geo@oncoursefp.com 425-861-9997

The Eleventh Commandment

I'm often asked for my opinion about how to invest "now that the stock market is (insert latest headline here)". I came up with a one-size-fits-all answer and the more I think about it the more I like it -- "Invest as if you don't know what will happen".

Imagine the headline -- **"11th Commandment Discovered!"** Archeologists working on Mount Sinai discovered an ancient stone tablet, apparently dropped by Moses on his way down the mountain, that contains an 11th Commandment – "Thou shall invest as if you don't know what will happen." In response to this startling discovery, the Securities and Exchange Commission issues a new rule mandating that all persons who offer financial advice must abide by this new Commandment. In their press release the SEC mentions that to maintain the separation between church and state, folks on Wall Street will still be allowed to ignore or break any of the original Ten Commandments.

This new rule would bring grief to Wall Street and the financial media. Things would get quiet in a hurry. Financial advisors would have to answer the question "What's next for stocks?" truthfully -- "I don't know what will happen." How refreshing that would be! The logical follow-up question would be, "Then what should I do?"

The answer is to create an opinion-neutral portfolio. First, identify a target mix of stock and bond funds and cash reserves that should yield a rate of return sufficient to achieve your financial goals with a level of volatility that won't keep you up at night. Your portfolio's allocation is the primary factor that will determine your long-term rate of return. Second, diversify broadly in each of the asset classes in your portfolio so that you're not overexposed to any one company, country or industry sector. The third step is to rebalance back to the original target allocation on an annual basis. Finally, don't allow anyone's predictions about the future cause you to abandon your strategy.

Recommendations to make portfolio allocation changes based on the predictions of people who pretend to know what will happen are commonplace in the investment advisory business. Yet, there is no academic data that supports the idea that this asset shifting can be done successfully over the long-term. I loathe the "Whatsnexters", the pundits who pontificate confidently about what they can't possibly know – what the stock market will do this year, where interest rates and inflation are headed, the future value of the dollar, the price of bitcoin, gold or oil or which stocks will outperform the market. Their predictions don't have to come true; they just need to be plausible for these modern-day Pied Pipers to attract new followers. Unlike Moses, they speak without Divine inspiration; their prophesies are just personal opinions that lead gullible investors astray. I'm tired of them all. It is bewildering that so many financial advisors make recommendations to clients based on the forecasts of people of questionable accreditation and dubious motives whom they have never met and might not want to have as neighbors.

If the 11th Commandment is discovered, investing would become boring -- just like it's supposed to be. Investors wouldn't waste their time obsessing over daily market fluctuations or be tempted to make changes to their portfolio based upon what someone thinks will happen. I recommend that you invest as if the 11th Commandment exists by creating an opinion-neutral portfolio and adopting a long-term view. But I'm convinced that most investors will continue to be deceived by the false prophets of financial advice, who will continue to profit at their expense.

Active Managers' Scorecard

There are, broadly speaking, two competing investment strategies. The older, more common strategy is called active management. Active fund managers attempt to identify stocks that will outperform the market and avoid those that they believe will underperform. The other strategy is known as passive management. Retail passive investing was birthed in 1976, when John Bogle, then the CEO of Vanguard, launched the first retail index fund that tracked the S&P 500 Index. Index funds match the return of an asset class by owning most or all of the securities in the asset class. Passive investors make no attempt to outperform the market. They believe that by keeping costs and taxes to a minimum and capturing the market's return, they are likely to outperform most active investors. While the performance advantage might be modest in any given year, it compounds and becomes more evident as time goes on.

S&P's Indexes Versus Active (SPIVA) Scorecard is a semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. The latest SPIVA Scorecard, covering the 20 years ending December 2021, notes that 2021 was the 12th consecutive year in which the majority (85%) of large-cap domestic stock funds underperformed the S&P 500 Index. Additionally, 80% of actively managed domestic stock funds underperformed the S&P 1500 Total Market Index last year.

