On Course Financial Planning

Facing the Future with Optimism and Courage

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What to Do Now?

Investing presents mental and emotional challenges. It's difficult to keep up with the ongoing changes in the investment arena and our emotions tend to work against us. In last month's newsletter I noted that if your financial goals have not changed since New Year's Day, the events of the first six months of this year provide no compelling reason to tinker with your portfolio. Fortunately, the foundations of successful investing will be the same in the post-Covid-19 world as they were in the pre-Covid-19 world. Unfortunately, they are rarely promoted in the financial media (which has perfected the ability to say nothing in innumerable ways) because they do not enhance the welfare of its advertisers. Fortunately, your financial success does not depend on Wall Street or the financial media. It comes from putting these important foundations of successful investing to work for you -

Portfolio diversification is the most important part of any successful investment strategy. Owning both fixed income funds and stock funds is the foundation of asset allocation. Global equity diversification can be accomplished at almost no cost with just a few index funds. Owning individual stocks is a poor alternative because it brings individual company risk into a portfolio with no reasonable hope of higher than market returns. You might get rich quick by under-diversifying your portfolio -- but it's extremely difficult to stay rich by doing so. Markets can stay irrational longer than most people can stay solvent, so store your eggs in many baskets. Just like Hussey, I'm a big fan of diversification.

Have a plan. Successful investors are goal focused and planning driven. You cannot react your way to a secure retirement. Your portfolio allocation should be governed by a financial plan based on your time horizon, risk tolerance and financial goals. Most do-it-yourself portfolios that I see are a haphazard collection of overlapping assets -- a junk drawer of brokerage house products, stocks and mutual funds purchased years ago for reasons long forgotten. Asset allocation is the biggest factor that determines your portfolio's risk and return. If you don't know your asset allocation, you have no idea how much risk you're taking or what kind of long-term returns you are likely to receive. A comprehensive financial plan and investment strategy will help you stay the course in those unpredictable and inevitable times when everyone around you is shouting: "This time it's different!"

Don't trust your emotions. Investing involves our emotions as well as our money. Fear and greed are the dominant emotions in investing and in a one-on-one battle, fear always wins. It easily overcomes the weight of all historical evidence and rational analysis. An essential part of a financial advisor's value proposition is keeping clients out of emotion-induced trouble. Basing your investment strategy on the most likely scenario rather than the worst-case scenario is the first step in avoiding emotional investing mistakes.

Don't chase past performance. Past performance is a perishable product with an expiration date of…today. More money has been lost chasing past returns than at the point of a gun. The financial media focuses on the recent relative performance of different financial assets. *"Gold is up 28% in 2020! It's time to buy gold!"* Or maybe not. Past data helps us estimate the relative risk between two financial assets but what they will yield from today forward cannot be predicted with any degree of certainty. Fund company advertisements encourage performance chasing when they prominently display the past performance of their best performing funds. These ads often mention that a fund has a four or five-star Morningstar rating - even though Morningstar cautions investors that their ratings measure relative past performance among similar funds and should not be used to predict future performance. Price and value are inversely related. The success of Walmart and Costco proves that we understand this relationship in our everyday shopping. But once we start shopping on Wall Street, we lose our bearings – assuming that rising prices are a sign of better value. An asset class that has produced exceptional performance of late is likely to yield disappointing returns in the future. Design your portfolio to take advantage of the long-term trends in the market, not recent hot sectors.

Understand reversion to the mean. Few investors understand reversion to the mean. It means that the recent performance of a financial asset, whether above or below long-term trends, will eventually revert to its long-term average. Thus, recent above average performance is likely to be followed by a period of subpar performance. Most investors assume just the opposite – that the outperformers will march on and the underperformers will never recover.

Wall Street makes a fortune by offering products that satisfy investors' desire to buy what performed well yesterday. A better understanding of reversion to the mean would do wonders for investor behavior and portfolio performance.

