On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Are You Afraid?

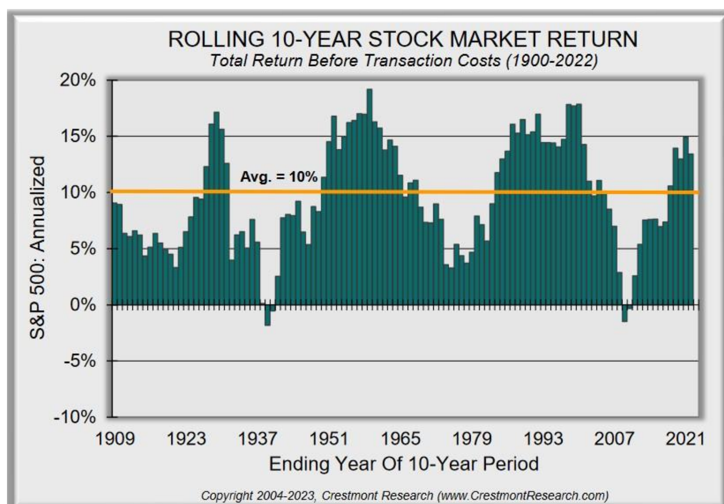
In a recent interview with a potential client, I noticed that her 401(k) was all in cash. I asked her the reason for this lamentable situation, and she replied that she recently met with another advisor who told her that “the market is getting pricey” or words to that effect. After speaking to him, she sold all her stock funds. The reason she took such a drastic step in a year when the stock market has outperformed most investors’ expectations is that he scared her.

The overconsumption of financial news is a serious problem for investors. The producers of financial news have zero interest in you and are indifferent to what you do with the information they provide. They only care about eyeballs, ears and clicks because that’s what drives their ad revenue. They make the ordinary sound catastrophic in order to grab and hold our attention. Every day they feed us numerous articles of clickbait catastrophism that produce an unnecessary fear of “volatility”, the perfectly normal ups and downs of the stock market. Most of the scary scenarios describe events over which you have no control, the arrival and consequences of which no one can predict.

There have been many long forgotten, frightening, large font headlines over the past decade. Recent headlines have focused on what the Fed is going to do with interest rates, the debt ceiling, and whether we're about to enter a recession. Next year, the election will dominate the headlines which, I predict, will also be long forgotten a decade from now. Almost no forecasts for 2022 predicted a bear market for both stocks and bonds, and few predictions for 2023 expected the stock market to rally as it has done. In fact, many forecasters expected the economy to be in a recession by now, a recession that has yet to appear. Typically, the hasty, emotional investment decisions that investors make in response to scary headlines cause more long-term financial damage than the events themselves. The most damaging consequence of last year’s bear market was not the temporary decline in stock prices. It was the unrecoverable losses experienced by frightened investors who missed this year’s rebound in the stock market because they are still sitting in cash.

Pick your biggest fear from a recent podcast, YouTube video or market forecast. The recommended solution will likely enhance someone else’s income and leave you with a narrowly focused, undiversified portfolio. Recommendations for one disaster scenario could be the worst course of action if a different disaster scenario occurs. Even if the scenario that you’re trying to avoid comes to pass, if your timing is off, the recommended action might still do more harm than good.

Throughout history, recurring periods of turmoil have led to stock market volatility. The world is complicated, the future is uncertain and there's nothing you can do about it. Get used to it. The ultimate consequence of all the disasters of the past was a temporary decline in stock prices. Last year was a disappointment but remember that we expect a well-diversified portfolio to appreciate over the long-term, not every year. Here’s one forecast you can trust – there will be periodic interruptions in the growth of your portfolio in the years ahead.



Since 1909, there have only been four periods where the rolling 10-year annualized return of the S&P 500 Index has been negative. Two occurred in the late 1930s, which coincided with the stock market crash and the Great Depression, and two (1999-2008 and 2000–2009) which coincided with the financial crisis and the Great Recession.

Ten years prior to those periods, we had the Roaring Twenties and the dotcom bubble of the late 1990s. In both cases, stock market euphoria created prices that didn’t match economic fundamentals, and reversion to the mean eventually reared its ugly head.

Periods of great uncertainty, when there is nothing but fear in the air and investor confidence is low, have given disciplined investors the opportunity to take advantage of low asset prices – note the rebound in the ten-year annualized returns following the four negative periods.

