On Course Financial Planning
Facing the Future with Optimism and Courage
April 2024
Vectors
geo@oncoursefp.com
425-861-9997

In the News

Domestic stocks experienced a strong first quarter. International stocks also yielded positive returns but lagged U.S. stocks for the quarter. The large-cap S&P 500 Index ended the quarter at a record high, its twenty-second all-time high of 2024, up 10.6% including dividends - even though two of its biggest constituents, Apple (-11%) and Tesla (-30%), suffered big declines. There were 7 days when the index rose by 1% or more and 3 days when it fell by 1% or more. The small-cap S&P 600 Index was up 2.5% and the S&P 1500 Total Market Index rose 10.3%. The S&P 500 ended the **quarter** higher than 19 of the 20 **year-end** 2024 forecasts of big-name strategists and economists surveyed by Bloomberg last December. Revised forecasts in the works. Annual forecasts are incomprehensively foolish. Stock market performance over 12-month periods is unknowable and unpredictable, and the forecasters know it. Everyone knows what happened yesterday, no one knows what will happen tomorrow. QED.

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 0.10%. Rebalance the portfolio on your birthday and ignore the stock market for the rest of the year. In the first quarter, the Lazy Golfer rose 7.3%. It has yielded an annualized 7.9% for the past 5 years, and 7.0% for the past 10 years according to Morningstar. You could have done worse.

The December 2022 issue of *Kiplinger Personal Finance* magazine contained a list of their 15 favorite dividend paying stocks for 2023. Had you invested equally in those 15 recommended stocks, you would have trailed the return of the S&P 500 by 8% last year because 13 of the 15 recommended stocks underperformed the S&P 500 in 2023. The lesson is simple and should not be forgotten – you should never expect to get an edge in the market following the recommendations of "What to Buy Now" articles in the financial media.

FTX founder Sam Bankman-Fried was sentenced to 25 years in prison on March 28 for swindling billions of dollars from his crypto exchange's customers, which he used to enrich himself and advance his political influence. Lawyers for the 32-year-old former King of Crypto, who orchestrated one of the largest financial frauds in history, argued for a six-and-a-half-year sentence because they claimed that their client intended to use his wealth (stolen or not) to improve the world. Proof, once again, that the road to hell is often paved with good intentions. Despite his claims of altruism, the jury was convinced that he acted to maximize his own wealth; using customers' money to buy a $30 million penthouse in the Bahamas, donate to his favorite political causes, make risky investments, and expand his crypto empire. Ever the deceiver, Bankman-Fried claimed that the $10 billion that went missing from customer accounts was the result of honest mistakes. Judge Lewis Kaplan justified his 25-year sentence by saying, *"There is a risk that this man will be in a position to do something very bad in the future. And it's not a trivial risk."* Bankman-Fried told the judge that he is "*sorry about what happened*". Especially after he got caught. Unlike so many other investment frauds, most FTX customers are likely to get their money back from the sale of assets seized during the FTX bankruptcy.

Active Managers' Scorecard

There are, broadly speaking, two competing investment strategies. The older, more common strategy is called active management. Active fund managers attempt to identify stocks that will outperform the market and avoid those that they believe will underperform. The other strategy is known as passive management (called evidence-based investing by some proponents who think that passive sounds, well, too passive). Retail passive investing began in 1976, when John Bogle, then the CEO of Vanguard, launched the first retail index fund that tracked the S&P 500 Index. Index funds match the return of an asset class by owning most or all of the securities in the asset class. Passive index investors make no attempt to outperform the market.

S&P's Indexes Versus Active (SPIVA) Scorecard is a semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. The latest SPIVA Scorecard, covering the 20 years ending December 2023, notes that 2023 was the 14th consecutive year in which the majority of large-cap domestic stock funds underperformed the S&P 500 Index. Additionally, 75% of actively managed domestic stock funds underperformed the S&P 1500 Total Market Index last year.

`

Proponents of active management admit that it is difficult for large-cap fund managers to outperform the S&P 500 Index because the stock market efficiently prices large-cap stocks. But they assert that in less efficient markets, such as small-cap stocks and emerging market stocks, active managers have an edge. But this assertion is not supported by the evidence. According to the latest SPIVA Scorecard, over the past 10 years, 89% of actively managed emerging market stock funds underperformed their benchmark S&P index and 93% of actively managed domestic small-cap core funds underperformed the S&P 600 Small Cap Index.

