Factors In Focus

September 2019

A Better Way To Invest

by Eric Nelson, CFA

One of the prevailing trends in investing over the last decade has been the shift away from **actively-managed** mutual funds—strategies run by managers trying to pick the *right* stocks or the *right* time to be in/out of the market—and into **index** mutual funds and exchange traded funds (ETFs). Index funds, like the S&P 500, make no effort to outguess the market, instead they buy all of the stocks or bonds in a market and hold them until a merger or bankruptcy occurs and the security disappears.

The shift has been so pervasive, in fact, that there is now talk of a "bubble" in indexing. The assets flowing into index funds are said to be pushing up the prices of the stocks and bonds they automatically buy, and if investors start selling their index funds in a bear market or a panic, it may force stock and bond prices down as index funds automatically sell to meet redemptions. This could lead to cascading losses. The answer, active managers claim, is to hire them *instead* to sidestep such a catastrophe.

Which approach is better for your wealth? Or is there an alternative to consider? Keep reading to learn more.

Active Managers Can't Beat the Market

The claim that indexing's popularity could crash the market, and that active managers could save you from this calamity, is bogus. Active managers, as a group, buy all the same stocks and bonds that are in the indexes. The collective result of their decisions is that they own the market and get approximately the market's return, before their higher costs. When markets go up, they'll go up by less due to higher fees and more active trading (and taxes). When markets go down, managers will follow suit, but will lose more due to additional costs.

Some active managers will do better than their index some of the time, but it's mostly random and we haven't found a way to identify managers who will outperform in the future. Some active managers hold an allocation to cash that helps buffer bear market losses, but they don't know when to reinvest in stocks; therefore they are destined to underperform in the recovery.

Despite the emotional allure of active management—the comfort of having an all-knowing, all-seeing manager to steer you out of danger and towards the promised land—this approach typically disappoints in practice and is not the best way for you to achieve your long-term goals.

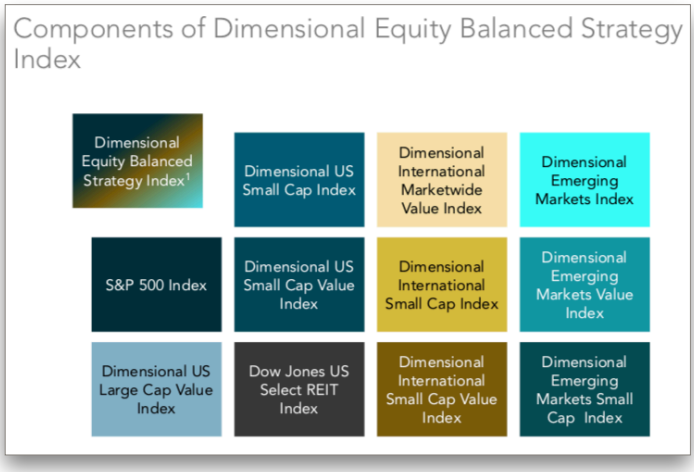
The Limits of Indexing

Indexing is superior to active management, mainly because it costs less; however it's not a panacea, certainly not the way the majority of investors practice it.

Many investors who buy index funds invest too conservatively, holding excessive amounts of low yielding bond index funds. Another issue with the index approach is that many stock investors buy only the S&P 500 or "Total" Stock Market Index funds. These popular strategies have very low costs and hold hundreds or thousands of companies, but they're all in one asset class—large cap growth. When that asset class underperforms, as all individual asset classes do occasionally, basic index funds are sunk.

Fortunately, there is an alternative to both active management and basic indexing. This approach doesn't try to outguess the market, where active management has failed, and it does maintain the benefit of indexing—low costs and diversification. But unlike indexing, it features more portfolio balance across multiple "asset classes" beyond US large companies. What are some additional components of a diversified portfolio outside the S&P 500? The graphic on the following page gives us an example.

Continued on Page 2



A Better Way To Index

The Dimensional Equity Balanced Strategy Index is a globally diversified stock allocation, spread across US, international, and emerging markets. It also targets a higher weighting in smaller and more value-oriented stocks relative to basic indexes. History shows that over time these asset classes have higher risk but also higher returns than the larger growth stocks that comprise the S&P 500. Smaller and more value-oriented stocks also tend to go up and down (as we have seen in recent years) at different times than the S&P 500, meaning that they provide additional portfolio diversification benefits.

For 49 years, from 1970-2018, the all-stock Dimensional Equity Balanced Strategy Index has outperformed the S&P 500 by about 3% per year, but without more *portfolio* risk (the standard deviation, or volatility of the two portfolios, are almost identical). This higher return shows up in the Growth of $1 since 1970—to almost $117 in the S&P 500 but over $422 in the "asset class" index!

Performance

January 1970 – December 2018

	S&P 500 Index	Dimensional Equity Balanced Strategy Index
Annualized Return	10.21%	13.13%
Growth of Wealth ($1)	$116.96	$422.74
Annualized Standard Deviation	15.07%	15.14%

Aiming For Better Outcomes

If you are *saving for retirement*, this asset class approach could work much better than basic S&P 500 or Total Market indexing. The potential for higher returns means you could retire sooner or have more income when you retire.

If you *need periodic income from your portfolio*, sticking with the diversified stock allocation but setting aside two to four years of spending in a short-term bond fund, to avoid selling stocks during temporary bear markets, has the potential to achieve greater lifetime retirement cash flow and a larger legacy to your beneficiaries.

Higher returns are desirable, but investors also benefit from *more consistent returns*, and that too is a hallmark of a diversified asset class index portfolio. During the "Lost Decade" from 2000-2009, while basic indexing (the S&P 500) had a cumulative loss of -9.1% for 10 years, the Dimensional Equity Balanced Strategy Index gained +7.3% per year (+102.4% cumulatively). Despite 2000-2009 experiencing two of the worst bear markets in a century, diversification paid off while a simple index strategy left you with less than you started.

A Better Way To Invest

The debate between old-school, active management and low-cost basic indexing continues to rage on in the financial media and amongst investors who don't know an even better approach exists.

The data conclusively shows that indexing beats active management. *But that doesn't mean indexing is optimal.* Investors can't expect to be successful by focusing solely on expense ratios while ignoring timeless investing principles such as diversification and asset allocation. History shows that a more balanced "asset class" investing approach has far outpaced basic indexing and made it easier for investors to potentially achieve the real-world goals they care most about: the ability to retire sooner, generate more ongoing income in retirement, and/or leave the largest legacy possible to beneficiaries.

Tuning out financial headlines, focusing on your long-term goals, investing in a well-diversified portfolio, including higher expected returning small cap and value asset classes, minimizing fees/taxes, and staying disciplined during difficult times—***that's a better way to invest***.

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