On Course Financial Planning
Facing the Future with Optimism and Courage
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Vectors

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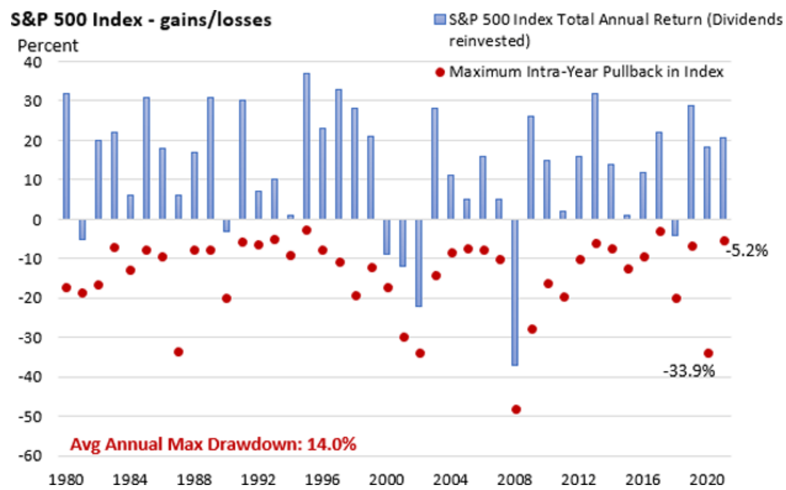
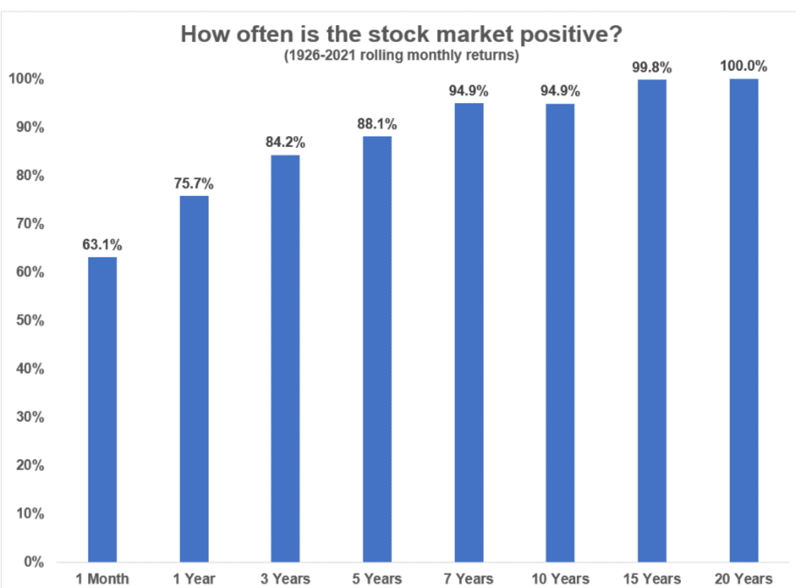
Stay Invested



This chart shows the annual return (in blue) and the maximum intra-year drawdown (in red) for the S&P 500 since 1980. The average of the maximum drawdowns – which must be seen as normal and expected - has been 14%. Year to date, the largest drawdown has been 5.2% - well below the average of the past four decades. These maximum intra-year drawdowns were accompanied by end-of-the-world, large font headlines. Yet the index, including dividends, yielded positive returns in 34 of the past 41 years. That's an 83% success rate for those keeping score at home.

Compounding is often called the 9th Wonder of the World. The first rule of compounding is to avoid interrupting it unless absolutely necessary. No jumping ship every time the market falls 14%. Compounding is automatic, the discipline to stay invested is not. Every significant market decline gives pessimists the opportunity to shout: “This time, it's different!”. Thus, the pessimist has no need to study or understand the lessons of history. Despite all the gloom and doom I've heard from pessimists during my adult years, the future keeps turning into the present and we're all still here. It seems like there's always something about to bring down the economy - which eventually becomes nothing and is soon forgotten.

The 2020, 33.9% drawdown, was noteworthy – it was the worst intra-year drawdown in a year that ended with a positive return. Although the 2020 stock market was an outlier, beyond what anyone would expect, it’s not out of the ordinary for stocks to produce annual gains despite unpleasant, intra-year losses.

