On Course Financial Planning

Facing the Future with Optimism and Courage

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geo@oncoursefp.com

425-861-9997

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This is the 200th issue of Vectors. My intention these past sixteen-plus years has been to educate readers about financial planning, how markets work and how to create a portfolio to achieve your financial goals. The central theme of this newsletter has been that planning, which you control, should be your focus because your portfolio's performance is beyond anyone's control. For 199 issues I have emphasized these strategies and insights about successful investing -

**Have A Plan.** Creating a written financial plan is the essential first step in achieving your financial goals. Your plan should be focused on your goals, time horizon and risk tolerance and contain a comprehensible investment strategy that determines your portfolio allocation. Your investment strategy should be based on what has worked in the past, not on anyone's predictions about the future. The ultimate benefit of good financial planning is peace of mind and the cost of creating a comprehensive financial plan is a small fraction of its long-term monetary benefit.

**Shun complexity and embrace simplicity.** When it comes to investing, I am a believer in Leonardo da Vinci's dictum that *"simplicity is the ultimate sophistication.*" Unfortunately, too many financial professionals make investing more complicated than necessary. Perhaps this is because complexity can act as a smokescreen that hides an advisor's lack of experience, confidence, or perspective. Complexity has often been used by scammers and scoundrels to hide their fraudulent activity. Regardless of the promised upside, avoid complex investments that you do not understand.

**Diversification in and among asset classes is the cornerstone of good portfolio design.** Your portfolio should contain assets that are "non-correlated", meaning that they do not go up and down in lockstep with one another. The natural tendency is to want all the funds in your portfolio to increase in value every year. The only way to do this is to own a "concentrated" portfolio that contains correlated assets. Unfortunately, correlated assets not only go up together they go down together, producing higher portfolio volatility. Each year a well-diversified portfolio will contain funds with disappointing performance, but it should yield better long-term performance with less volatility than a concentrated portfolio. The economist who figured this out won a Nobel Prize in Economics. By making a globally diversified stock allocation the centerpiece of your portfolio, you'll be hitching your wagon to the ongoing growth of the global economy.

**Be content with market equaling returns.** Because that's all there is. Every investor falls into one of two categories- active or passive. Passive investors use index funds and own all the stocks in a market or asset class. All other investors are active and own portfolios that differ from the market or asset class. Active investors attempt to outperform the market by overweighting stocks they believe to be undervalued and shunning those they believe to be overpriced. Every dollar in the stock market is owned by either a passive or active investor. This year, each dollar owned by passive investors will yield the market's return. If we subtract all passively invested dollars from the market only active dollars remain. We have no way of knowing what any active dollar will earn, and some will outperform, but the average return of all active dollars must also equal the market's return. This is true for any timeframe, any market, and any asset class. Active funds are a subset of active investors and since they charge higher management fees than index funds, the after-cost return of the average active fund must be less than that of the average index fund. Proponents of active management never mention, and perhaps are unaware, that the average outperformance (called "alpha") of the few funds that outperform comparable index funds is less than the average shortfall of the funds that underperform index funds. The predictions and relentless chattering of the financial media hide the simplicity and value of index investing. Morningstar's Active/Passive Barometer is a semiannual report that measures the performance of domestic actively managed mutual funds against their index fund competition. In its latest report it noted – *"In general, actively managed funds have failed to survive and beat their benchmarks, especially over longer time horizons; only 23% of all active funds topped the average of their passive rivals over the 10-year period ending December 2020*." Some proponents of active management claim that the disappointing performance of active funds in recent years has been caused by temporary, extraordinary circumstances. But active managers fail, not because of temporary economic events, but because of the laws of arithmetic -- which will still hold true in the years ahead. The intellectual foundation of indexing is not based on an elaborate economic theory, but on low-cost, diversification, and tax efficiency. By contrast, there is no intellectual foundation of active management because all active investors, as a group, can receive no more than the market's return. Investors seem to be learning the benefits of passive index investing. As of the end of 2020, only 11% of mutual funds and ETFs were index funds, yet they held 33% of all fund assets.

