Factors In Focus

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Maximizing Your Returns

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After saving for years, the returns on your investments should be important to you. If you're an investor, that's exactly what a recent study from Morningstar found. After "helping me reach my goals," "has the relevant skills and knowledge," and "communicates and explains financial concepts well," "can help me maximize my returns" was the fourth priority out of a list of 15. Surprisingly, financial advisors who were asked to rank the same set of 15 priorities they thought their clients had, *maximizing returns* came in next to last.

Why this disconnect between investors and advisors? Many investors still look at advisors through an old-school lens as money managers, stock (or fund) pickers, and market timers. It's hard for investors to put a value on the other important services many advisors provide including financial planning and behavioral counseling. But there's another reason—*most advisors don't know where investment returns come from* or *how to generate them*. Servo and our clients are different. Maximizing your long-term portfolio returns in pursuit of your most important lifetime goals is a conversation we have regularly and is also a frequent subject of *Factors In Focus*, including this month.

Avoid Trying To Outguess The Market

Stock and bond prices change continuously to reflect the most up-to-date information available to buyers and sellers. According to DFA, over $400B worth of stocks were traded on a daily basis in 2017, which represents a lot of information that quickly finds its way into prices. Our ability to outguess market prices (the collective wisdom of all investors) or predict their errors through selection and timing is highly unlikely, except by random chance. According to DFA, only 14% of professional stock fund managers and 13% of professional bond fund managers outperformed their index benchmark from 2003-2017. The few who did succeed over one period rarely repeated the feat—only 26% and 32% of top quartile stock and bond fund managers over rolling three-year periods managed to stay in the top 25% over the next three years. Counter-intuitively, better returns happen when you stop trying to beat the market.

Stocks For The Long Run

Decades of research into the behavior of capital markets reveals that different investments have different expected returns. For example, most investors realize that stocks have greater volatility than bonds and achieve greater returns. What fewer investors (and too few advisors) also understand is the longer you hold stocks, the more likely it is that you will earn higher returns.

From 1970-2018, the S&P 500 returned +10.2% per year, almost identical to its average from 1926. Over the same period, bonds (Five-Year Treasury Notes) returned +7.0% per year. The chart below looks at the relationship between the S&P 500 and bonds over rolling periods since 1970. The likelihood that you achieved the higher expected returns from stocks increased from 68% at one-year periods to 85% at 10-year periods.

Investing Return "Premium"	1-YR Periods	5-YR Periods	10-YR Periods
Stocks (S&P 500 Index) **over** Bonds	68% (+5.0%/yr)	69% (+3.7%/yr)	85% (+3.4%/yr)
DFA Equity Balanced Index **over** S&P 500 Index	60% (+3.2%yr)	74% (+3.2%/yr)	80% (+3.3%/yr)

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Holding more of your portfolio in stocks than a typical "age-in-bonds" formula would suggest exposes you to additional short-term volatility and losses; however the expected payoff is worth it.

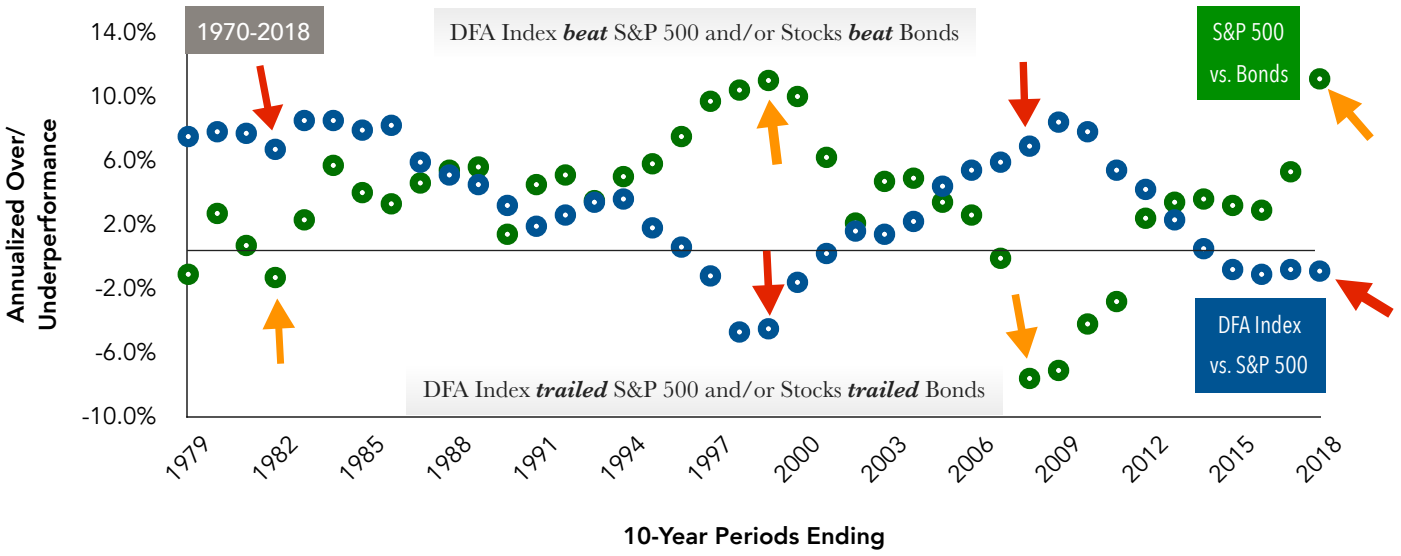
Don't Ignore the Dimensions

Most investors and advisors can't beat the S&P 500, so they simply buy a few market-based Vanguard or iShares ETFs and call it a day. But this ignores that different asset classes ***within*** the stock and bond markets also experience different long-term returns. Specifically, smaller stocks have higher expected returns than larger stocks, and lower-priced "value" stocks have higher expected returns than "growth" stocks. Investors looking to maximize returns don't just have the stock/bond mix to work with—diversifying globally across smaller and more value-oriented stock "dimensions" is also a powerful tool.

Over the same 1970-2018 period, the globally diversified, small/value tilted DFA Equity Balanced Strategy Index returned +13.1% per year, +2.9% annually more than the S&P 500. What's more, the DFA Index outperformed the S&P 500 almost as frequently as stocks beat bonds. Over one-year periods, the DFA Index beat the S&P 500 60% of the time. At the five-year mark, outperformance rose to 74% of the time, and over 10-year periods higher returns from the diversified index occurred 80% of the time. At each interval, the average outperformance was over 3% per year. If your stock to bond allocation is important, and it is, your allocation within stocks matters just as much.

Unfortunately, *the map*—which tells us that more exposure to stocks than bonds, and smaller and more value-oriented stocks in particular, are the mostly likely paths to maximizing your returns—*is not the territory*. We've seen 10-year periods where stocks have underperformed bonds ***and*** more diversified stock portfolios have trailed the S&P 500. *But rarely do they occur at the same time.*

The chart below lists the outcome of each return dimension over all calendar 10-year periods since 1970. They are almost mirror images. During the 2000s, stocks badly trailed bonds, but diversified stock portfolios far outpaced the S&P 500. The last 10 years have seen the opposite. Investors in diversified portfolios are understandably disappointed in lower returns than the S&P 500 over the last decade, but the total return on all stocks during this stretch has been well above average and more than sufficient to fund reasonable goals. At some point trends will reverse and diversified portfolios will shine. Whether or not that will be during a period of above average or below average S&P 500 returns compared to bonds is anyone's guess. One thing we do know—if you want to maximize your returns, switching to an S&P 500-only portfolio today, after its run of above average returns, is about the worst move you can make.



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