On Course Financial Planning
Facing the Future with Optimism and Courage
August 2009 Vectors

geo@oncoursefp.com 425-861-9997

Information Analysis Paralysis

As of late, I have noticed a disturbing trend among my fellow citizens that, for lack of a better term, I will call information analysis paralysis. It is, I suspect, a consequence of our 24/7 news culture that saturates us with more news and information than anyone can digest. I can remember, not so long ago, when today's events were reported in tomorrow's newspaper. For those who couldn't wait until tomorrow, a 30 minute TV news program at dinner time or just before bed summarized the day's events. We were not unaware of what was happening and nothing of historical significance passed by unnoticed.

Now let's fast forward to the 21st century. Do we really need to see CNN Headline News at the check-in desk at a hotel or, heaven help us, at a gas pump? Does this information saturation make us any wiser? I don't think so. I suspect that, rather than making us wise, it confuses and frightens us by painting a picture of a bleak and uncertain future. But the future has always been uncertain and whether it looks bleak or not is opinion, not fact. I wonder how much of the 24-hour news cycle could be filled if opinions were prohibited. Perhaps we would be back to 30 minutes of TV news a day.

Let's imagine that every fact you hear on the news in the next two weeks is a wooden log. After two weeks you have a large pile of wood, which will eventually rot in the rain. You need someone who knows how to turn logs into a log cabin so that you can stay dry in the rain. Let's call him Mr. Perspective. Mr. Perspective knows that 99% of everything reported this week will never make it into the history books. He also knows that predictions are worthless. He realizes that most people think that they are much wiser than their ancestors, will ignore the lessons of history and therefore repeat the same silly mistakes. Mr. Perspective will tell you that Armageddon has, so far, been a no-show and the odds are pretty good that the world isn't going to end anytime soon. He's learned that fixating on what is possible rather than what is probable is intellectually paralyzing. His study of history has taught him that it's the runaway trains that nobody sees coming, not trains that can be seen from miles away, which pose the real danger. He will tell you that the impossible sometimes happens and the inevitable often doesn't. Hopefully he can help you differentiate between the historical and the inconsequential, enabling you to use the best logs and discard the rest.

Last fall and early this year, the 24/7 media bombarded us with an endless barrage of facts, opinions, scary headlines and projections that made Great Depression II seem imminent. As one might expect, when nothing but fear was in the air, Mr. Perspective was nowhere to be found. There was a panic among investors who abandoned their investment strategies and fled to cash – a move guaranteed to hinder the attainment of any financial goals. But it's hard, if not impossible; to make good decisions in a state of panic and knowing that account values would stop declining brought a temporary sense of relief to many.

Suddenly and for no apparent reason, while many of our friends and neighbors had their money sitting in cash, the stock market rebounded 45%. Great Depression II has apparently been avoided but now we are being bombarded by new fears. Worried about hyperinflation? If not, how about deflation? What about a nuclear Iran or a nuclear North Korea? What about the budget deficit? What if the Chinese stop buying our bonds? What about a health care plan costing trillions of dollars that we don't have? And did you hear that Social Security and Medicare are going bankrupt? Oh yeah, and then there's those flu bugs. And the Democrats are running the show in Washington, so sell everything and buy gold. Ad infinitum ad nauseam. All of this drivel gets shoveled out of the media's Bottomless Bag of Scary Stuff all day, every day. On and on it goes, log upon log and once again Mr. Perspective is nowhere to be found. No wonder that individual investors are in such a state of confusion. But now, instead of being panicked into inappropriate action, they are being paralyzed into inaction.

So let me try to play the part of Mr. Perspective. If the world is going to end next year or 5 years from now or even 10 years from now you really don't have much to worry about. Most people reading this newsletter

have enough assets to get them through the next 10 years. My advice would be to put everything in a checking account and party like there's no tomorrow -- because there is no tomorrow. There will be no need to be concerned with financial planning, tax planning, long term care insurance, investment portfolios, budgeting, estate planning or any of those icky topics. But if history is any guide, we'll muddle our way through this latest mess that we've gotten ourselves into. What then? Financial planning will be more important than ever before. Don't be paralyzed into inaction because the future seems uncertain and scary. The future is always uncertain and can always be made to sound scary. Ignore the talking heads and get your financial planning house in order. Focus more on what is probable and less on what is possible. That way if Armageddon once again goes missing in action, you won't be facing the future paralyzed and unprepared.

Survivorship Bias

I am a proponent of passive index investing. I would rather own every stock in a low cost index fund than pay extra fees for a manager to pick stocks in an attempt to outperform the market. In any time period, they will be some fund managers who outperform an appropriate benchmark index. But the percentage of those who do so declines as the time period lengthens. The evidence shows that those managers who do outperform the market are unidentifiable in advance and rarely are they the ones who outperformed in the past. I use what I call my 30 - 15 - 10 – 5 rule of thumb. In any one-year period, 30% of stock fund managers will outperform their benchmark index. After 5 years this number falls to 15%, after 10 years it falls to 10% and in any 25 year period only about 5% of actively managed mutual funds will outperform a comparable index fund.

