SERVŌ WEALTH MANAGEMENT
Simplify Complexity

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Factors In Focus

All That's Left Is Discipline

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Once you have become a Servō client, we've already taken the time to thoroughly understand your goals, recommended a course of action and invest your money in a way that gives you a high probability of financial success. Some might say that by the time everything is in place, the hard work is over.

If, by "work," you mean thinking through and articulating your long-term goals and transferring and consolidating assets and accounts to simplify your financial situation, you are probably right. If, instead, you are referring to managing the emotional strain and anguish that naturally arises from watching your assets gyrate randomly from month-to-month and year-to-year (happening in concert with the volatility in your own life, work, family, health, etc.) in an effort to achieve meaningful long-term financial progress, the "work" has only begun.

The Map Is Not The Territory

The original plan and asset allocation is just that—a plan. Really, it is a map showing us how we propose to get to where we eventually want to go. It incorporates all aspects of your personal situation that you have shared with us and includes and seeks to capitalize on everything we know about financial markets.

But, as Polish-American scholar Alfred Korzybski said, "the map is not the territory." As soon as the plan is in place and the monthly statements and quarterly performance reports start to arrive, we are struck with a strong dose of reality—short-term results almost never resemble the long-term expectations. The only reality we know and can observe is what has happened recently, and we are hard wired to extrapolate those results, both good and bad, into the indefinite future.

That is the hardest part about investing in general or achieving the investment results needed to accomplish your financial goals and aspirations in particular. Seeing your plan through to its long-term destination requires confidence, faith, and above all, discipline. It has always been, and will always be that way.

Expect Investment Adversity

Imagine you started investing in 1995, or you were newly retired. The most sensible plan would have been to diversify your assets broadly—across US and non-US stocks, including value and small cap companies to improve diversification and increase expected returns, as well as high quality, short-term bonds if portfolio cash flow or reduced volatility was a priority. For most of the next 20 years, the territory looked altogether different than what you would have expected.

Blue-Chip Mania

From 1995-1999, a relatively small handful of US stocks, most of whom had "dot com" in their names, took the global markets by storm. The S&P 500 Index, which was richly populated with these companies, produced remarkable results—over 28% per year. Small cap and value diversification? It cost you 8% to 12% per year in lower returns. Foreign stocks? The EAFE (Europe, Asia, Far East) index did only half of what the S&P 500 produced, international value stocks did even worse and international small cap value stocks actually lost money! What about short-term bonds? With annual returns of less than 10%, few thought they made much sense to own. Never before in financial history had we seen such a period of polarizing asset class performance.

End of the New Era

The landscape changed in 2000 with the turn of the century, but it was no easier to accept. Stocks of all sizes and geographical origins fell precipitously over the next 3 years. Those high-flying stocks in the S&P 500 lost 38% of their value and large foreign stocks (EAFE) faired even worse—losing almost 42%! Large and small value diversification helped some, with small cap value stocks globally ranging from a small loss to modest gains. But it was really only high-quality bonds that held up, returning almost +8% per year. At some point by late 2002, every single investor at least considered, and many acted on the urge to give up on stocks entirely.

Global Stock Glory

Just as investors were questioning their stock exposure in general, and foreign shares in particular, global markets saw an impressive recovery starting in 2003. For the next 5 years, the S&P 500 returned +12.7% per year, but was dwarfed by the +15.4% and +18.5% returns for US large and small value stocks. But no US stock asset class could match the performance turned in by international markets. The EAFE Index returned +21% per year, with international large and small value stocks compounding at an impressive +27% to almost +30% per year. The conventional advice to hold 30% to 40% of a stock portfolio in foreign shares was being seriously questioned.

TABLE 1: Periodic Annualized Asset Class and Portfolio Returns (1995-2014)

Asset Class/ Portfolio Mix	1995-1999	2000-2002	2003-2007	2008	2009-2014	1995-2014
S&P 500 Index	+28.3%	-14.7%	+12.7%	-36.8%	+17.2%	+9.7%
US Large Value	+20.1%	-0.9%	+15.4%	-40.8%	+19.1%	+11.3%
US Small Value	+16.7%	+6.7%	+18.5%	-36.8%	+19.4%	+12.9%
Int'l EAFE Index	+14.0%	-16.5%	+21.0%	-41.4%	+9.1%	+5.4%
Int'l Large Value	+9.2%	-8.2%	+26.9%	-46.3%	+9.4%	+6.7%
Int'l Small Value	-0.2%	-0.7%	+29.6%	-41.7%	+13.1%	+7.6%
Short-Term Bonds	+9.4%	+7.6%	+3.3%	+4.0%	+3.5%	+5.6%
All-Stock Mix	**+16.9%**	**-2.7%**	**+19.6%**	**-39.9%**	**+16.4%**	**+10.5%**
Balanced Mix	**+14.2%**	**+1.0%**	**+14.2%**	**-24.6%**	**+12.1%**	**+9.2%**

