April 2021: *A Closer Look at our Core Investment Strategy*

In our last letter, we briefly commented on the variety of investment strategies that we may use to serve your objectives. We kicked that list off with our Core Strategy, commonly described by a long-winded compilation of terms: "a Buy and Hold portfolio of globally diversified lower-cost funds allocated among the stock, bond and cash markets". Whew!

This time out we dig a bit deeper into that portion of your investment funds allocated to the stock markets. **Here is what was said:**

BUY AND HOLD

This is the classic (60/40, 40/60 or similar) allocation among stocks, bonds, and cash with sufficient sources of income earmarked to last you through another broad market decline; or sufficient liquidity to take advantage of significant dips or downturns at bargain prices. We think It worked decently for our clients who endured the Great Recession and the market's recovery almost six years later.

But clients had to deal with faith-testing portfolio volatility along the way. Buy and hold with conviction in what is owned may still be an investor's best friend.

It is "not set it and forget it", however.

But buy and hold what? Well, in a world where half the market forecasts are no better or worse than the markets' average return, the advent of index investing—the notion that the stock portion of your portfolio could simply be comprised of the whole stock market delivered to you at low cost—makes some sense.

You won't earn glorious returns; neither will you risk dramatic underperformance. You will instead earn the average return of the market. Once damned or only given faint praise by Wall Street, indexing has become a respected strategy.

Today, indexing solutions are widely available and often found in employer 401k plans, etc. These are popularly associated with investment in the S&P index of 500 large US stocks via fund companies such as Vanguard, Fidelity and others. Investment in such funds represents a very large and growing share of US investor dollars.

So, what's wrong?

Traditional indexing and its popularity come with unintended consequences.

Stock prices can be driven by two, sometimes competing forces: fundamentals related to company strength but also by investor perception/emotion. In the recent environment, it appears to us that perception/emotion has had the upper hand. In this generation, government efforts to quell the 2008 crisis have accelerated dramatically in the battle against the financial impacts of Covid 19. The ensuing flow of easy credit and stimulus money has found its way to the stock market. Since the rebound from the March 2021 correction, stocks popular with the crowd saw huge dramatic gains even though there were more stumbling company stocks than big winners.

The decision of what companies to include in this index is determined each quarter by committee in a procedure known as index reconstitution. Rules for company inclusion seem strict enough but making the cut can be arbitrary. It can come down to a choice among competing committee members. Companies with strong balance sheets and growth can be replaced by companies that barely meet the requirements but offer a great story and an enthusiastic investor crowd that have boosted the company stock price. Conversely, like club membership, it might be harder to be deservedly kicked out than accepted in.

If a large portion of all investor capital sits in a fund blindly seeking to own all the stocks of the S&P 500 index at the moment of its re-jigging and at whatever price, a skewed result may be what one will receive**. In a twist, investor capital in traditional index funds may have joined the gamble of investing with the forecasting crowd.**

We think that a more durable approach to stock market investment, particularly for the longer term, is a Core Strategy that may benefit from the virtues of indexing (cost control, broad diversification with exposure to both highly priced and lower-priced fare) **while minimizing indexing's disadvantages.**

One such approach is offered by Dimensional Fund Advisors© (DFA). It is certainly not your grandfather's index strategy, the one found in so many 401k offerings. However, it's worth noting that the Nobel prize-winning work of its mentors and board members dates to the early days of traditional indexing.

It is among the first and perhaps best source of information in the respected and often emulated research into the factors that drive portfolio performance:

1) First among these, of course, is the percentage of the portfolio allocated to stocks vs. bonds and cash etc. *(It should be noted that the S&P 500 is not the whole story for the US stock market. The S&P 500 misses some large, plus medium and smaller companies that comprise more than 25% of the US market.*)*

2) A fund's portfolio tilt to include value and smaller companies can balance exposure to growth stock fare.

3) A culture of ongoing academic research can empirically refine its strategies to exploit additional drivers of performance such as profitability and momentum.

4) Patient trading strategies (*in contrast to the traditional index fund mandate to immediately buy and sell at whatever price whenever index member stocks change*) should improve outcomes.

5) Long-standing experience with tax management and securities lending can help boost returns.

** In another letter we will address the fact that the US stock market represents less than half of the world's stock market value of companies worldwide. That is a lot of potentially missed opportunity.*

Stock prices can indeed move away from realistic expectations. Most investors should want the opportunity to minimize their serious money's exposure to the perils of traditional indexing, especially given the huge volume of capital that traditional indexing now commands. One would not desire the immediate purchase of a volatile Tesla (TSLA) at an inopportune time, or a fad-driven GameStop (GME) at any price. Valuations matter.

Finally, if an investor is frustrated by the difficulty of knowing what companies one actually owns in a fund, the relative transparency and tax efficiencies provided by the adoption of the exchange traded fund (ETF) structure may be appreciated. When appropriate, it may also provide the opportunity for more timely trade actions by us right here at Willink.

We can use DFA's research as a launch point to discuss with you the strategy and best fit for your investment goals, its role as part of a core strategy, and complementary solutions.

Next Up:

The Role Financial Planning Plays along with Portfolio Design to Achieve Retirement Success

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