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

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The Investor Gap 2022

Mutual funds and ETFs report performance on a “time-weighted” basis that measures the return of $1 invested at the beginning of the year and held through the end of the year. But few dollars in a fund are invested this way. A better way to report fund performance is on an "asset-weighted" basis. This is done by analyzing the flow of money into and out of a fund to calculate the annual return realized by the average dollar in the fund. Each year, in its Mind the Gap study, Morningstar calculates and compares the asset-weighted return of funds to their time-weighted performance. Any difference is called the “investor gap”. According to Morningstar, the investor gap “*stems from poorly timed purchases and sales of fund shares, which cost investors nearly one-sixth of the return they would have earned if they had simply bought and held.*” Many investors are portfolio fiddlers, and the more you tinker with your portfolio, the larger your investor gap is likely to be. Online information, tools and calculators provide little help in shrinking the gap because they do not provide the perspective or insight to prevent emotional buying and selling.

In its Mind the Gap 2022 update, Morningstar reports that for the ten years ending December 31, 2021, the average annual investor gap in domestic stock and bond funds was 1.2%. It noted that a fund's investor gap is directly related to its volatility. Funds with volatile performance tend to attract performance chasing, short term investors. Sector equity funds attract “tactical" investors who invest in sectors with strong recent performance, and then leave when performance falls. The Mind the Gap report notes that investors in sector funds experienced a 4.3% annual investor gap. Making “tactical” strategic changes to your portfolio is an impulse, and almost always a counterproductive one.

Poor behavior is the primary reason that investors underperform the funds in which they invest. As Cassius told Brutus - the fault is not in our stars, but in ourselves. Your actions should be guided by a financial plan, not speculative guesses about what the future holds. In its summary Morningstar notes, *“The endless drumbeat of market and economic news can make it tempting - even for professional investors and financial advisors - to feel like they should be doing something to respond to shifting market conditions. But for the most part, the time and energy that investors spend on trading decisions is wasted effort - and often counterproductive. Investors can improve their results by setting a rational asset allocation, buying low-cost funds, and just sticking with their plan. It also makes sense to set a strict schedule for rebalancing, such as rebalancing once per year or when your portfolio's allocations drift significantly away from target levels.”* Here are some causes of the investor gap --

Lack of Education. Sadly, the average American is pretty close to illiterate in financial matters and that’s not likely to change anytime soon. Good financial planning requires an understanding of how capital markets work, tax law, employee benefits, insurance, and estate planning. Most people find these subjects boring and lack the time or interest to study them. Target Date Funds (TDFs) are the default investment option in most 401(k)s. In the 2022 *Retirement Confidence Survey* by the Employee Benefit Research Institute, 4 in 10 respondents admitted that they do not understand target date funds, how TDFs adjust their portfolio allocation over time, or how to select the proper TDF.

Portfolio Peeking. Studies of investor behavior show that the more you peek at your portfolio, the more you will trade. Berkeley professor Terry Odean analyzed data from two discount brokerage firms and discovered that the investors who traded the most experienced the lowest returns. Each year Wall Street spends billions of advertising dollars to get you to start trading. Free trades! Free trading aps for your smart phone! You can beat the market! This fantasy is Wall Street's biggest lie and is promoted throughout the financial media and on social media. The truth is just the opposite – the more you trade, the more Wall Street makes -- which is why it's so easy to find a stockbroker in every village, hamlet, and town in the USA.

Having No Plan. ***A*** collection of portfolio assets is not a financial plan. You need a written financial plan that incorporates your cash flow, expenses, risk tolerance, financial goals, and that contains a comprehensible investment strategy to achieve your goals. Without a written plan your portfolio is a rudderless, rusty tub in stormy seas. A firm commitment to your financial plan helps anchor your emotions, which are major contributors to the investor gap. I hate “What to Buy Now” articles that appear in personal finance magazines. Your portfolio allocation should be based upon your needs, goals, and risk tolerance, but these articles make it seem that your portfolio allocation should be based upon what the markets are doing today or someone’s prediction of what they might do tomorrow.

Chasing Past Performance. Past performance is no guarantee of future returns. Remember this the next time you hear the financial media heaping praise on a successful fund manager who has done well in the recent past – usually by taking big risks that go unmentioned. Just as in sports, last year's victories don't count towards this year's championship. Reversion to the mean lurks behind all good past performance. Nevertheless, every mutual fund advertisement proclaims good past performance. It's a very effective marketing tool, an easy sell. But you can't invest in past performance. Caveat emptor.

