don't take candy from strangers. Likewise, don't take financial advice from strangers on social media. Numerous scammers hang out there along with innumerable people who don't know what they're talking about.

Investors too often fall for a cognitive bias known as "hindsight bias". Using 20/20 hindsight, we think that past events were inevitable and easily predictable. "I knew it would happen!" But we are kidding ourselves, it's pure self-delusion.

Politicians, sports figures, and celebrities don't give a hoot about you. Stop caring so much about them.

Two noteworthy quotes. One from John Bogle: *"Sure, it would be great to get out of the stock market at the high and back in at the low, but in 55 years in this business, I not only have never met anybody that knew how to do it, I've*

never met anybody who had met anybody that knew how to do it." One from John Kenneth Galbraith: *"There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."*

The most important function of a financial advisor is to encourage clients to develop a long-term perspective. On the other hand, politicians have a short-term perspective. They are quick to spend money they don't have to bail out whoever is squealing the loudest in the latest financial mess. They have no problem taking enormous risks in such interventions, especially if the cost can be deferred to the future.

Worrying is a feeble attempt to control an uncontrollable future. Things will never be perfect, but rarely as bad as the worst of our imaginations can conjure. For most of us, life fluctuate between "pretty good" and "not so hot". But investor sentiment usually oscillates between "wonderful" and "hopeless". It's just natural to be demoralized during a bear market. There wouldn't be a bear market if there wasn't bad news, and the financial media specializes in making bad news sound ominous. But wise investors don't vacillate between being bullish and bearish. They understand that the stock market will always be volatile, so why get excited about temporary declines? No one knows how long the current bear market will be with us, but that doesn't stop pundits from giving us their useless opinions. Let's make it a goal this year to be rationally optimistic and ignore those who are irrationally pessimistic.

I don't spend too much time pondering fantasies. Things like a non-volatile stock market, wealth without risk, a fund manager who can consistently outperform the market, safe investments with high returns, or a reasonable, rational politician who I would like to have as a neighbor.

The investments most people feel good about are those whose recent performance has been positive, and the outlook is rosy. But they are unlikely to be available at bargain prices. Rather, bargains are usually found among the investments that are controversial, that people are pessimistic about, and that have performed badly of late.

Investing isn't supposed to be exciting. Long-term success is the result of continuously funding and periodically rebalancing your portfolio, no matter what the headlines are saying. Attempting to time the market offers ongoing opportunities to make mistakes. The purpose of a financial plan is to ensure that your continuous, boring investing process never ceases. So don't try to outguess markets. Come up with a plan, take no more risk than you can tolerate, and leave market timing to truth-challenged folks and social media braggers who, lucky for them, are never required to produce proof of their proclaimed market timing prowess.

The idea of earning a bit of income by selling a call option while taking the risk of having the stock called away from me if it goes higher than I expected seems silly to me. Take my stock, please! Options are market timing vehicles. Capital is better put to use in investments designed for the long-term.

Cryptocurrencies are not backed by any issuing authority. There is no reliable basis for their valuation, and they produce no income. They are clearly not an inflation hedge, as has been shown during the current inflation spike. Their extreme volatility makes it unlikely they will ever be a mainstream store of value, the criteria for any "coin". If bitcoin disappeared tomorrow, there would be large font headlines but almost nobody would care. Even 15 years after its inception, there is still no problem for which bitcoin is the best solution. To my simple way of thinking, if you can't use it to buy a cup of coffee, it's not money. But as long as crypto provides visions of instant wealth for its true believers, they will continue to proclaim its usefulness. Time will tell, I'm not holding my breath.

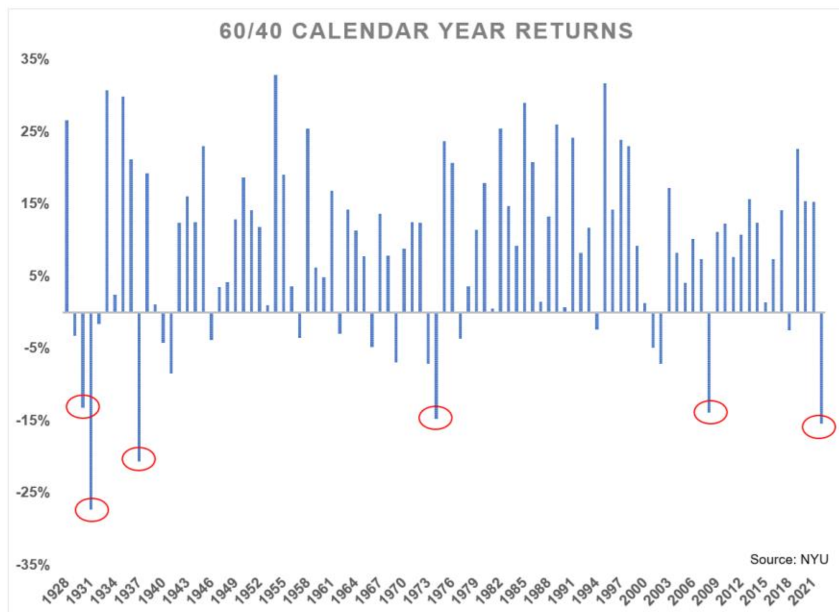
There are few things the financial media likes more than a fund manager with an outstanding performance record – even a short one. It is never mentioned that episodes of noteworthy outperformance are exactly what we would expect to see if results were entirely random. Thus, there is no way to determine if the good performance was the result of skill or luck. Investors who assume that the results were produced by skill take the risk that after investing in the fund they'll suffer the regret that comes from experiencing reversion to the mean.