Fund Asset Class	1 YR	3 YRS	5 YRS	10 YRS	20 YRS	%
Large-Cap Growth	P	F	F	F	F	6%
Large-Cap Value	F	F	F	F	F	9%
Mid-Cap Growth	P	F	P	F	F	10%
Mid-Cap Value	F	F	F	F	F	4%
Small-Cap Growth	F	F	F	F	F	2%
Small-Cap Value	P	P	F	F	F	6%
Domestic REITs	F	F	F	F	F	9%
Int'l Large Stocks	F	F	F	F	F	7%
Int'l Small Stocks	F	F	F	F	F	22%
Emerging Market Stocks	F	F	F	F	F	5%

Data as of December 31, 2023

This is the year-end 2023 SPIVA report card for active managers. The far-left column lists ten popular stock asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5, 10 and 20 years. If more than 50% of actively managed funds in an asset class outperformed their benchmark S&P index, they get a passing grade of P for that period. If the majority underperformed, they get a failing grade of F. The last column shows the percentage of funds in each asset class that survived and outperformed their benchmark index over the past 20 years.

Active managers have an incentive problem. They want to generate good long-term returns for their shareholders. But they are trapped by the need to generate good short-term performance in order to keep current investors and attract new ones. Thus, they often engage in behavior that is detrimental to fund investors' long-term interests – trend following, sector rotation, market timing and other wealth destroying activities.

The Scorecard also tracks the longevity of mutual funds. Of the 2,337 domestic stock funds available to investors on January 1, 2004, only 804 (34%) were still in business on January 1,2024. Typically, poor performing funds are merged into other funds or liquidated. If we assume that the surviving funds have the most talented managers, the removal of less talented competitors will make it even harder for active managers to outperform in the future.

The best method to grow your wealth isn't trying to beat the market. It's in creating a financial plan that incorporates your goals, time horizon and risk tolerance. Where does the idea of trying to outperform the market come from? It has been promoted primarily by fund managers who, in order to justify their fees, promote the hope of market beating returns. The SPIVA Scorecard reveals how difficult it is to beat the market, especially over longer time horizons - a fact that active managers hope will remain hidden from their shareholders. But to be nice, I thought I might list a few good things that active managers do for investors -

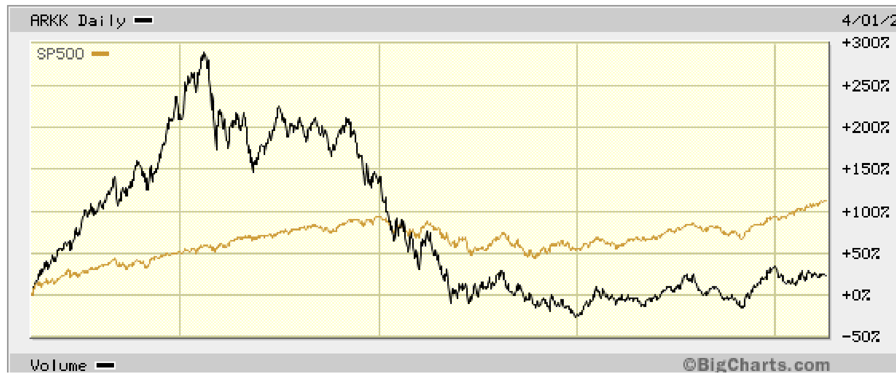
They create an efficient market. Active money managers employed by mutual funds, pensions, endowments and hedge funds are skilled professionals who conduct extensive fundamental research in their quest to find mispriced securities. They have access to a worldwide network of information from securities firms, data providers, and news sources. The technological revolution of the past few decades has leveled the playing field – technology has become the great manager equalizer – essentially increasing the number of informed, active investors. Each day they make millions of trades in the global financial markets that aggregate vast amounts of information, yielding consensus pricing that is difficult to outsmart. In investment speak we say that all their trades create a market that is "efficient" at pricing stocks. Not every stock is perfectly priced, but it's impossible to determine with any assurance which stocks are mispriced. To outperform, a fund manager must outsmart the collective pricing wisdom of all other investors, know how the future will be different from what other investors expect and how prices will react to unexpected news. Good luck to them. Index investors are "price takers" who accept current prices as the best estimate of fair value and receive the return of the capital markets at virtually no cost.