Overconfidence. I am amazed that so many investors have firm opinions about what the stock market, a particular stock or the economy will do in the near future. I wish I could be so confident. I am also disheartened to see so many portfolios containing individual stocks. The only reason to own individual stocks is to beat the market – a difficult task even for the most skilled fund managers. All the evidence indicates that investors can earn better long-term returns by owning a portfolio of diversified stock funds. A study entitled *"Why Inexperienced Investors Do Not Learn"* sheds some light on the issue. Investors in the study greatly overrated their investing skill, 70% saying that they were above average investors. They also overestimated their portfolios' past returns. The study concluded that most individual investors are incompetent and overconfident -- a dangerous combination. A study by two Cornell University professors is *"Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self Assessments."* The study concludes that we tend to hold an overly optimistic assessment of our abilities in intellectual fields in which we are unskilled. We suffer what the authors call a dual burden -- not only do we reach erroneous conclusions and make poor choices, but our incompetence prevents us from realizing it. Self-attribution bias is a cognitive process that helps boost overconfidence. We credit our own talents and abilities for past successes while blaming failures on bad luck. Thus, our overconfidence and the investor gap persist.

Portfolio Dissecting. The risk and return of any one fund in your portfolio is irrelevant. It is the risk and return of the entire portfolio that demands attention. We tend to look at the funds in our portfolio in isolation. If one fund has done poorly recently, we sell it and buy more of a fund that has done well -- falling into the sell low/buy high trap which contributes to the investor gap. A better strategy is to consider your portfolio as a whole and annually rebalance it to its original allocation. You will be selling what has gone up and buying what has gone down -- exactly the opposite of what the portfolio dissectors are doing.

Noise Trading. Investopedia defines noise traders as *"investors who make decisions to buy or sell based on factors they believe to be helpful but in reality, will give them no better returns than random choices."* The name comes from the idea that changes in a stock's price creates "noise" which attracts attention but is unrelated to the stock's true value. Noise traders pay close attention to short-term, irrelevant information, leading to excessive portfolio tinkering. Professional investors think of themselves as informed traders, yet they also engage in noise trading that is a major component of daily stock market volatility. Investors who follow the daily market news typically assume that more information leads to better investment decisions. But news and value-relevant information are two different things. Publicly available information, what you read or see in the financial media, has no value. It's already incorporated in asset prices and it's too late for you to profit from it.

I cannot mention the investor gap without placing some of the blame on the financial services industry. It is constantly developing new products to meet the whims and demands of its clients. Unfortunately, what most people want to buy is different from, and often the exact opposite of, what they should buy. Many Wall Street products promise to yield the return of stocks without their inherent volatility. This is a lie. Anything that lowers volatility must, and always will, subtract from return. Today, some quant is hard at work creating the next "must have" alternative investment that will promise to go up regardless of what stocks are doing. It will be birthed as a hedge fund, structured note, annuity, or ETF. Like its predecessors, it will snag those who fall for a story too good to be true. In its recent study of alternative funds, Morningstar concluded that they sound nice in theory and look good in backtests, but most haven't performed as advertised.

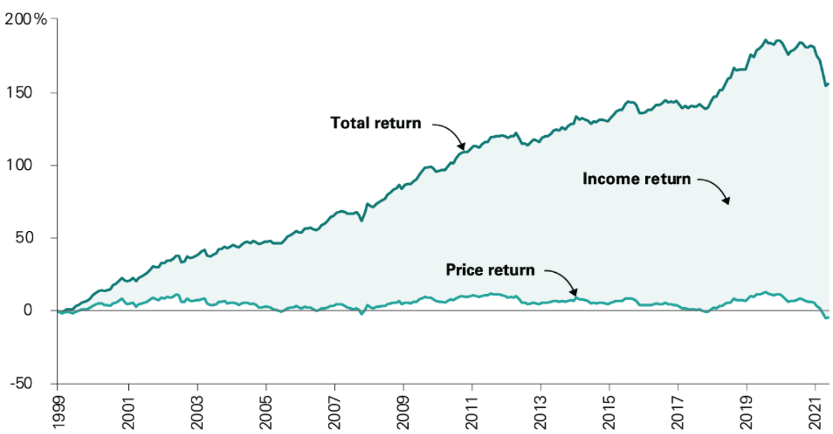
Your portfolio's performance is the sum of two parts. The predominant part is the return of the funds in which you invest. To this you must add or subtract gains or losses produced by attempts to outperform the market. Morningstar's Mind the Gap report reveals that investors are not very good at fund selection or market timing. The capital markets are subject to the vagaries of the economy and geopolitical events -- which no financial advisor can predict, control, or deftly outmaneuver. Still, most financial advisors devote time and energy to the security selection/market timing component of performance in an attempt to provide "value" to their clients. They know that most fund managers are unable to beat the market, but the true believers that I talk to are confident that they can identify those skilled few that will outperform. But this is just false bravado. They are not uniquely skilled at manager selection and just as susceptible to noise trading as their clients. It hasn't dawned on them that anyone who helps clients avoid the investor gap provides value that is a multiple of the fee they charge. These misguided advisors hope that clients will never realize that their ever-changing recommendations do not come from inspiration but from an attempt to appear to be one step ahead of the markets. They have abdicated their fiduciary duty to be good stewards of their clients' assets and instead are engaging in the folly of short-term speculation with their clients' portfolios.

