SERVŌ WEALTH MANAGEMENT

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You Don't Have To Outrun The Bear

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You've probably heard the joke about Steve and Mark, two campers who encounter a bear. Steve reacts by lacing up his sneakers, to which Mark asks, "What are you doing? You can't outrun a bear!" Steve's response is simply, "I don't have to outrun the bear—I just have to outrun **you**!"

Humorous, for sure, but what does this have to do with investing and achieving your financial goals? Plenty, it turns out. You don't have to accomplish the extraordinary to be successful: identifying only the right stocks to own or when to be in and out of the market. *You don't have to outrun the bear.* Knowing that most of your fellow investors tend *not* to make smart financial decisions, *don't* save enough and *don't* live within their means, all you need to do to achieve relative success is to perform a basic set of core financial behaviors well. What are these behaviors and how do you adopt them?

Have a realistic purpose

There is no simpler nor more powerful question than the first one we ask every prospective client we meet: "What are you trying to accomplish with your wealth?" The answer(s) should provide the direction for all current and future financial decisions. The money you save, the cash flow you need—the purpose of these activities should be to accomplish what matters most to you financially.

Your purpose and goals need to be realistic. If you have a lifestyle that requires a $5,000,000 investment portfolio but you only have $500,000, you won't be successful. If you are able to live within the confines of a $500,000 portfolio, you are in much better shape and relatively more "wealthy" than someone who has more material items but whose financial goals require much more wealth than they currently possess.

Invest broadly and capture market returns

There's a basic truth that most investors and professional advisors still struggle with: we don't know how to pick the right stocks or when to be in or out of the market. All the experience and knowledge we have; it moves us no closer to finding the proverbial needle in the haystack: the investment approach that consistently outperforms the markets or achieves market returns with far less risk.

But this doesn't keep most people from continually trying and failing. The important take away is that just by accomplishing market rates of return, you can achieve better actual results than most investors. If we look at all professionally-managed US stock mutual funds that existed in 1984, we find they returned +9.3% per year through 2015. The US stock market, on the other hand, returned +10.7% (source: DFA). Not a big difference you say? Well, consider that $100,000 invested in the average stock mutual fund would have grown to $1,709,749 by 2015, and $2,571,230 in the US (Russell 3000) market index—over 33% more ending wealth.

Long-term growth versus short-term stability

One of the biggest mistakes I see investors make, especially today, is confusing the risk of a *short-term* stock market decline with a much more serious problem: earning a low *long-term* return that results in a a slow but inevitable erosion of a portfolio's purchasing power.

While each client's situation is unique, we know that portfolios with a higher percentage in stocks have reliably outperformed more bond-heavy allocations. Consider a pre-retiree still dollar-cost-averaging into their portfolio. Adding some bonds might seem like a good idea to dampen price swings. But if we look at all 20-year periods from 1926 through 2015, we find that a 100% S&P 500 allocation outperformed a 65% S&P 500, 35% Bond (5-YR T-Notes) mix 90% of the time and the average of all 20-year periods was +1.6% per year more for the all-stock allocation.

For a retiree, it might feel more comfortable to take income from a portfolio that is mostly in bonds. But looking again at all 20-year periods since 1926, a 65% S&P 500, 35% Bond mix outperformed a 35% S&P 500, 65% Bond mix 99% of the time, by an average of +1.7% per year. Accepting a little more short-term volatility in your portfolio can mean a significantly better long-term result.

Avoid unnecessary fees and taxes

We've already discussed the prohibitive costs of traditional active management. You wind up paying 1% or more in fees when compared to an index or asset class-based approach without any corresponding advantage. But some indexes also have hidden expenses.

Take the Russell 2000 Value, a common small cap value index. It buys and sells new stocks (reconstitutes) just once a year and telegraphs to the market beforehand which will be bought and sold. Traders and hedge funds tend to buy and sell these stocks ahead of time, artificially bidding up and suppressing the values prior to Russell's trading day.

We can quantify this cost by comparing the long-term returns of the Russell 2000 Value Index to the DFA US Small Value fund (net of fees), which updates its portfolio on a daily basis and does so anonymously, without announcing to the market ahead of time which stocks it plans to buy and sell. Since April 1993, the DFA US Small Value Fund (DFSVX) has earned +11.7% a year, 1.6% annually more than the Russell 2000 Value Index. If we included the ETF fees necessary to buy the Russell index, this cost would rise to almost 2% a year!

Taxes are another area where investors sacrifice wealth. Buying and selling too often and holding tax inefficient investments (such as actively-managed funds, real estate or taxable bonds) in taxable accounts, causes investors to give up 0.5% to 1% per year more than they should to Uncle Sam. By employing tax-managed stock funds in taxable accounts, rebalancing with fund cash flows or new portfolio inflows/outflows and restricting tax-inefficient bonds to IRAs, you can significantly increase your after-tax returns.

Stick with your strategy

This comes up in almost every edition of *Factors In Focus*, because it's so important and also such a challenge. Researchers have found that investors typically lose 1% to 2% per year of their returns simply from buying and selling at the wrong time.

Even knowledgeable investors who look for broad diversification and low fees fall victim to this issue. For the 10 years ending in August, Morningstar reports that investors in the Vanguard Lifestrategy Growth Fund lost -0.9% per year of their returns to bad behavior and the same amount in the Lifestrategy Moderate Growth Fund. Your costs aren't nearly as low as you think when you're giving up almost 1% per year to poor timing.

Have a back-up plan

Reading through this list, hopefully you get the sense that none of these activities is particularly difficult. And that's the point, they aren't. Stringing them all together and adhering to them consistently isn't as easy as it might seem, but it's certainly doable.

But just in case I've oversimplified, or in the event that something unfortunate or untimely happens to you personally, you've also made the smart decision to have a back-up plan. As your advisor, we're well aware of each of these behaviors and have considerable experience adapting them to each of our clients' personal circumstances and updating them when those circumstances change and evolve.

Edited by Kathy Walker