We should have put every dollar we could get our hands on into stocks last October, when the current bear market was at its low point. But most investors were unable to do so in an environment of universal gloom. It was at this point that a well-constructed portfolio, a prudent investment strategy and a long-term focus provided great value to investors who ignored the financial media's permanent negativity and fear mongering and continued funding their portfolios.

There will be numerous events that impact your portfolio in the years ahead. As long as the financial media maintains its relentlessly negative outlook, its viewers and readers will be tempted to make short-term portfolio changes that, over the long haul, will likely bring more risk than reward. How you respond to future events will be more important to your financial health than the events themselves. To succeed as an investor, you need to let go of what you can't control – your portfolio's performance - and devote your time and energy to what you can control – your portfolio's asset allocation and the commitment to fund it regardless of the headlines. Your budgeting and saving decisions will have more influence on your retirement lifestyle than anything you hear about in today's news. Let your financial plan guide your actions rather than the noise of markets or the ups and downs of your emotions. Then use annual rebalancing to undo the effects of the prior year and return your portfolio to its proper allocation.

Here's my recommendation -- eliminate the daily financial news from your to-do list and devote the freed-up time to the more important things in your life. As a bonus you'll have less stress, fewer things to worry about and more time to think creatively. Thinking requires concentration and concentration requires time -- which most of us find to be a rare commodity these days. Information is everywhere but perspective is in short supply. Investors need more perspective, not more information, and perspective comes from studying history, not by watching the news.

Some people are not able to ignore today's market noise and maintain a long-term focus. Their fear of stock market volatility cannot be eliminated by a reasoned, intellectual explanation of the benefits of long-term investing. They are savers, not investors. This is a description, not a criticism. I left the interview with my potential client knowing that I could not help her. Her fear of the stock market caused her emotional flight to cash. To her, Wall Street is a casino where risky, incomprehensible games are played. She owned stock funds in her 401(k) because she was supposed to, not because she wanted to. For her, owning a diversified portfolio will not bring peace of mind. For her, peace of mind will only come from cash in the bank. Few people who shun stock investments will be able to save enough money to build a nest egg large enough to sustain them in retirement. For those trying to do so, I have very little advice to offer except to say, "Save a lot, you're going to need it."

In the News

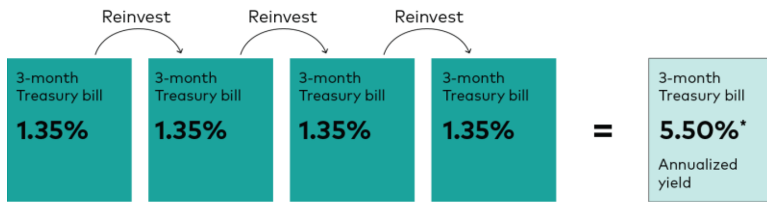
My Lazy Golfer portfolio consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSAX), 20% to the Total International Stock Index Fund (VTIAX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBTLX) and 10% to the REIT Index Fund (VGSLX). It has an annual expense ratio of 0.1%. Rebalance the portfolio on your birthday and ignore the stock market for the rest of the year. The Lazy Golfer portfolio generated a net return of 9.1% for the 12 months ending June 30th, according to Morningstar.

For the fiscal year ended June 30th, the median return (half had more, half had less) for state and local pension funds was 8.3%, according to Wilshire Trust Universe Comparison Service. That's above most pension plans' long-term targets of around 7% per year. The California Public Employees' Retirement System, the nation's largest pension fund, (CalPERS) reported a preliminary return of 5.8% for the fiscal year ended June 30th. The second largest, the California State Teachers' Retirement System, returned 6.3%. New York City has reported that the $253 billion pension funds for civil employees, firefighters, police officers, school personnel and teachers generated a net return of 8% during the fiscal year through June 30th. Meanwhile, lawyers for New York City's pension funds filed a motion calling for the dismissal of a lawsuit that argues that the funds violated their fiduciary duty by selling fossil fuel investments. The lawsuit contends that fossil fuel stocks performed well recently and that the decision to sell the stocks was made without proper financial analysis. The Lazy Golfer has no problem with fossil fuel investments.

