FACTORS IN FOCUS

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Less But Better

by Eric D. Nelson, CFA

Last month's article suggested that simplifying your financial life and focusing on a handful of primary financial decisions could ultimately lead you to a better overall outcome with greater happiness. This is a page from Servo's company philosophy — ***less but better***.

Some industry experts advise wealth management firms to take a different route, to branch off into more complex services such as business transition planning, tax and trust preparation, and trustee services. I believe in a simpler approach that focuses on core investment planning, management, and counseling efforts. These other services are sometimes needed, but each has highly experienced professionals who address them on a full-time basis with a high degree of expertise. Servo partners with these folks and regularly refer clients to them. This streamlined approach frees Servo to concentrate on the areas of greatest ongoing value to clients, explained below.

Leveraging The Long Term

We live in a short-term focused world, so it's not always intuitive to consider and prioritize our long-term objectives and what it will take to get there. Studies find that we don't "time travel" well, meaning that we have a hard time accurately predicting what our futures will look like and how we will feel at that time. When it comes to investing, however, we do have a pretty good idea of what the long-term future will look like, and if that is our focus, we can profit from these expectations.

Consider the historical difference between stock (S&P 500 Index) and short-term bond (Five-Year T-Note Index) returns. Net of inflation (2.9% a year), since 1926, $1 has grown to $533 in stocks (+7.1% per year) versus less than $8 in bonds (+2.2% per year). Significant differences in lifetime wealth can accrue to the investor who makes it a priority to invest and maintain a substantial percentage of their assets in stocks, despite their considerable short-term volatility. In spite of their paltry returns, short-term bonds have a place as well, primarily for liquidity when cash flow needs arise during tumultuous bear markets.

Too many investors over-allocate to low risk and low return assets because they mistake short-term (temporary) declines as their primary long-term risk. For most investors, however, the real danger is needing more future cash flow than you had initially intended because of unexpected inflation or surprise spending needs such as health care or other circumstances. Only stocks offer the opportunity to earn the long-term rates of return necessary to grow wealth to address this risk. Servo's clients embrace this view; across managed assets as of June, approximately 15% are in short-term bonds, with the remaining 85% in diversified stock portfolios.

Understanding Markets

For most investors and their advisors, the real returns on the S&P 500 and T-notes represent a starting point easily eclipsed through active management—security selection and market timing. This has a nice ring to it, as in many aspects of life finding someone smart and experienced can lead to a superior result. Not so in financial markets.

Dimensional Fund Advisors conducted a thorough study of actively managed US stock mutual funds over the period from 1984-2015. Their findings were surprising to most but predictable to long-term clients and readers: professional managers underperformed the stock market on average by 1.6% per year, far more than their higher fees. While the S&P 500 Index earned +10.9% over this stretch, the average pro achieved a return of just +9.3%.

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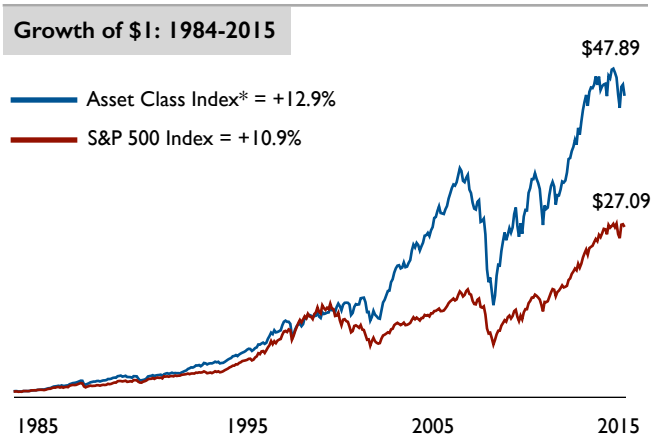
A small number of managers did outperform the market, but no more than we'd expect from chance. By discarding an entire school of investing—active management—Servo clients start several percentage points ahead of the average investor who is drawn to more speculative approaches.

While this study is an endorsement for broad-based indexing, a thorough examination of market behavior reveals that various sub-asset classes have different long-term returns. Typical portfolios we manage start with an allocation to US large cap stocks, but add higher-expected returning smaller and more value-oriented stocks in US and non-US markets as well. Instead of using traditional index funds from Vanguard or ETFs from iShares, we rely on the asset class mutual funds from DFA due to their superior design and consistency of implementation.



*21% S&P 500, 21% DFA US Large Value Index, 28% DFA US Small Value Index, 18% DFA Int'l Value Index (MSCI World ex-US Value before 1990), 12% DFA Int'l Small Value Index

As the graph shows, over the period referenced in the Dimensional study, this "asset class" approach would have generated 2% a year higher returns, resulting in significantly greater wealth, with only 0.7% higher volatility. By understanding how markets work and taking advantage of the returns available not just across but within markets (asset classes), Servo clients profit to a higher degree than the uninformed investor or the misinformed one who emphasizes expenses above all else.

Behaving Better

From goal planning to portfolio design and implementation, a simple yet highly structured approach can yield significant benefits; however, all is lost if we abandon a well-designed plan at the wrong time.

Unfortunately, buying high, selling low, chasing performance, and reacting in fear are very common.

The simplest of all investment decisions is to buy the S&P 500 through an index fund, but bad behavior typically stands in the way of achieving even this result. Morningstar reports that investors in the Vanguard S&P 500 Fund earned 1.2% per year less than the fund itself over the last 15 years, presumably from buying and selling at the wrong time. Data on the Fidelity S&P 500 Fund for the previous five years confirms this—investors in the fund trailed its returns by -1.3% per year. Looking at more volatile investments like the Vanguard Emerging Markets Index Fund, we find the dismal 10-year return of +1.0% was made far worse through poor investor timing. The average shareholder in the fund *lost* -4.6% per year!

Most investors won't admit to bad timing. We've evolved with a mental "blind spot" to our own poor decision making (yet we can easily recognize it in others), and many will argue that behavioral mistakes accrue mostly to the inexperienced and ill-informed. We don't need to look far to find evidence of the contrary. A Seattle Times article from 18 months ago was the first submission for a regular column from vaunted Boston University economist and retirement planning expert Laurence Kotlikoff. His advice? Sell stocks due to looming geopolitical risks! Professor Kotlifkoff later admitted his mistake, but for those who acted on his advice the damage is done — the S&P 500 has gained over 22% since the article was published.

Beyond rebalancing to target allocations, this helps to explain why Servo's primary approach to ongoing investment management is to manage client behavior and emotions. A few ill-timed decisions can sacrifice serious wealth and I believe most investors without regular guidance will eventually succumb to them.

Servo's approach is purposely simple: long-term, goals-based planning, foregoing the false promises of selection and timing while embracing asset class investing, and avoiding behavioral mistakes through ongoing conversations and communication such as *Factors In Focus*. For clients who achieve a better and more predictable financial outcome, one that comes with greater peace of mind and additional time to spend on other, more rewarding, non-financial aspects of life, you will find there is a lot of value in simplicity.

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your personal financial situation.