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Facing the Future with Optimism and Courage
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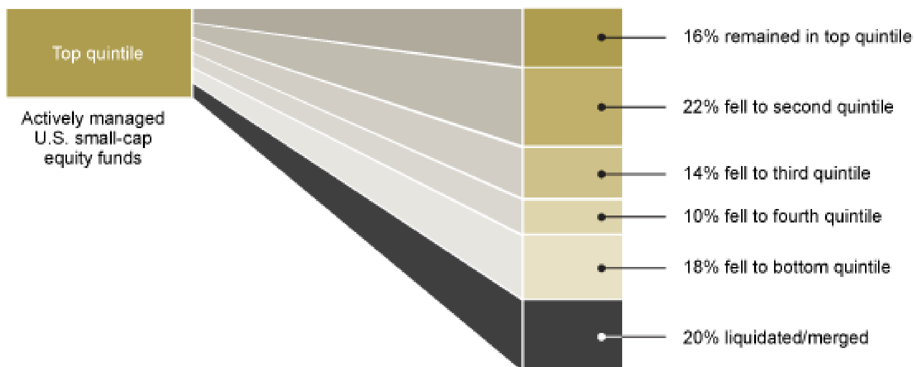
Overconfidence

All investors are susceptible to the behavioral error known as overconfidence. Too often, we credit our investment successes to our superior skill, rather than the fact that we merely benefitted from market returns - which are available to every market participant. Overconfident investors tend to overrate their knowledge and insight, overestimate future returns and underestimate the risk they are taking. Overconfidence is most common during bull markets when speculative guessing can be mistaken for shrewd perception. Overconfident investors tend to pay attention to the daily financial news; not realizing that publicly available information isn't actionable because it has already been incorporated into stock prices. Typically, overconfident investors own individual stocks, incorporate active strategies and change their portfolio allocation in response to economic and market forecasts. This, even though no academic data supports the idea that market timing or tactical asset re-allocation can be done successfully over the long-term.

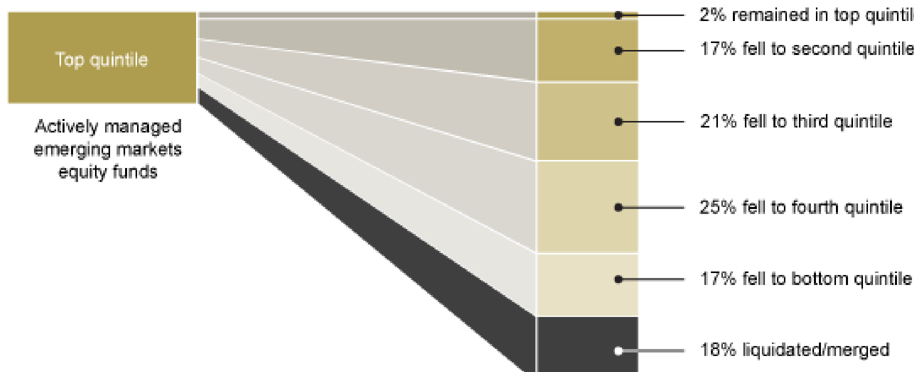
Institutional investors are not immune to overconfidence. They must give the impression that they are smarter than the market – despite the evidence that few, if any, are so prescient. Most claim to possess an insight or have an exciting new strategy that will motivate their salesforce and attract new investors. Many overconfident institutional investors claim that in less efficient markets – small-cap domestic stocks and emerging market stocks are often cited - active managers can demonstrate skill and outperform index funds. This claim sounds reasonable, but according to the latest Morningstar *Active/Passive Barometer*, only about 1 in 3 actively managed emerging market mutual funds and 1 in 5 actively managed domestic small-cap mutual funds outperformed their index fund competitors in the ten years ending December 31, 2017. Additionally, as seen in these charts, a Vanguard study found no persistence in performance for funds that outperformed.

Small Cap Mutual Funds



These charts show the performance of top-quintile (20%) actively managed small-cap and emerging market mutual funds for the five years ending in 2012 and how they ranked five years later. We would expect that 20% of the top quintile performers would remain top quintile performers by chance alone. Yet only 16% of small-cap stock funds remained top quintile performers while 38% became bottom quintile performers or were liquidated.