The Secure 2.0 Act, passed late last year, mandated that if 401(k) plans allow older workers to make "catch-up" contributions, starting in 2024 they must ensure those earning more than $145,000 use an after-tax Roth for their contributions — rather than a traditional pre-tax 401(k). But now, companies will have until 2026 before the change takes effect. This is good news for smaller companies that were finding it difficult to make the change with such short notice.

Although 30-year mortgage rates now exceed 7%, the average mortgage rate in the country is still only 3.6%, according to Bloomberg. Thus, homeowners with low mortgage rates are hesitant to sell and buy a new home at these higher rates. This helps explain the low inventory of homes for sale which has kept existing home prices higher than one would expect after such a large increase in mortgage rates.

High yields on the short end of the yield curve have led to increased interest in certificates of deposit (CDs), short-term Treasuries, and other short-term fixed income investments. But few investors understand the concept of "annualized yield" for these investments. For example, recently the 3-month Treasury had a 5.5% annualized yield even though it only yielded 1.35% for 3 months. The 5.5% annualized yield assumes that after the first three months, the proceeds will be reinvested into another 3-month Treasury bill yielding the same 1.35% and the process will be repeated twice more. The 5.5% yield assumes that interest rates will stay the same for each of the three reinvestments. But rates can change, and the investor can only be sure of earning 1.35% for 3 months. The math is the same for advertised annual yields for CDs that mature in less than one year. This type of risk in short-duration fixed income investments is called "reinvestment risk" – the risk that when the investment matures, the proceeds will be invested in a similar security with a lower yield. From a financial planning perspective, consider using short-term fixed income investments for cash reserves and use longer duration fixed income investments in your portfolio to lock in higher yields for longer time horizons.



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 mutual funds and exchange traded 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-fifth of the return they would have earned if they had simply bought and held."*

In its Mind the Gap 2023 update, Morningstar reports that for the ten years ending December 31, 2022, the average dollar invested in stock and bond funds earned about 6% per year – 1.7% less than the annualized average, time-weighted return of the funds in the study. Sector equity funds had the largest gap – 4.4%. These funds are popular with "tactical" investors who tend to invest in sectors with strong recent performance, and then sell when performance sags. Allocation funds hold a fixed balance between stocks and bonds and are rebalanced on a regular basis – making them set-it and forget-it investments. These had the smallest gap – 0.5% - which demonstrates the benefit of minimizing investors' proclivity for portfolio tinkering. The report notes that 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 that can prevent emotional buying and selling.

Interest rates have been on the rise for well over a year. The yields on savings accounts, CDs, money market funds, and bonds have all gone up. For risk-free U.S. Treasury bills, the 10-year yield has gone from 1.6% at the beginning of 2022 to 4.1% at the end of August 2023. Does this mean that investors should "tactically" shift capital away from stocks and towards bonds? Shifting assets between stocks and bonds based on recent performance or forecasts is a classic form of market timing. Your portfolio should contain stock and bond funds allocated in a way that is appropriate for your goals, time horizon and risk tolerance. Unless you experience significant changes to your financial situation, goals, or cash flow needs, there's no reason to change your stock/bond mix based on recent performance. Another Morningstar study analyzed tactical allocation funds which are sold on the promise that the fund manager can deftly change the fund's stock/bond mix to maximize returns. Sounds nice in theory, but how has it done in the real world? Morningstar analyzed the performance of 34 tactical allocation funds for the ten years ending April 30, 2023. The annualized average return of these funds was 2.3% compared to the 7.5% return of the 60% stock/40% bond Vanguard Balanced Index Fund (VBIAX). Even worse, only 12 of the original 34 funds were still in business on April 30, 2023. Morningstar took a snapshot of each fund's portfolio on April 30, 2013, and calculated the performance of the holdings over the ensuing ten years – the do-nothing option. Of the 34 funds, 30 yielded worse returns than if the manager had kept the original allocation. Furthermore, none of the do-nothing portfolios outperformed VBIAX.

No one can time the stock market. Occasionally, someone achieves 15 minutes of fame due to a lucky guess, but nobody can predict the highs and lows of the stock market consistently. Long-term performance is about time in the market, not timing the market. Making "tactical" strategic changes to the stock/bond allocation of your portfolio is an impulse, and almost always a counterproductive one – for professional as well as amateur investors.

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