In the News

A senior citizen or disabled person whose primary residence is in Washington State can receive a reduction in property taxes. They must have income below $58,423 - including Social Security and other sources and be age 61 or older by December 31st of the year prior to the current tax year. The age 61 limit does not apply to anyone who is disabled or a veteran with at least an 80% total disability rating.

Notes: Source – Bloomberg. Monthly data are from December 31, 1999, to May 31, 2022. U.S. aggregate bonds are represented by the Bloomberg U.S. Aggregate Bond Index in USD. All bond income is assumed to be reinvested. Income return is the reinvestment of coupons and compound interest on the reinvestment.

Total return and price return



This chart from Vanguard shows that bond fund returns have two components: price return and return from income. Changes in interest rates cause bond fund prices and bond fund income to move in opposite directions. Long-term investors should care more about their bond funds' total return not the negative short-term impact rising rates have on bond prices. As can be seen in the chart, the long-term performance of the Aggregate Bond Index has come primarily from the compounding of reinvested interest, not by price returns. The recent disappointing performance of high quality corporate and government bonds shouldn't cause worry. Rising interest rates cause bond prices to fall temporarily. Upon maturity, the bonds will yield their face value and recoup all the interim price decline. There is no guarantee that a decline in the price of a stock will ever be reversed. While bond price declines are upsetting, it's important to remain focused on the long-term benefits of higher bond fund yields as funds purchase newly issued, higher yielding bonds.

According to BofA Global Research, since 1929, the S&P 500 Index has posted declines in 46% of days in which the stock market was open. It produced negative returns over one-year periods only 25% of the time – think of it as three steps forward, one step back. The S&P 500 fell in 2018, rose in 2019, 2020 and 2021 and will likely be down in 2022. This is normal, get over it. Over 10-year periods, the S&P 500 suffered a loss only 6% of the time. Checking your portfolio on a daily basis is likely to lead to anxiety, frustration, excessive portfolio tinkering and a widening investor gap.

Here's an interesting fact - The S&P 500 has dropped 20% or more 16 times since World War 2. In all 16 cases, once the S&P rebounded and recovered half of its decline, it never dipped below its former low point before making a new all-time high. The S&P 500 recently recovered half of its drop from its June low point. What does this tell us about the current bear market? Absolutely nothing. Past data doesn't tell us why something happened, just what happened.

The USA set an all-time record for crude oil exports in the second week of August - five million barrels per day. And we are taking oil from the strategic petroleum reserve because…….?????

The amount of an annual required minimum distribution (RMD) is based on your IRA's value on 12/31 of the prior year and your age in the current year. If you don't need all the RMD for ongoing spending needs, you can take advantage of an alternative method of taking RMDs - an "in-kind" transfer. Instead of selling fund shares within your IRA and withdrawing the cash, fund shares can be transferred directly to your taxable brokerage account. Taxes due on the transfer should be paid using cash from a non-IRA source. Today, an in-kind transfer allows you to satisfy your RMD without selling stock and bond fund shares at their current depressed values. As long as the asset is held in the taxable account for more than a year, it will receive long-term capital gains treatment when sold at a (hopefully) higher price in the future. If held until your death, the shares will receive a step-up in basis for your heirs.

A mint condition 1952 Mickey Mantle rookie card sold at auction last month for $12.6 million, the highest price paid for any piece of sports memorabilia. Will we soon see an ETF that owns old baseball cards that will be promoted as the latest, must have, inflation beating alternative investment? Don't think it can't happen.