Emerging Market Mutual Funds



The results for emerging market fund managers were even worse – only 2% remained top-quintile performers and 35% became bottom quintile performers or were liquidated. Whether you count on your fingers or use the most sophisticated software, analyzing past performance to predict the future performance of any fund is a loser's game. The universal disclaimer that past performance is no indicator of future returns is a perpetual investing reality.

All markets are dominated by professional money managers. The reason that so few funds remain top performers over multiple time periods can be attributed to the "paradox of skill". Each manager has so many talented competitors that it's difficult to consistently find mispriced securities before the competition. Consequently, the difference in performance between the winners and losers is more likely to be the result of luck rather than skill.

Every investor must choose between two fundamentally different investment philosophies. Will you attempt to outperform the returns of the stock and bond markets or accept market equaling returns? Novice investors often believe that there are large, easily attainable gains available to stock investors via stock picking and/or market timing strategies. But I'll let you in on the secret that none of the big-name Wall Street firms want you to know. You, and any financial advisor you may employ, have virtually no chance of outperforming market returns. Each day, millions of trades worth hundreds of billions of dollars are made in global stock markets. This trading activity acts as an information processor that aggregates the vast amount of information that lies behind the trades of profit-seeking investors. All this trading activity drives prices towards a fair value that represents the consensus opinion of all institutional market participants.

No financial advisor or stockbroker has the skill to consistently add value to your portfolio by finding securities that the rest of investors have mispriced. Pity the client who takes advice from an overconfident financial professional who doesn't know the statistical improbability of outperforming the market. Attempts to do so are more likely to increase portfolio risk and decrease return. The illusion of skill is deeply ingrained in the financial advisory business. Data that contradicts the illusion of skill, disproves the persistence of performance or reveals the "paradox of skill" is ignored because it threatens too many advisors' livelihood and self-esteem.

The best that any investor can hope for over long period of time is receiving the market's rate of return. Why? Because that's all that's available and all investors share the market's return. I realize that that's not the type of message most investors want to hear. Although the big Wall Street firms employ thousands of very smart people, they've yet to figure out how to make getting rich slowly by accepting market returns sound exciting. By avoiding the expense and fruitless toil of trying to outperform the market, passive index investors will, if they can manage their emotions, likely receive better returns in the long run than most overconfident professional money managers.

The New Champ?

It seems that a day doesn't go by where I don't hear someone spout off a baseball statistic that sounds interesting, but upon deeper analysis, is completely irrelevant. "Joe Blow is the first rookie younger than 22 years old to hit 16 doubles before Memorial Day!" Likewise, the world of finance and investing is full of interesting sounding statistics that tell us nothing or reveal less than the complete story.

This month's example is the widely reported fact that the current bull market, as measured by the S&P 500 Index, is the longest since the end of World War II. The S&P 500 Index bottomed on March 9, 2009. On August 22, its run extended to 3,453 calendar days with a total, inflation-adjusted return of more than 300% - to the delight of patient, disciplined investors. This achievement is even more remarkable when you consider the countless fear mongering headlines and predictions of imminent stock market crashes coming from financial pundits these past nine years. In the dark days of the financial crisis, investors were repeatedly told to expect a "new normal" of low GDP growth, high inflation and depressed stock returns. The "new normal" has yet to arrive. Unfortunately, many investors, panicked by the headlines or their own imagined disaster scenarios, fled the stock market during the financial crisis and never got back in. So far, I haven't seen or heard any apologies from the financial media for the financial damage done by what might be the worst groupthink financial prediction of my adult life.

So, we're told that we've gone more than nine years without a bear market in domestic stocks. But is it true? A bear market is defined as a 20% decline from a previous high. But rarely, if ever, is it mentioned that the S&P 500 Index fell 21.6% between May and October 2011. The number crunchers don't consider this to be a bear market decline because the low point occurred during intraday trading and by the close of that day's trading, the market had rallied, leaving the index down just 19.4%. But why limit our analysis to the large company stocks that make up the S&P 500 Index? Unlike large-cap stocks, small company stocks, as measured by the S&P 600 Index, didn't avoid a bear market in 2011 when the index declined about 23%. The S&P Composite 1500 Index, a total stock market index, fell just over 20% in 2011. So, to my way of thinking, we've just celebrated the 9th birthday of a 7-year-old bull market.