Proponents of active management admit that it is difficult for large-cap fund managers to outperform the S&P 500 Index because the stock market efficiently prices large-cap stocks. But they assert that in less efficient markets, such as small-cap stocks and emerging market stocks, active managers have an edge. But this assertion is not supported by the evidence. According to the latest SPIVA Scorecard, over the past 10 years, 80% of actively managed emerging market stock funds underperformed their benchmark S&P index and 93% of actively managed domestic small-cap funds underperformed the S&P 600 Small Cap Index. By eliminating manager risk, minimizing taxes and keeping management fees and transaction costs low, index funds have provided investors with superior results over the long-haul, even in asset classes in which markets are less efficient at setting prices.

The "skewness", or dispersion, of equity returns continues to frustrate active managers. It seems logical that half of the stocks in an index will outperform the index each year. Yet most years, index performance is driven by the top performing stocks and most stocks underperform the index in which they reside. For example, according to S&P, only 96 of the 230 stocks in the S&P 500 Growth Index outperformed the index in 2021.

Fund Asset Class	1 YR	3 YRS	5 YRS	10 YRS	20 YRS
Large-Cap Growth	F	F	F	F	F 3%
Large-Cap Value	P	F	F	F	F 17%
Mid-Cap Growth	F	P	P	F	F 10%
Mid-Cap Value	F	F	F	F	F 6%
Small-Cap Growth	F	P	P	F	F 3%
Small-Cap Value	F	F	F	F	F 14%
Domestic REITs	F	P	F	F	F 16%
Int'l Large Stocks	P	F	F	F	F 10%
Int'l Small Stocks	P	F	F	F	F 12%
Emerging Market Stocks	F	F	F	F	F 7%

Data as of December 31, 2021

This chart is the year-end 2021 SPIVA report card of active managers. The far-left column lists ten popular stock asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5, 10 and 20 years. If more than 50% of actively managed funds in an asset class outperformed their benchmark S&P index, they get a passing grade of P for that time period. If the majority underperformed, they get a failing grade of F. The 20 YRS column includes the percentage of active funds in the asset class that outperformed their benchmark index for the past 20 years.

The reason that long-term performance results are so poor, and bound to remain so, is due to the compounding effect of the ongoing performance shortfalls as the years go by.

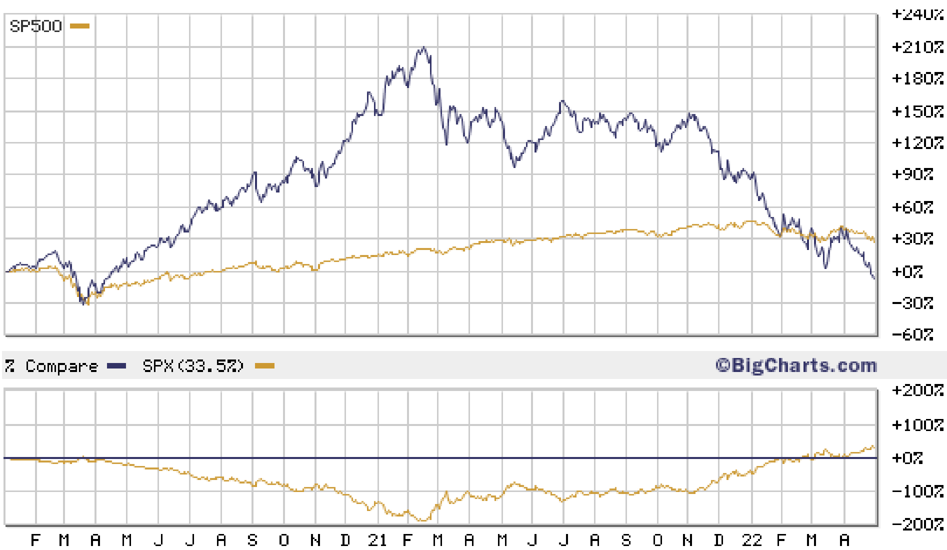
The Scorecard also tracks the longevity of mutual funds. There were 2,236 domestic stock funds available to investors on January 1, 2002. By January 1st of this year, only 677 (30%) were still in business. Funds that expired were poor performers that were merged into other funds or liquidated. So, for every three actively managed stock funds available to investors in January 2002, only one exists today. If we assume that the surviving funds have the most talented managers, the removal of less talented competitors will make it even harder for the surviving managers to outperform in the years ahead.

