On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Conversations

A friend recently mentioned his disappointment with a stock fund that he bought in 2020. He purchased shares of the ARK Innovation ETF (ARKK) after noting its outstanding performance and the financial media's anointing of its manager, Cathie Wood, as the newest superstar fund manager. According to Morningstar, ARKK returned 157% in 2020, ranking in the first percentile of performers, beating the S&P 500 Index by 141%. The fund attracted $20 billion of new money in 2020 and another $16.5 billion in the first quarter of 2021. ARKK was a performance chasing investor's dream come true. Like most outperforming funds, ARKK has a concentrated, undiversified portfolio – currently it holds only 36 stocks. Undiversified portfolios increase "manager risk" because a few bad picks can ruin fund performance. When you can create a globally diversified portfolio for almost no cost, it makes little sense to expose yourself to the added risk contained in a concentrated fund. Every financial professional warns clients that past performance is no guarantee of future returns, but all too often the warning falls on deaf ears.

All superstar fund managers possess fading glory. Random chance has fooled more investors than all the magicians in the world and it can never be proven or known for sure if past performance was the result of skill or luck. Unfortunately for my friend, ARKK lost 23% in 2021 - underperforming the S&P 500 by 60% and placing the fund dead last among the 540 mid-cap growth funds in the Morningstar database. To add insult to injury, through the first week of March the fund is down another 33%, and its 3-year annualized performance trails 73% of mid-cap growth funds.

Morningstar's analysis of ARKK would have provided a warning for my friend had he looked at something other than past performance: "*Wood's reliance on her instincts to construct the portfolio is a liability. This is a high-risk, benchmark-agnostic portfolio…The firm favors companies that are often unprofitable, highly volatile, and could plummet in tandem…The fund lacks well-defined risk controls, which are now more important than ever. As its asset base has swelled to $23 billion, the fund has become less liquid and more vulnerable to severe losses…ARKK's untested analysts, go-with-your-gut risk management approach, and bloated asset base raise doubts about whether this fund's outstanding historical results can continue.*"

For the last few years, the Federal Reserve has kept interest rates artificially low. This policy harms conservative investors and retirees who depend on the cash flow from their fixed income investments. Recently, I was having lunch with someone who is frustrated with today's low interest rates. His broker recommended that he reallocate some of his bond fund money into a mutual fund that invests in high dividend paying stocks. The rationale is that the dividend yield of the fund exceeds the yield on government bonds or CDs. So, you can increase your cash flow and gain the upside potential that stocks provide in the long run. After gagging on my chicken soup, I replied that this was a terrible idea and that anyone who can tell the difference between an apple and an orange is smart enough to understand why.

The Worst Years For Stocks

Year	Stocks	Bonds
1931	-43.84%	-2.56%
2008	-36.55%	20.10%
1937	-35.34%	1.38%
1974	-25.90%	1.99%
1930	-25.12%	4.54%
2002	-21.97%	15.12%
1973	-14.31%	3.66%
1941	-12.77%	-2.02%
2001	-11.85%	5.57%
1940	-10.67%	5.40%
1957	-10.46%	6.80%

This flawed strategy ignores the rationale for owning bonds. Bonds should be the safe assets in a portfolio. They should hold their value when stocks decline. This chart from Ben Carlson's blog shows the 11 largest annual losses in the S&P 500 since 1928 as well as the performance of the 10-year Treasury note in the same year.

This is why we own US Treasury securities, regardless of yield. They act as portfolio shock absorbers when the stock market experiences one of its periodic declines.

Stocks are the capital growth assets in a portfolio. You own them to earn the equity risk premium over the long-term. Rather than spending stock fund dividends, I prefer that they be reinvested, taking advantage of market volatility by dollar cost averaging over the long term. Exchanging bonds for stocks, alters the risk-reward balance of your portfolio and my conservative friend wasn't interested in accepting more stock market risk. He would not adopt this strategy if his broker explained that when a stock fund pays a dividend, the share price of the fund must, and does, decline by the amount of the dividend.