With the US representing only 50% of the world stock market, and with foreign shares producing significantly better returns, should 50%, 60% or more of a long-term portfolio go abroad?

(Almost) Nowhere To Hide

The bear market in 2008 began to answer this question, but unfortunately created a bunch of new ones. Stocks fell between 37% and 46%, and no major equity asset class was spared. The question quickly went from "should we hold more foreign stocks" to, "should we hold any stocks at all?" Short-term bonds, in a result reminiscent of the 2000-2002 bear market, were the only place to hide, returning a modest 4%. But in 2008, any gain was a moral victory with the most prominent fears being that things would only get worse.

The Reluctant Recovery

There was no reason to believe markets would recover in 2009, governments and central banks had badly botched their "rescue plans," economic growth had come to a screeching halt and unemployment was continuing to rise. But stock prices had already fallen in anticipation of the situation getting considerably worse. Unexpectedly, a ***rollback*** of financial accounting regulations helped to stabilize markets and the economy began to heal in spite of bureaucratic bumbling. Over the next 6 years, US stocks returned 17% to over 19% per year. Non-US stocks in Europe and Asia recovered some too, with 9% to 12% gains, but foreign politicians and central bankers seemed unwilling to learn from our mistakes, to the chagrin of their own economies. The question about foreign-stock diversification has come full circle, with investment luminaries such as Vanguard founder John Bogle questioning whether it makes any sense at all (It does, of course. See December's *Factors In Focus*, "Don't Lose Faith In Foreign Stocks").

The Hard Work Never Ends

After reading that short historical perspective, you might be surprised to see that diversified portfolios faired just fine over the years. The "All-Stock (Asset Class) Mix" returned +10.5% annually, despite only earning 10% once in two decades. The actual range of annual returns was 36% higher and 50% lower than the 20-year average. The "Balanced (Asset Class) Mix" returned +9.2% per year, but it too only returned 9% in one calendar year. The range of 22% higher to 34% lower annual returns compared to its 20-year average was less extreme than the all-equity version, but still volatile enough to unnerve even the most experienced investors.

The bad news about successful investing is the hard work is never done. There are always reasons for us to reconsider and make adjustments to our original plan that have nothing to do with changes in our personal circumstances. Recent history is rich with examples. The good news is, if you've invested in a way that matches the purpose for your wealth, and you have confidence in your plan, all that's left is discipline. It's not easy, but together, it's something we can master.

Source of data: DFA Returns 2.0

S&P 500 Index = DFA US Large Co. fund - DFUSX (DFLCX prior to 2010)
US Large Value = DFA US Large Value fund - DFLVX
US Small Value = DFA US Small Value fund - DFSVX
Int'l EAFE Index = DFA Large Cap Int'l fund - DFALX
Int'l Large Value = DFA Int'l Value fund - DFIVX
Int'l Small Value = DFA Int'l Small Value fund - DISVX
Short-Term Bonds = DFA Five-Year Global Bond fund - DFGBX

All-Stock Mix = 21% S&P 500, 21% US Large Value, 28% US Small Value, 18% Int'l Large Value, 12% Int'l Small Value, rebalanced annually.
Balanced Mix = 13.5% S&P 500, 13.5% US Large Value, 18% US Small Value, 12% Int'l Large Value, 8% Int'l Small Value, 35% Short-Term Bonds, rebalanced annually.

Asset class mixes are for illustration purposes only and do not include the advisory fees that Servo charges, 1% on the first $2M and 0.5% on amounts over $2M for new clients. Actual returns would be lower if advisory fees were deducted.

Past performance is not a guarantee of future results. Indexes and index portfolios are not available for investment, and do not include the costs or market impact that comes with managing actual investments. This information is provided solely for educational purposes and is not a promise of results or a solicitation of services.

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