The media's recent emphasis on the 3,453 day milestone is a perfect example of creating an interesting sounding story using carefully selected statistics that reveals nothing of value. The current bull market is the result of record high corporate profits and low inflation. No one knows when it will end. In the meantime, if you have a portfolio allocation appropriate for your goals, time horizon and risk tolerance, continue making your regular contributions and let someone else waste their time worrying about whether the current bull market is nine years old, seven years old, or how long it might last.

The New Socialists

A strange fondness for socialism seems to be infecting many of America's ill-informed young adults. It is astonishing that people whose lives have been awash in peace, prosperity, freedom, leisure time, technological marvels, education opportunities and more mobility than any other prior generation have fallen under the spell of socialist gloomsters. Somehow, they've come to believe that the USA is a bad place to live; that the fault lies at the feet of greedy capitalists and the solutions are to be found in the wisdom of politicians and benevolent government bureaucrats.

"The Intellectual Poverty Of The New Socialists" by Richard A. Epstein of Stanford University's Hoover Institution is required reading for anyone concerned about this strange turn of events. Here are some highlights –

"*These new wave socialists will push the Democratic Party further to the left with their constant calls for free and universal health care, free college tuition, and guaranteed jobs for all Americans – all paid for in ways yet to be determined. The New Socialists try, of course, to distance themselves from the glaring failures of the Old Socialists, who suffered from two incurable vices. First, they ran the economies of such places as Cuba, Venezuela, the Soviet Union and virtually all of Eastern Europe into the ground. Second, they turned the states into one-party dictatorships governed by police brutality, forced imprisonment for political offenses, and other human rights abuses. When viewing the proposals of the New Socialists, one looks for any kind of explanation for how their proposals for the radical expansion of government control over the economy aimed at mitigating income inequality will protect both personal liberty and economic well-being… The New Socialists in the United States live in a world of intellectual self-denial. They think that they can control the distribution of all the good things in life without undermining the economic and social institutions needed for the creation of that wealth in the first place... Competition leaves people with choices. But under the New Socialism, people will really discover what it means to be unfree when they only have this choice: work for the state and spend your falling wages on government-supplied goods—or starve. And to whom does the unhappy citizen turn when there is only one healthcare provider, one landlord, and one education system? The state monopolies under socialism offer a kind of subjugation and submission far greater than that in competitive markets.*

Socialism fails because it ignores the part that incentives play in economic decision-making. Imagine a country with a rat infestation problem. The government attempts to lower the rat population by offering a cash bounty for every rat carcass delivered to a government rat collection facility. Soon thereafter it discovers that the rat population has doubled because a large portion of its citizens are now breeding rats.

People who don't understand the fundamental deficiencies of central planning are continually surprised when socialism's promises of prosperity, equality, and security, lead instead to tyranny, poverty and misery – as the unfortunate citizens of Venezuela are experiencing today. In his excellent article, "Why Socialism Failed" Dr. Mark J. Perry, the creator and editor of the *Carpe Diem* economics blog at www.aei.org notes –

"In a world of scarcity, it is essential for an economic system to be based on a clear incentive structure to promote economic efficiency. The real choice we face is between imperfect capitalism and imperfect socialism. Given that choice, the evidence of history overwhelmingly favors capitalism as the greatest wealth-producing economic system available, while socialist economies like Venezuela destroy wealth and leave its citizens impoverished, malnourished, sick and desperate."

Greed is a vice possessed by individuals, not societies. Free markets teach citizens the benefits of cooperation, fairness and respect for others. In free exchanges, participants learn that enlightened self-interest leads to serving and cooperating with others. An amazing benefit of free markets, one that is so commonplace that we never think about it, is the ease in which two individuals, who never meet, can exchange goods and services that benefit each other.

The wealthiest nation will always be the one in which people are most free. America's economic success is the result of minds working with the freedom to innovate. Acting as a fertile ground for entrepreneurs is what separates the USA from other nations, and it is the key to wealth creation. Our government must protect personal property rights and intellectual property. Sailing without wind, horseless carriages, flight without propellers, cameras without film, pocket telephones, light without flame, heat without smoke, music without instruments, food that never spoils and books without paper. All were impossible fantasies a little more than a century ago, unavailable to even the wealthiest people. They existed only in the minds of dreamers and today they have become so commonplace that we never think about how much they improve our daily lives. And none were foreseen or created by politicians or government bureaucrats.

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