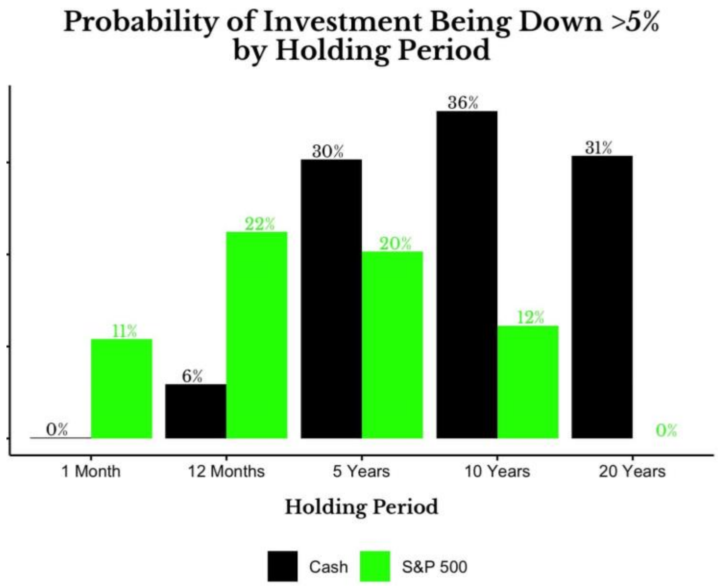


It’s probably never been harder to have a long-term mindset when it comes to investing. This chart, from Ben Carlson's blog, shows how often the S&P 500 has yielded a positive return over various rolling monthly periods since 1926.

In 94.9% of 10-year monthly rolling periods (120 months), the S&P 500 had a positive return. Extend that to 15 years and the return was negative only once in more than 1,000 180 month rolling periods. All 20-year monthly rolling periods produced positive returns.

An important question asked by soon-to-be retirees is "How much of my portfolio should be invested in stocks?" To my way of thinking, if you have enough high-quality fixed income assets to fund 15 years of drawdowns, you can invest the rest of your portfolio in stocks for the long-term without worrying about interim stock market declines.

This strategy is very conservative and can be adopted by any investor, regardless of the size of their portfolio, because it's based on the difference between expenses and income, not net worth. Of course, historical returns don't tell us what future returns will be. The month you retire might be the first month of another 180 month period with a negative return for stocks. So what? Life's not fair and you should know that by now.



Source: Returns 2.0, 1926-2021 (OfDollarsAndData.com)
Note: All returns adjusted for inflation. Cash return is 1-Month Treasury Bills.

This chart shows how often cash or the S&P 500 was down by 5% or more in real (inflation adjusted) terms over different time horizons since 1926. Cash is unlikely to lose a significant portion of its purchasing power in the short run, but over longer time horizons it has not been a safe investment. It provides the illusion of safety because the dollar value of cash remains steady or rises slightly over the long term, but its purchasing power is eroded by inflation. Conversely, as we saw in the previous chart, the S&P 500 often loses value in the short run, but the likelihood of experiencing real loss over longer holding periods declines with time. As can be seen in the chart, there has never been a 20-year period in which the real, inflation adjusted return of the S&P 500 fell by more than 5%. You don't protect your long-term assets by taking them out of the stock market. Investors who succumb to the temptation to do so when volatility spikes will feel safe and comfortable sitting in cash as the real value of their wealth slowly diminishes over time.

An Honesty Problem

On Course Financial Planning opened for business seventeen years ago this month. I've been proud to work in a fiduciary capacity with my clients, helping them to get and stay on course to achieve their long-term financial goals. The strategy in our collaborative adventure has been to maintain a long-term focus, ignore short term market gyrations, shun any temptation to time the market, keep an appropriate percentage of assets permanently invested in stocks and maintain an optimistic view of the future. Along the way I've developed a few core beliefs that have stood the test of time --

- Low-cost, tax efficient index funds allow investors to receive whatever returns the capital markets are generous enough to yield -- which historically have been sufficient to meet any prudent investor's needs. Owning individual stocks brings more risk into a portfolio and offers no legitimate expectation of higher than market returns.
- Taking unnecessary risk with the safe portion of your portfolio makes no sense, so limit fixed-income investments to investment grade corporate and municipal bonds and U.S. Treasury securities.
- Avoid hedge funds, private equity and other illiquid investments. They are unregulated, charge high fees, lack transparency and implode on a regular basis. Beware of the alternative investments du jour, which seem to change on an annual basis. They are overly complex, often hold derivative securities and employ strategies that are incomprehensible to the adult mind. I can't think of any examples in investing where complexity and opacity have proven to be superior to simplicity and transparency.
- The best, simplest inflation hedges are Treasury Inflation Protected Securities (TIPs). Their principal value increases annually with the CPI, and they act as insurance against unexpected inflation, which may or may not arrive.
- A simple passive portfolio of index funds has many advantages - low ongoing fees, tax efficiency, it simplifies asset allocation and rebalancing, and requires little time or energy to maintain.

Sadly, after 17 years of observations, I must acknowledge that the financial advice business has an honesty problem; that much of what it does is built on a lie. Despite decades of evidence and academic research showing that consistently outperforming the stock market is all but impossible, the industry and its media shills promote just the opposite. Institutional investors who manage mutual funds, hedge funds, pension funds, etc. continue to earn a fortune speculating with other people's money in an attempt to outperform simple index funds. Some gain prominence by producing superb short-term results but there's no way of knowing if the outperformance was the result of skill or luck. No matter, the financial media will promote them as investment stars. There are many talented fund managers but for most of them, any alpha (outperformance) they produce is eroded by the fees they charge. The rising popularity of index funds shows that many investors understand this, but too many financial professionals, who must be aware of the data, pretend as if it doesn't exist or that it is fake news promoted by proponents of index investing.