The evil twin of the exchange bonds for dividend paying stocks strategy is one that recommends exchanging your low yielding, high quality bonds and CDs for high-yield bonds. Wise investors take risk in the stock portion of their portfolios not in the fixed income side. History shows that only the safest fixed-income investments -- U.S. Treasury securities or investment grade bonds -- can be relied upon to keep their value when the stock market spumoni hits the fan. Junk bonds, euphemistically called high-yield bonds (a great marketing sleight-of-hand), are issued by companies of suspect sustainability when the economy is doing well. These bonds pay a higher rate of interest to compensate investors for assuming the additional default risk they contain. When the economy is doing well, they deliver a steady income stream. But when the economy slumps, the interest payments and repayment of principal are now in doubt and their price will decline in tandem with stocks. This recommendation replaces non-correlated assets (high quality bonds) with bonds that have a high correlation to equities. The extra interest offered by high-yield bonds is unlikely to compensate for the price declines they will experience in the next bear market.

Higher yield and higher risk are inseparable. Yield chasing is a dangerous game and why anybody would recommend that a client add additional risk to what should be the safe portion of a portfolio remains a mystery to me. Until the yield on high quality fixed-income investments returns to more normal levels, investors will have to be patient, disciplined and avoid the folly of assuming more risk in their quest for higher yield.

In the News

Everything you think you know about what the future holds is either a figment of your imagination or the result of believing the rantings of someone you've never met, who has no idea what the future holds, who doesn't care about you and just might be nuts. The big problem with forecasts is that they fail when needed most - before the unexpected happens. Today, too many people are making predictions just to sound smart, to gain attention, although they have no idea what will happen with Russia and Ukraine, inflation, interest rates or the economy.

Optimism is infinitely more important than anyone's forecast or opinion. Successful investing is impossible if your actions are motivated by fear. Worrying about things that are out of your control does not serve you, your family, or those you care about. When it comes to your money, "uncertainty" and "investing" are synonymous. High impact/low probability events are components of modern life. In financial markets, they are known as “left tail risk” because they represent the lower left portion of the classic bell curve. Every long-term investor must be an optimist. Otherwise, the purveyors of imminent doom will scare you into keeping your money in your mattress.

I must confess to having a melancholy temperament. Thus, pessimism comes naturally. So, I like to say that I'm a pessimist by nature but an optimist by conviction – with the pessimism lurking just offstage. (After all, the glass IS half empty.) I'll define an optimist as someone who believes that good ultimately prevails over evil and that our world is headed in the right direction because we tend to solve our problems rather than let them destroy us. The world will end only once, so if you bet that the latest crisis is the end of the world, the odds are against you. I think most of us have both optimistic and pessimistic voices in our heads, that argue with each other on an ongoing basis.

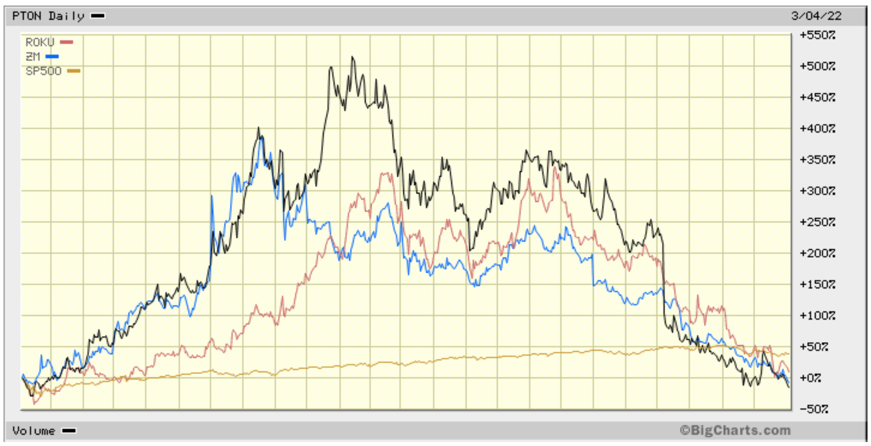
There is always risk in the stock market, it will never go away and cannot be avoided. According to JP Morgan, since 1950, the S&P 500 has experienced a drawdown at some point during the year that has averaged just under 14%. As the Covid pandemic and the Russia/Ukraine crisis both illustrate, risks can come out of nowhere and at any time. Distress is not new – only the specific reasons for the various distresses that come at irregular intervals.

There is no perfect portfolio. Investing involves trade-offs and you can't protect your portfolio from every risk. Every geopolitical crisis brings out Wall Street's snake oil salesmen who promise what they can't provide – the upside of stocks without the downside. The best way to mitigate the risk of unexpected events – whether geopolitical, natural disaster, social unrest or pandemics, is to have a disciplined investment strategy and a broadly diversified portfolio. Combining different asset classes helps smooth the collective volatility of its individual assets and helps prevent emotional investing mistakes that are common during troubled times. If your portfolio was built with the adult assumption that unexpected bad things happen, it makes no sense to start portfolio tinkering when bad things come to pass.