**Most stocks underperform the market.** There are two types of investment risk. "Good risk" is risk that we expect to reward us with higher returns over time. For example, over the past 90 years, large company stocks have returned about 7% more annually than risk-free one month US Treasury Bills. This is known as the "equity risk premium" – the higher return investors have received for taking the risk of stock ownership. Similarly, small company stocks have yielded about 2% more annually than large company stocks because they are riskier. This is known as the "small company risk premium". The higher risk of equities vs. Treasury Bills and small company stocks vs. large company stocks cannot be eliminated by diversification. Thus, for taking additional non-diversifiable risk, investors have been rewarded with higher returns. "Bad risk" is investment risk that offers no expectation of receiving a risk premium because the risk can be easily diversified away. An example of bad risk is owning individual stocks. This brings individual company risk into a portfolio but provides no expectation of higher than market returns. The only reason to own individual stocks is to beat the market. A recent Morningstar report, "How Many Stocks Beat the Indexes?" tracked the performance of the 5,000 publicly traded domestic stocks in the Morningstar Total Stock Market Index over the decade ending December 2020. The average stock underperformed the 13.9% annualized gain of the index, which benefited from the superior returns of the top performers. Only 2,100 stocks had a positive return for the decade, 1,800 posted losses and 1,100 were either acquired by another company or delisted. The evidence is overwhelming - owning individual stocks is unlikely to add to the return of your portfolio but will likely increase its risk.

**Understand the function of bonds in your portfolio.** The function of fixed income investments in your portfolio is to lower volatility and provide cash flow, not to make you rich. Owning anything but the highest quality fixed-income investments is counterproductive to these functions. Not all bonds are safe places to put your money. Bonds issued by companies or countries that lack an investment grade credit rating are called high yield (or junk) bonds. High yield bond funds have been sold to yield starved investors over the past few years with the promise that these funds will provide a stable cash flow. The risk of high yield bonds is hidden when interest rates are low and when the economy is doing well. But as many high yield bond fund investors have learned, when the economy slows or the specter of default rears its ugly head, these bonds begin to display equity like volatility and suffer sharp price declines. If you seek greater return, don't lower the credit quality of the bonds in your portfolio, increase your allocation to stocks. Don't chase yield, accept whatever rates are being offered by high quality bonds, and consider it a bonus if their yield exceeds inflation.

**Investor behavior, not investment performance, determines long-term results**. Most investors are doomed to fail because in investing temperament is more important than intellect. The financial goals of most people can be accomplished by capturing the long-term return of the stock market. Yet studies reveal that the average investor receives only a fraction of the stock market's long-term return because of emotional biases that lead to poor investment decisions. Recency bias, overconfidence, panic, and greed are common behavioral flaws that work against our long-term success. It is during steep stock market declines, when investor behavior is at its worst, that a well-constructed portfolio, a prudent investment strategy, discipline and a long-term focus provide the greatest value. With 20/20 hindsight, we recognize that we should have invested every dollar we could get our hands on into stocks in April 2020, but most investors were emotionally incapable of putting more money into stocks during those days of frightening volatility.

**Don't chase past performance**. None of us has 20/20 foresight and 20/20 hindsight has never made anyone a nickel. The disclaimer *"past performance is no guarantee of future returns"* appears in fund ads to warn investors that the advertised past performance is unlikely to continue. Despite this disclaimer, I doubt that past performance will ever lose its place as the predominant factor that investors use when selecting mutual funds. Mutual fund companies advertise the funds that have done well in the recent past because they know that investors, and too many advisors, believe that good fund performance correlates to manager skill. But there is no compelling evidence that any fund manager can consistently beat the market and it is difficult to determine whether an outperforming manager is skillful or has been lucky. Twice each year, Standard & Poor's publishes the S&P Persistence Scorecard which tracks the performance of top actively managed mutual funds over consecutive multiyear periods. The latest Scorecard analyzed the subsequent performance of the 981 domestic stock funds that produced top-half performance for the five years ending December 2015. Random chance alone would keep 50% (491) of the funds top-half performers for the next five years. Yet only 41% (402) managed to retain top-half status. There are three primary reasons why outperforming funds rarely persist. The first is that some top funds benefitted from being invested in a hot market sector. But when the sector's performance inevitably cools, the funds' performance is likely to decline. A second reason is the "paradox of success". As new money flows into a top performing fund, the manager must add more stocks to the portfolio. Eventually, the fund can contain so many stocks that it becomes a "closet index fund" and its performance will eventually approximate its benchmark index. The third is the "paradox of skill". There are so many skilled fund managers, all looking for mispriced securities, that it is unlikely that any one manager can continually outsmart and outmaneuver the competition. To the dismay of successful fund managers, their stock picking strategy will soon be adopted by competing funds, thus eliminating any edge they may have once had. Wall Street regularly bestows deity status on its market beating stars. But when their radiance dims, they quietly disappear.