Financial advisers share much of the blame in this sham. Probably four out of five financial advisors that I meet are proponents of active management in one form or another. They believe that if they don't promise outperformance, no one would hire them. Many know that most active funds underperform comparable index funds each year, so they pretend to know the funds that will outperform. This is pure hubris. Deep down inside they realize that they don't know which stocks or funds will outperform, yet the charade continues because they believe that this is what clients and prospective clients expect from them. They dismiss index investing by saying - "Sure, you can invest in index funds, and they'll do just fine when the market is rising. But when the spaghetti hits the fan and volatility spikes, you want your money invested with active managers who can make quick decisions to protect you from the downside - something index funds will never do." This sounds reasonable, but all the evidence indicates that it is just another industry-wide lie.

Most studies compare the performance of active funds to their benchmark index – which has no fees or expenses. Morningstar's Active/Passive Barometer avoids this problem by comparing the performance of active mutual funds to the average return of the index funds in its asset class. In its mid-year 2021 Barometer report, Morningstar noted, *"In 2020, the coronavirus selloff and subsequent rebound tested the narrative than active funds are generally better able to navigate market volatility than their passive peers. As we documented in our year-end 2020 report, active funds' annual performance showed that there is little merit to this notion. Across all 20 categories we examined, just 49% of the nearly 3,500 active funds included in our analysis survived and outperformed their average passive counterpart. During the 12 months through June 2021, active funds' one-year success rate dropped slightly…Roughly 47% of the nearly 3,000 active funds that were available to investors across the 20 categories included in our analysis in June 2020 both survived and outperformed their average passive peer in their respective Morningstar category...In general, actively managed funds have failed to survive and beat their passive peers, especially over longer time horizons; only 25% of all active funds topped the average of their passive rivals over the ten year period ended June 2021."*

Morningstar's methodology favors active funds because it compares a fund's performance to the average performance of all index funds in its asset class, not the largest index funds, which typically have lower fees and higher returns.

Fund managers may outperform for a year or two, but it rarely lasts because market beating performance is the by-product of taking on more risk -- which contains the seeds of future underperformance. The "paradox of skill" is another reason. The competition is getting smarter each year and the pool of unskilled investors that can be exploited has been decreasing, as individual investors own a shrinking share of publicly traded stocks. There are so many talented money managers that it is almost impossible for one person to outsmart the competition on an ongoing basis. Fund managers know this better than anyone else, but most choose to act as if it isn't true and continue with the active management charade, camouflaging it with complexity and financial jargon. And who can blame them? If they succeed, even for just a few years, their earning potential is unlimited, yet they assume almost no personal financial risk.

Much personal financial advice is intentionally and unnecessarily complicated, often for the purpose of selling something you probably don't need. Don't assume that a complex strategy is better than a simple one. Complex investment products are likely to be more expensive and have more failure points than a simple buy, hold and rebalance strategy. Advisors add value not by stock and fund selection or market timing but by helping clients control costs, manage their behavior and, most of all, by creating a financial plan that simplifies their financial lives and brings peace of mind.

In the News

The Social Security Administration announced last month that retirement benefits will increase by 5.9% in 2022, the largest cost-of-living adjustment (COLA) since the 7.4% increase in 1982. Over the past 12 years, Social Security COLAs have averaged only 1.4%. The maximum monthly retirement benefit will rise from $3,148 to $3,345 for someone who reaches full retirement age in 2022. Social Security taxes are paid on the first $142,800 of gross earnings this year. This will increase to $147,000 next year.

Most retirees should see an increase in their net Social Security benefits in 2022 even after factoring in Medicare Part B premiums, which are deducted from their Social Security benefit. In 2021, most Medicare beneficiaries pay $148.50 per month for the Medicare Part B premium. Medicare premiums and surcharges for high income beneficiaries (known as the income-related monthly adjustment amount (IRMAA)) for 2022 will be announced next month.

Due to the recent spike in the CPI, tax brackets will be adjusted upward in 2022 and the maximum contributions to 401(k) and 403(b) plans will rise to $20,500. The $6,500 catch-up provision for employees aged 50 and over remains the same as does the $6,000 maximum IRA contribution and the $1,000 catch-up provision for those who are age 50 and older.

It is hard to imagine the amount of wealth in America. Perhaps this might help - the National Retail Federation estimates that Americans spent $10.1 billion on Halloween this year—an all-time high, up from $8.1 billion in 2020.

As of November 5th, the S&P 500 has hit an all-time closing high 64 times this year, eclipsing the former annual record of 62 all-time closing highs in 2017. Thus, since New Year's Day, proponents of "The market is too high" timing strategy have had 64 opportunities to make decisions that they now regret.