Managers of mutual funds, pensions, endowments and hedge funds are skilled professionals who conduct extensive research in their quest to find mispriced securities. Each day they make millions of trades in the global financial markets that aggregate vast amounts of information, yielding consensus pricing that is difficult to outsmart. To outperform, a fund manager must outsmart the collective pricing wisdom of all other investors, know how the future will be different from what other investors expect and how prices will react to unexpected news. Index investors are "price takers", they accept current prices as the best estimate of fair value, and they receive the return of the capital markets at virtually no cost. So, a tip of the cap to active managers. Due to their tireless activity, index investors can "piggyback" on their research and efforts – that are paid for by active investors.

Once again in 2021, investors favored index funds over actively managed funds. According to First Trust, for the 12-month period ended 3/31/22. index mutual funds and ETFs reported estimated net inflows totaling $902 billion, compared to estimated net outflows totaling $15 billion for actively managed funds.

In the News

There will always be active funds that outperform, especially over short periods such as one, three or five years. Unfortunately for active fund investors, outperforming funds are unidentifiable in advance and the winning funds usually change from one year to the next. The financial media will promote any fund manager with an outstanding performance record – even a short one. They never mention that we would expect to see a few noteworthy outperforming funds even if results were entirely random. Although there's no way to distinguish random results from results obtained by skill, outperformance is always attributed to the skill of the fund manager. Which brings us to the ongoing saga of media darling, "superstar" fund manager Cathy Wood's Ark Innovation ETF (ARKK).



The top chart compares the performance of ARKK to the S&P 500 Index from January 1, 2020, through the end of April 2022. Before 2020, nobody heard of Cathy Wood or ARKK but that all changed when, according to Morningstar, ARKK gained 157% in 2020, ranking in the first percentile of performers, and 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 – just as the fund's performance and the number of Ms. Wood's admirers peaked.

The bottom chart notes the cumulative percentage differential in performance between ARKK and the S&P 500 Index since Jan. 1, 2020. As can be seen, by mid-February 2021, at the peak of ARKK's renown, it had outperformed the S&P 500 index by almost 200% in just 14 months. But unfortunately for ARKK's investors, Wood's magic touch disappeared, the S&P 500 continued to rise and ARKK continued to fall. Despite outperforming the S&P 500 by 141% in 2020, it has given back all those gains, plus some, over the past 14 months. According to Morningstar, the fund is down 50% year-to-date through the end of April. ARKK was a performance chasing investor's dream come true – for a while, anyway. But as the SPIVA Scorecard and ARKK's recent history show, outperformance rarely persists and investors who arrive late to the party are likely to get a first-hand education in reversion to the mean.

According to FactSet, the S&P 500 yielded a 9.4% annualized average return for the 20 years ending Jan. 31,2022. Yet if you missed the 10 best days of the more than 5,000 trading days during the past two decades, your annualized return would have been 5.2%. Miss the 20 best days (0.4% of the total) and your annualized return would have fallen to 2.5% - similar to the return of short-term government bonds. Seven of the 10 best days occurred within 15 days of the 10 worst days, during times of extreme market volatility. This is just another reason why market timing is an impossible task. The latest example of this phenomenon occurred on May 4th when the S&P 500 rose 3.0% - the best performing day of 2022. The next day it fell 3.6% - the worst performing day of 2022. Yet there was no significant news on Wednesday or Thursday that wasn't known on Tuesday. Heightened volatility like we have experienced recently is exacerbated by computer programs designed to invest long-term assets (stocks) for short-term gains.

Since the beginning of the year, the stock and bond markets have been rattled by high inflation and uncertainty over by how much and how quickly the Federal Reserve will raise interest rates. Whenever someone bemoans that the stock market is falling, I respond, "No, it has fallen, and no one knows what it will do next." High inflation, worries about the Fed, slowing global growth, and the ongoing war in Ukraine are already priced into stocks and bonds. Wise investors know that their emotions are likely to lead them astray, so they maintain their investing discipline, and long-term perspective. Nine words comprising the best investing advice you will ever receive – Have a plan, invest properly, sit tight, don't peek.