A research paper published in 1998 contained the results of a survey asking hundreds of students and faculty at Harvard the following question –

*There are two states in the world (State A and State B). You are asked to pick which of the two you would prefer to live in. "Others" is the average other person in society -**(purchasing power is the same in each choice)**.*

In state A, your yearly income is $50,000; others earn $25,000.
In state B, your yearly income is $100,000; others earn $200,000.

Half of the respondents chose A. If you did, I recommend that you seek professional help in managing your finances.



This chart, from Ben Carlson's blog shows that a 60/40 portfolio of U.S. stocks (S&P 500) and U.S. bonds (10-year Treasury) finished the year down more than 10% just 6 times from 1928 through 2022. Thus, the decline in 2022 was a rare, but not unexpected occurrence.

My question – did you focus on the negative blue lines and red circles or the far more numerous positive blue lines?

The best lesson to learn from this chart is that in any year, anything can happen, but that diversification works most of the time, especially over long time horizons.

S&P 500 Calendar Year Returns: 1928-2022

-20% or worse	-20% to -10%	-10% to 0%	0% to 10%	10% to 20%	20% to 30%	30% or Better
				19.17%		
				19.03%		
				18.76%		52.56%
				18.52%		49.98%
				18.49%	29.28%	46.74%
			9.97%	18.30%	28.47%	43.81%
		-1.10%	7.49%	18.15%	28.36%	43.72%
		-1.19%	7.44%	18.01%	28.34%	37.20%
		-1.21%	6.51%	16.54%	26.64%	37.00%
		-3.06%	6.15%	16.42%	25.94%	35.82%
		-4.23%	5.81%	15.89%	25.06%	33.10%
		-4.70%	5.70%	15.61%	23.83%	32.60%
		-6.98%	5.48%	14.82%	23.80%	32.15%
		-8.24%	5.20%	14.22%	23.68%	31.94%
-21.97%	-10.46%	-8.30%	4.83%	13.52%	22.68%	31.74%
-25.12%	-10.67%	-8.43%	3.56%	12.40%	22.61%	31.48%
-25.90%	-11.85%	-8.64%	2.10%	12.06%	22.34%	31.24%
-35.34%	-12.77%	-8.81%	1.38%	11.77%	21.61%	31.22%
-36.55%	-14.31%	-9.03%	1.33%	10.81%	20.89%	30.81%
-43.84%	-18.11%	-9.97%	0.34%	10.74%	20.42%	30.23%

Data: NYU

This chart, also from Ben Carlson's blog, shows that over the last 95 years, the S&P 500 Index had more years in which it gained 20% or more than years in which it suffered a loss. There have been 26 years, including 2022 (-18.11%), when the S&P 500 ended the year with a loss and 34 years in which it yielded gains of 20% or more. 2022 was one of only 12 years, in which the S&P 500 suffered a loss in excess of 10%. Last year was ugly but it was entirely within the realm of the expected. The trade-off for enduring the red years has been long-term green returns that have been well above the rate of inflation and the yield of fixed income investments.

Stocks represent the ownership of real assets and have been an effective inflation hedge for more than a century. According to data from NYU, from 1928 through 2022, the S&P 500 had an annualized average return of 9.6%, the 10-year Treasury note averaged 4.6% and cash (3-month T-Bill) 3.3%. Inflation averaged 3.1% over that time, netting real (inflation adjusted) annualized returns of 6.5% for the S&P 500, 1.5% for 10-year government bonds and 0.2% for cash.

Researchers at Vanguard created a model to determine the optimal portfolio rebalancing frequency. They found that rebalancing more often than annually resulted in higher transaction costs and higher taxes for taxable accounts. Less-frequent rebalancing caused the portfolio to drift too far from its target asset allocation, leading to a disconnect with the investor's risk tolerance. Thus, although some advisors might be tempted to demonstrate value by rebalancing more frequently, for calendar-based rebalancing methods, Vanguard considers annual rebalancing the optimal choice.

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