Be optimistic and patient. Optimism is the belief that, over time and despite obstacles along the way, things will likely turn out OK. Patience is a necessity no matter what investment strategy you implement. Few investors possess these important attitudes, which is why there are so few successful do-it-yourself investors. A warning to millennials - if your baby boomer parents are pessimistic, impatient investors you might find them asking to move in with you some day.

Study investing. The trend of shifting the responsibility for retirement savings away from professional investors and onto workers makes it essential that we become better educated about the basics of investing. Having access to an unlimited amount of free financial information does not guarantee well-informed decisions. When investors don't understand the basics of investing, even free trades and inexpensive index funds won't make up for poor decision making. We all start out in life knowing nothing and have a lifetime to learn. Investing is no different. If you want to be a successful investor, spend time learning all you can about investing.

Choose passive over active. There are two diametrically opposed investment philosophies. Passive investors buy and hold broad asset class index funds and are content to receive market equaling returns. Active investors seek to obtain returns that exceed market averages. Their success or failure depends on how well they time the market, pick stocks, or find fund managers on a hot streak. Few fund managers have been able to outperform a comparable index fund over a 10-year period. Investors seem to be getting the message. Over the past decade, trillions of investor dollars have shifted from active funds to index funds. One reason that I use index funds is that I never have to guess what will happen next in the stock market or come up with excuses for why the performance of previously recommended funds turned out to be less than hoped.

Ignore forecasts. Stock pickers, market timers, hedge funds, actively managed funds, financial gurus and "What to Buy Now" articles promise what they cannot deliver – safe investing through a knowledge of the future. Too many market strategists, brokers, analysts and mutual fund managers pretend that investment success requires knowing what will happen – that's the message the financial media sends out every day. No matter how many "wise" men proclaim otherwise, trying to predict the future is a fool's errand and the financial media provides an endless parade of such fools. If we could see into the future, the word surprise would not be in the dictionary.

Shun market timing like Superman shunned kryptonite. Market timing is any strategy that attempts to be in stocks when the market is rising and on the sidelines when stocks are declining. Its siren call is hard to resist. Avoid any investment strategy that attempts to time entries into and out of the stock market. This year, the stock market has once again revealed why market timing is the modern-day equivalent of alchemy, the pursuit of an illusion. Through July 31st, there have been 42 days in which the S&P 500 rose 1% or more and 33 days when the index fell 1% or more. This type of day-to-day volatility is impossible to predict or tap dance around. Market timing has such a bad reputation that it's been renamed – it's now called a tactical allocation strategy. It would be more accurate to call it what it really is – a guessing allocation strategy. After 50 years of relentless computer analysis of market data, no system has been found that can successfully time the market.

Your portfolio needs to outperform inflation. Most investors consider market volatility to be the greatest risk to their financial security. But inflation is a much greater risk. Markets recover, but the loss of purchasing power is permanent. Despite their volatility, stocks have historically been the best inflation beating asset for investors to own.

Stop peeking. Monitoring investment performance on a daily basis can be emotionally disruptive because we tend to mistake volatility for permanent loss. Over the last 90 years, the stock market has been down approximately 5 days in 10. Almost nothing of long-term significance happens on any given day, but there is a false sense of urgency behind the media's daily noise and babbling. It is irresponsible for financial advisors to focus their client's' attention on short-term market activity. Focusing on the short-term often leads to portfolio tinkering in response to current events - a sure recipe for disaster.

Tune out the noise. Each year brings more information into our lives and we don't have enough time to process and evaluate what it all means. When we were kids, we'd put our fingers in our ears when there was too much noise. Now we are grown-up and when bombarded with more financial noise than we can absorb, we try to listen harder. Too many investors are overthinking things. It's much wiser to simplify and focus on the basics. Investors don't need more stock picking advice, market analysis, or any great new investment ideas. They need perspective and advice from a trusted advisor who knows them and can help them ignore the noise and make sound decisions. Someone who can help them distinguish the true from the false, the practical from the useless and the important from the merely interesting. This type of advisor is not often found working for insurance companies or the big-name Wall Street firms. They wouldn't know where to find them, how to train them or how to make money employing them.

