SERVO achieve *more*

FACTORS IN FOCUS

July 2016

Buy Lower, Sell Higher

by Eric D. Nelson, CFA

The strategy for successful investment is fairly straightforward: Start with a full account of your long-term goals. Create an investment plan that is aligned with these goals. The plan should be well diversified, consisting of a handful of "core" stock asset classes for growth. Use high-quality bonds for controlling volatility and increasing liquidity for cash flow or emergencies. Rebalance your portfolio periodically to assure random short-term asset class drift doesn't have an adverse long-term impact on your wealth. Why, then, is such a simple, time-tested approach exceedingly rare?

Responding To Randomness

Before we answer that question, let's consider the short- and long-term past returns of core stock and bond asset classes reported in Table 1.

Table 1: Periodic Asset Class Returns (through June 2016)

	1928-2013	2014-2016
1-Mo Treasury Bills	+3.5%	+0.1%
5-YR Treasury Notes	+5.3%	+3.9%
20-YR Corp. Bonds	+5.9%	+11.6%
US Large Cap Stocks	+9.5%	+6.6%
US Large Value Stocks	+11.4%	+1.6%
US Small Value Stocks	+13.7%	-0.3%

Source: DFA Returns Web

Bonds = Ibbotson T-bill, T-Note and L-T Corporate Indexes, US Large Cap Stocks = DFA US Large Cap Index, US Large Value Stocks = DFA US Large Value Index, US Small Value Stocks = DFA US Small Value Index

The long-term results, beginning in 1928, should be familiar to you. Bonds have had lower risk, without much additional return available beyond five-year maturities, even when considering lower-quality, longer-term (20-year) holdings. For long-term growth, there's no beating stocks, and in particular value and small cap companies. *Eventually*.

But short-term returns often deviate meaningfully from long-term expectations. Since 2014, short-term bonds (due to lower interest rates) and large cap stocks have had returns that were about 1% to 3% per year below their long-term averages. Large and small *value* stocks have barely produced any gain and trailed their historical returns by 9.5% and 13.6% *per year*. Equally as surprising is the +11.6% return on long-term corporate bonds, almost double their historical average—due to a one-time boost from falling interest rates (bond prices move opposite interest rates).

The intelligent investor, with guidance from their advisor, uses these opportunities to upgrade their portfolio—rebalancing from short-term bonds to underperforming value and small cap stocks (including international). If there are no bonds in the plan, then dividends or fresh portfolio inflows can be used to purchase more shares of depressed stock asset classes. Buy lower, sell higher. Sounds easy enough, so surely everyone must be doing this, right? Apparently not.

Stampeded By The Herd

I've summarized the top ten mutual funds ranked by cash inflows over the last year on the next page.

Figure 1: Mutual Funds With Biggest 1-Year Inflows

1. Pimco Income (**bonds**)
2. Doubleline Total Return (**bonds**)
3. Metropolitan West Total Return (**bonds**)
4. American Funds Balanced (stocks/**bonds**)
5. Vanguard Int'd Term Tax Exempt (**bonds**)
6. Vanguard Int'd Term Corporate (**bonds**)
7. AQR Managed Futures (alternatives)
8. Prudential Total Return (**bonds**)
9. Invesco Dividend (US large cap stocks)
10. Vanguard Dividend Growth (US large cap stocks)

source: Morningstar

If you are looking for value stock funds, or small cap funds, or international (esp. value and small cap) funds, you can stop right now. You won't find them. Six of the top ten funds attracting the most new assets this year are *bond* funds. Despite record-low yields and surging prices over the last few years, investors aren't trimming their positions; they are buying even more!

Other popular destinations include an "alternative" managed futures fund (strong recent performance), and two funds that buy large cap US stocks with above-average dividend payouts. This dividend focus shouldn't be surprising, Table 1 reveals US large cap stocks have been the best performers recently and investors fighting low yields in bonds have been flocking to them (again, buying high).

Fear and Greed

What we're seeing is a classic combination of investors' desire to avoid short-term losses combined with unbridled overconfidence.

It has been well established that investors are "risk averse." We don't handle losses very well. Even the small ones. Studies have shown we need to earn $2 in a gain to feel the same amount of pleasure as the pain we get from losing just $1.

Despite low long-term returns from bonds relative to stocks, their popularity endures because of their perceived safety. Investors are more than willing to sacrifice important long-term growth for short-term stability.

Dividend-paying stocks have a similar story. Their historical returns are far below traditional value stocks, and while tending to be less volatile than the overall market, they don't compare favorably to diversified stock and bond combinations. Yet risk aversion is still at work—the belief you can get stock-like returns without taking stock-like risk.

At the same time, investors are overconfident in their decisions. If we see something that's been "working," and if there is a compelling narrative why it will continue, we believe we've found the next great investment from which we are sure to profit. We don't weigh all the evidence, consider longer-term perspectives or how the strategy fits within our overall plan. We're just sure it'll be a money maker for us. With bonds, investors are overconfident in their ability to get out before interest rates or inflation rise or before the overall stock market resumes its upward trend. There's no basis for this overconfidence.

These fear and greed-based approaches are extremely common, as the fund-flow data indicates. And they are costly. Investors have a strong tendency to shift money away from underperforming investments, even those with a viable role in their long-term portfolio and which may be about to recover. That money usually makes its way to recent outperformers or investments with low short-term risk (and similarly low long-term returns), sometimes both. This results in excessive taxes, lower long-term returns and, worst of all, the constant anxiety and uncertainty that is associated with reshuffling your portfolio looking for the next winner.

Exciting or Effective?

This is not, and will never be, our process. We'll continue to stick with proven, core investment principles, including the discipline to rebalance our portfolios—*buying lower* and *selling higher*. While the short-term results may not always line up with our long-term expectations, and our approach lacks marketing sizzle or the thrill of the performance hunt, it remains the most reliable and effective way to achieve your most important goals. What's more exciting than that?

Edited by Kathy Walker