Their self-preservation instincts limit the damage they do. Active fund managers know that if they slightly underperform their benchmark index, it's unlikely that they'll lose many investors. But if their portfolio significantly underperforms their benchmark index, this will lead to an exodus of investors. Consequently, to preserve their livelihood and lifestyle, many become "closet indexers" – owning portfolios that differ little from their benchmark

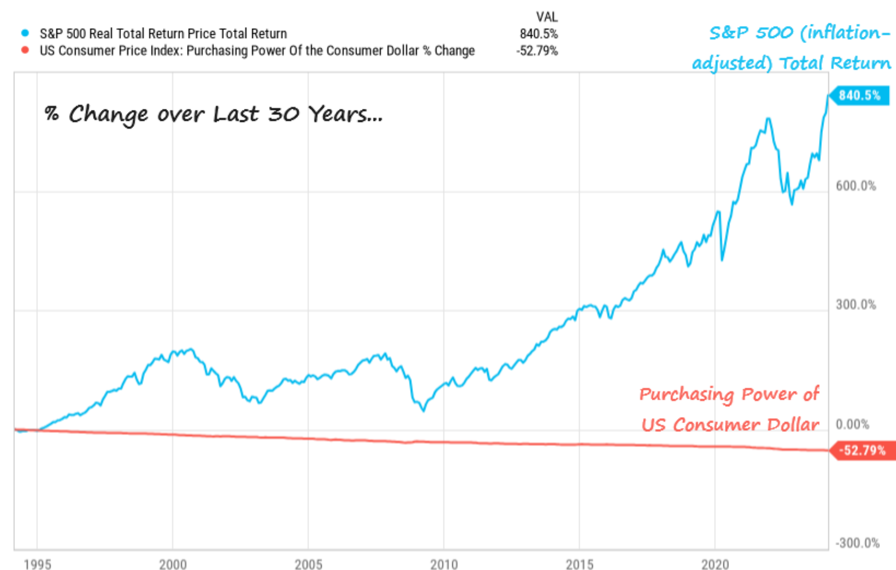
`

index. By doing so, they limit "manager risk" and the financial damage they might do to their shareholders - who they hope will never take a close look under the hood of their fund.

They provide ongoing examples of reversion to the mean. Let's face it, it's hard to make index investing sound exciting. People want an exciting story they can invest in. Every active manager has a story to tell about why his fund will produce exceptional results. A few will succeed for a short time; they will become media darlings and performance chasing investors will flock to them. Late arriving Investors will get a first-hand, school-of-hard-knocks education in reversion to the mean - Cathie Wood's ARKK fund being a recent notorious example. It came in third place in Morningstar's list of the 15 funds that destroyed the most shareholder wealth for the 10-year period ending in 2023 ($7.1 billion). In recent years, an increasing number of investors have realized that stock picking, market timing and performance chasing is a loser's game. They have adopted index investing because of what I'll call the "active manager gap" – the difference between what active managers promise in their stories and what they actually deliver.



Their activity is well documented. Like the benefit that cadavers provided early medical researchers, active managers provide academic researchers with an endless supply of new data which can be dissected to discover what, if any, benefit they provide. As the SPIVA Scorecard reveals, even the most talented active managers find it difficult to deliver added performance in excess of their additional costs, especially over longer time horizons. The reason long-term performance results revealed by the SPIA Scorecard are so poor, and bound to remain so, is due to the compounding effect of the short-term performance shortfalls as the years go by. By eliminating manager risk, minimizing taxes and keeping management fees and transaction costs low, index fund investors have outperformed most active investors over the long-haul, even in asset classes in which markets are less efficient at setting prices. So, a tip of the cap to active managers of all stripes. Because of their tireless activity, index investors receive their fair share of what the capital markets freely offer.



This chart, from Charlie Bilello's blog shows, better than words can explain, why you should not enter retirement with an all-fixed income portfolio.

For the 30 years, ending March 13, 2024, the purchasing power of the US dollar declined 53% due to inflation (red line). Over those same 30 years, the S&P 500 has gained 841% (7.8% per year) on a real (after adjusting for inflation) basis (blue line). You cannot expect high quality fixed income investments to yield more than inflation, especially on an after-tax basis (the 0.0% line). The purpose they serve in your portfolio is to limit portfolio volatility, not yield inflation beating returns.

Disclaimer - The information in this newsletter is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how its content 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 has been obtained from sources believed to be reliable. Past performance is not an indication of future returns. The calculations or other information in this newsletter regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are shown for illustrative purposes only. Unless otherwise noted, rates of return reflect historical annual compounded total returns including the reinvestment of dividends but do not include taxes, fees or operating expenses. If included, these additional costs would materially reduce the results. Index performance is provided as a benchmark and is not illustrative of any particular investment. It is not possible to invest directly in an index. All expressions of opinion are subject to change. OCFP accepts no responsibility for losses arising from the use of the information contained herein.