Innumeracy is the mathematical counterpart of illiteracy. It describes a person’s inability to make sense of the numbers that Impact their life. Numbers don't lie but only if they are properly used. We are all susceptible to being fooled by the improper use of numbers. Some numbers should never be looked at in isolation because they only tell part of the story. For example, a February 9th article in the *Wall Street Journal* had the headline: “US Households Took On $1 Trillion In New Debt In 2021” The article noted that this was the largest increase in 14 years and that Americans increased their credit card balances by $52 billion in the fourth quarter of 2021 - the largest quarterly jump on record. Surely, this must be bad.

But noting the dollar amount of debt is meaningless, because it's only the top half of an important fraction. If you tell me that you have $100,000 of debt, this tells me nothing. If you also have $200,000 of assets, a 50% debt to equity ratio is cause for concern. But if you have $2 million of assets, a 5% debt to equity ratio is nothing to worry about.

The *Wall Street Journal* article failed to mention that, according to JP Morgan, US household net worth (household assets minus liabilities) ended 2021 at an all-time high of more than $150 trillion. This is more than double its value in 2007 just before the subprime mortgage crisis. Thus, it is a mathematical certainty that the value of the personal assets owned by Americans must have increased by more than $1 trillion last year. Additionally, the household debt service ratio (debt payments as a percentage of disposable personal income) is lower than it has been at any time in the past 40 years. Thus, a proper analysis of the numbers reveals that the American consumer is doing quite well, thank you very much. These additional facts were known to the *Journal's* editors, so we must assume that the misleading headline and the lack of clarification of the debt numbers was intentional, pure clickbait. Sadly, exploiting the innumeracy of Americans isn't a rare occurrence and it's not likely to change any time soon.



Many stocks that went straight up during the lockdown days of the pandemic are now down 50% or more from their peaks - the latest examples of the danger of investing in individual stocks. They are also the latest examples of my adage: *If the left side of the chart looks like the left side of the Eiffel Tower, eventually the right side of the chart will look like the right side of the Eiffel Tower*. This chart compares the performance of the S&P 500 (lower line) to Zoom (blue line), Roku (brown line) and Peloton (black line) over the last 24 months. Once again, investors piled in just in time to experience reversion to the mean. A temporary, current event that convinced many investors that "this time it's different", turned out to be less than permanent and not much different than what we have seen many times in the past.

Active fund success rate (%)				
Category	**1-year**	**3-year**	**5-year**	**10-year**
U.S. large value	34.1	37.0	21.9	14.8
U.S. large growth	31.9	31.5	31.8	8.2
U.S. mid value	28.8	53.2	37.1	10.7
U.S. mid growth	46.0	52.2	56.1	37.9
U.S. small value	37.1	41.4	36.2	20.2
U.S. small growth	47.4	65.8	55.1	44.0
World large blend	38.9	26.5	18.9	16.7
Europe stock	53.3	73.7	50.0	42.9
Intermediate core bond	69.2	47.0	43.2	37.8
Corporate bond	64.2	47.5	26.0	28.9

Morningstar's Active/Passive Barometer is a semiannual report comparing the performance of active funds to that of the average index fund in their asset class. This chart shows the percentage of active funds that outperformed index funds over 1-,3-,5-,and 10-year periods ending 12/31/2021. The success rates, dismal as they are, are inflated by "survivorship bias". Funds that existed at the beginning of each time period that didn't survive the period, likely due to poor performance, aren't included in the results.

Historically, active fund managers have taken advantage of amateur investors. But the percentage of trades made by amateur investors in the stock market has fallen from about 90% in 1945 to about 20% today. Thus, the opportunity for active managers to take advantage of less skilled investors has slowly disappeared. The "paradox of skill" has made the active management game more difficult. As the percentage of skilled professionals on the playing field increases, it becomes more difficult for any manager to find mispriced securities and outperform index funds. In summary, the report noted: "*In general, actively managed funds have failed to survive and beat their average passive peer, especially over longer time horizons; only 26% of all active funds topped the average of their passive rivals over the 10-year period ending December 2021.*"