Therefore I was surprised to read an article in the *Morningstar Advisor* which stated that, over the 10 year period ending May 30th, 2009, 56% (309 out of 548) of actively managed small company domestic mutual funds outperformed the Vanguard Small-Cap Index fund. Additionally, 59% (878 out of 1,478) of actively managed large company domestic mutual funds outperformed the Vanguard 500 Index fund. But the devil is in the details. If we go back to June of 1999 we would have, not 548 small company mutual funds to choose from but 919 such funds. Likewise, there were 2,757 large company mutual funds available to investors. What happened to the 1,650 missing funds? They died and went to the great trading desk in the sky. Mutual fund companies know that they can't sell mediocre performance, so they close poor performing funds. This leads to a "survivorship bias" in mutual fund performance reporting since only the performance of surviving funds appears in the database. Once corrected for survivorship bias, Morningstar found that only 34% of small-cap funds and 32% of large-cap funds outperformed their Vanguard peers. Still, this is a larger percentage than I would have expected but the end of this ten-year period coincides with one of the steepest market declines in history. This put the index funds at a serious disadvantage. Yet despite this disadvantage, only a third of actively managed funds were able to outperform the Vanguard funds. That might be the most surprising statistic of all.

But this still doesn't tell the complete story. Most funds are bought and sold based on recent past performance. By the time investors learn of funds that have done well (either from their broker or "hot fund" articles in the investment media) the party is oftentimes almost over. Morningstar went on to state that the returns experienced by actual investors (measured by the timing of cash flows into and out of funds) show that only 11% of small-cap fund investors and 13% of large-cap fund investors experienced returns better than the Vanguard index funds during this 10 year period. Morningstar concluded - "an investor's true odds of outperforming the benchmark are pretty much miniscule. Over reliance on shorthand measures based on past performance can lull investors into a state of overconfidence. That's especially true when investor cash flows -- namely investors' all too frequent tendency to buy high and sell low based on emotion -- are taken into consideration."

Most of us have the preponderance of our invested assets in 401(k), 403(b) and other defined contribution plans. These assets have a 30 to 40 year investment time horizon and roughly 90% of the money invested in these plans is in actively managed mutual funds - primarily because the preponderance of offerings are actively managed funds. There's little chance that a portfolio of actively managed mutual funds will outperform a similar portfolio of index funds over such a long timeframe. These funds have expense ratios that are a multiple of comparable index funds. Fund companies are not going to lower these fees anytime soon since last year's market decline has put a huge dent in their revenue. Also, actively managed funds tend to do more revenue-sharing -- a fancy name for the practice of rebating a portion of the fees paid by employees back to the plan's administrators. Recently, the House Education and Labor Committee approved a bill that would require retirement plan fees to be clearly disclosed. The mutual fund industry criticized the

bill saying that the disclosures would be confusing to participants, costly to prepare and put the government's nose where it doesn't belong. Perhaps, someday, we'll see more index funds available in defined contribution plans but I'm not holding my breath.

Missed It By That Much

It is inevitable during bear markets that large numbers of investors will flee to the "safety" of cash until things stabilize and investing in stocks seems less frightening. Unfortunately for them, some of the market's best days come when stocks unexpectedly rebound from a bear market low point. We have just experienced a classic example of this - the S&P 500 index has risen 45% since its low point on March 9th. Those of us who stayed invested during the unpleasantries of the prior six months were able to enjoy our hard earned reward with a sense of relief while those who fled to cash were burdened with the self-imposed torment of trying to decide when to reenter the market. Good luck to them.

History tells us that the stock market has most of its significant gains in a small number of days, often for no apparent reason. From March of 1989 through February of this year, a $10,000 investment in the S&P 500 index would have grown to $29,382 - an annualized rate of return of 5.5%. However, if you missed the best 10 days during this 20 year period (approximately 5,000 trading days) your annualized return would have been only 2.1%. If you missed the best 20 days you would have actually lost money. Of course, market timers argue that had you been able to miss the 10 or the 20 worst days during this period your performance would have been exceptional. There can be no arguing with that and if we let the argument end there, it ends in a tie. But the argument does not end there. I am not embarrassed to admit that I cannot time the market. I am a buy-and-hold investor, so I can be certain that I will be invested during the worst and best 10 or 20 days of any time period. I can live with this because throughout the history of the stock market the good days have outnumbered the bad days by a wide margin. If you subscribe to some market timing or stock picking philosophy, can you be sure that you will miss the worst days and be invested on the best days? Of course you can't. Nobody can. Beware of anyone trying to convince you otherwise. Nothing has turned more investors into speculators than the idiotic idea of market timing. Investment history may someday be rewritten by that guy hawking his market timing program on a TV infomercial, but I doubt it.

The second quarter of 2009 brought one of the most dramatic rebounds in the history of the modern stock market. Large company US stocks were up 15% and small company stocks were up 24%. Yet Morningstar has reported that during the second quarter, actively managed mutual funds were unable to outperform their benchmark index in 8 of the 9 equity classes into which they divide the US stock market. Somehow, they didn't take advantage of some of the best days that we are likely to experience in the next decade or so. But I'm sure that they'll turn things around any day now. If active management cannot get you out of the market before it goes down and get you back in before it goes up what good is it? To paraphrase Maxwell Smart, they "Missed it by that much." Sorry about that, Chief.

Disclaimer - The information in this article is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how the content of this newsletter should be applied to their investment portfolio. This newsletter is not a solicitation to sell investment advisory services where such an offer would not be legal. Investing in stocks and mutual funds involves risk and the potential loss of principal. Historical data is from sources believed to be reliable. Past performance is not a guarantee of future returns.