The Efficient Market

Legendary investor, Benjamin Graham, warned us that future stock prices are unpredictable because a company's future earnings are unknowable. Let's look at a recent report that analyzes the stock picking ability of active mutual fund managers that gives credence to Graham's assertion.

Standard & Poor's S&P Indices Versus Active Funds (SPIVA) Scorecard compares the performance of actively managed mutual funds to their S&P benchmark indexes. The Scorecard reveals that an inverse relationship exists between the time horizon and the percentage of active funds that manage to outperform their benchmark index. For the five years ending December 31, 2019, 81% of large-cap domestic funds, 64% of mid-cap funds, 77% of small-cap funds and 63% of REIT funds underperformed their benchmark indexes. Additionally, 83% of actively managed domestic stock funds underperformed the S&P 1500 Total Stock Market Index. Over the past ten years, between 80% and 89% of actively managed stock funds in each of these asset classes underperformed its benchmark S&P index and 89% underperformed the S&P 1500.

Proponents of index investing consider the stock market to be efficient. By this we mean that a stock's price reflects all available information about a company and its prospects, and that the price will adjust instantly to new information. No one knows if the next piece of news about a stock or the economy will be better or worse than expected, making stock price movements random in the short run. This "random walk" hypothesis was made famous by Burton Malkiel in his investment classic, "A Random Walk Down Wall Street" - required reading for all do-it-yourself investors. Talented, profit-seeking institutional investors account for about 90% of trading volume each day in the global stock markets. They are all aware of the latest news and their trading yields consensus pricing for stocks. Thus, today's good and bad news, as well as what is expected to happen tomorrow, is already reflected in prices. Prices will change only if tomorrow's news is better or worse than expected. Yes, there are mispriced stocks – but to quote Burton Malkiel -

"No one can consistently predict either the direction of the stock market or the relative attractiveness of individual stocks, and thus no one can consistently obtain better overall returns than the market. And while there are undoubtedly profitable trading opportunities that occasionally appear, these are quickly wiped out once they become known. No one person or institution has yet to produce a long-term, consistent record of finding money making, risk-adjusted individual stock trading opportunities, particularly if they pay taxes and incur transaction costs."

Active stock fund managers disagree. They do not believe that the market is efficient and are convinced that there are mispriced securities. They believe, and would like you to believe, that they can find these securities, exploit the mispricings and profit from them. It sounds so simple - buy stocks that are underpriced, shun those that are overpriced and outperform a comparable index fund. The unspoken assertion of active managers is that they are smarter than the collective wisdom of all other market participants. To beat the market, they must be right while all others are wrong. It's as if the playground bully challenged everyone else in the school to a fight, not one at a time, but all at once. When you realize this, it is easy to understand why the track record of active stock funds has been so disappointing. Here is a simple example of market pricing efficiency –

A 1952 Mickey Mantle Topps baseball card is one of the most sought-after cards among collectors. In 2016, one sold for more than $500,000 at auction. Imagine that at a local estate sale, you find one in a stack of old baseball cards selling for $1. You realize that the person selling the card has no idea of its value and quickly pull a $1 bill from your wallet. Before you can buy the card, another estate shopper offers $5 for it. You offer $10 and the auction is off to the races. Assuming money is no object, the bidding would rise to a price that both of you assume is slightly less than what the card would net at auction. In this example, it took only two informed buyers to set the market price for the card. Financial markets work similarly, but on a much larger playing field, with millions of global investors buying and selling securities each day that determine a stock's consensus fair market value. The most compelling evidence of the stock market's pricing efficiency is that so few fund managers outperform it. If stock prices were inefficiently determined by unskilled investors, the SPIVA Scorecard would be telling us a different story.

Investing would be much easier if past was prologue, if intelligence and hard work led to market beating performance. Alas, it is not so. There will always be fund managers who outperform but the majority will not. Wall Street regularly bestows deity status of its market beating stars. But when their radiance dims, they disappear from view. Don't be fooled, there's no way of knowing if market beating returns were produced by luck or skill. Your financial future is too important to leave to Lady Luck.