**Slow and steady wins the race.** Enjoy getting rich slowly. Retirement planning requires making broad conservative estimates about the unknowable future. We must always err on the side of excessive savings and moderate return expectations. Progress should be reviewed annually and reviews with your financial advisor should measure your progress by focusing on net worth accumulation, not your portfolio's rate of return. I don't care if your net worth increased because of portfolio performance, additional contributions, an inheritance, or a lucky weekend in Las Vegas, the endgame is dollar accumulation. It's the growth of your net worth, not some meaningless percentage number, that indicates whether or not you're still on course to achieving your financial goals. It's as simple as this – which of the following will get you closer to your financial goals, a 10% return on a $100,000 portfolio or a 5% return on a $500,000 portfolio? Wise investors will choose to focus on net worth accumulation and risk management, not meaningless percentage performance numbers.

**Shun market timing like Superman shunned kryptonite.** Sitting on your hands and not panicking when stocks are declining has proven to be one of the best, and most difficult, investment strategies. During market declines, we are susceptible to the siren call of market-timing. But market timing is the modern day equivalent of alchemy, the pursuit of an illusion. Despite 50 years of relentless computer analysis of market data, no reliable market timing system has been discovered. Fortunately, you don't need to be able to time the market; you need a strategy to capture the long-term return of the market – one that keeps an appropriate percentage of your assets permanently invested in equities. Market timing's fatal flaw isn't that you might be in the market when it is declining, it's that you might be on the sidelines during those unpredictable, short time periods that make stock investing profitable in the long run. Instead of market timing, commit yourself to annually rebalancing your portfolio to its original allocation. You'll always know what to buy – funds that have underperformed since the last rebalance. You'll always know what to sell – funds that have outperformed since the last rebalance. No guessing is necessary. We all want the upside of the stock market without its unpleasant declines. But enduring periodic market declines is the price we must pay if we wish to receive the long-term return of stocks.

**Ignore all stock market predictions.** Be prepared for unexpected outcomes. The only thing that will change a stock's price is unexpected news. The next piece of news about a company has a 50-50 chance of being better or worse than anticipated. Therefore, the next price change of any stock will be random. No one, regardless of their education or reputation, can see unexpected events any better than you can. There are three types of financial advisors. The first type of advisor has no idea what the stock market will do this year and is not ashamed to admit it. The second type of advisor has no idea what the stock market will do this year and will never admit it for fear of losing clients. This type of advisor is dangerous. The third type of advisor has no idea what the market will do this year but believes that he does. This type of advisor is radioactive. There is not a single person on the face of the earth who can be relied upon to predict the value of any significant economic variable a year from today. Don't confuse guessing with insight.

**Ignore the daily noise on Wall Street.** Wall Street makes money when money is in motion. They, and their willing accomplices in the financial media, emphasize the short-term and only give lip service to the tried-and-true strategy of buying and holding equities for the long term. They want you to be anxious; always feeling as if you should be tinkering with your portfolio. The financial media attracts eyeballs, ears, and clicks by taking the ever-changing apocalypse du jour out of its Bottomless Bag of Scary Stuff. How convenient to be able to repackage old catastrophic narratives and call it "news". I loathe click-bait, hype, exaggeration, dramatic hyperbole, and all other fraudulent means of attracting an audience. Many investors think that following the financial news or getting investing tips from social media gives them an advantage in the market. But anything you hear in the news has already been factored into prices. The only way you can benefit from new information is to interpret it better than the collective wisdom of all other investors. Not much chance of that. For the goals-based investor, the day-to-day movements in the stock market are irrelevant. Nothing of long-term significance happens on most days, thus it is unlikely that today's financial news will have any impact on your long-term financial goals.

**Ignore your neighbors.** They buy high and sell low. They bought dotcom IPOs in 2000, pre-construction condos in 2006, and bitcoin and GameStop stock this year. They invest when it is "safe" - after stocks have gone up. After a decline, they will sell because stocks have become too "risky." They get their investing ideas from dubious sources and allow media inspired fears of a worst-case scenario to influence their investment decisions.

In the end, investing is nothing more than trying to take advantage of probabilities. Prudent financial planning focuses on things as they are today, the most likely scenario for tomorrow and is flexible enough to accommodate changing circumstances. The best way to do this is to implement strategies and investment principles that have stood the test of time. Keep a long-term focus, minimize expenses and taxes, control your emotions, maximize diversification, and stick with your plan. Once you embrace these simple truths you can ignore Wall Street, delete the stock market app from your cellphone and get on with your life.

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