FACTORS IN FOCUS

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The Interview You'll Never See On CNBC

by Eric D. Nelson, CFA

If you watch any of the cable financial news networks, you will see a barrage of commentary about daily market movements, headlines that appear to impact stock and bond prices and experts opining about what it all means and forecasting what will happen next. None of these are relevant to long-term investors who are trying to achieve their lifetime financial goals; however it is easy to find yourself tuning in after a period of market volatility to hear what people are saying.

If you watch too long or too often, you could become persuaded that what you are hearing isn't noise but instead valid information that you should be using to make financial decisions. This is a huge mistake. The reality is, there is only one interview these networks would ever need to run, and they could replay it over and over as it would always be applicable and relevant to serious investors. We know this will never happen because redundancy doesn't attract viewers and without people watching, the networks would lose advertisers and revenue and eventually find themselves off the air. But if such an interview ever were broadcast, it should sound something like this:

> "If you need luck to be successful, you're not investing, you're speculating."

Q: The stock market has been a lot more volatile lately. How should investors be reacting?

A: I don't think they should react. Volatility is a normal part of investing. Volatile assets, like stocks, have higher long-term returns. Less volatile assets, like bonds, have lower long-term returns. For a long-term investor, and this is the only kind of investor worthy of the name, stock market volatility is a signal that the higher returning asset class is behaving the way it should. Without the high volatility, you wouldn't have the high long-term return, and most investors need the returns from stocks to achieve their goals.

This means you need the volatility.

Q: Wouldn't it be better if investors could avoid risk by picking safer stocks or getting out of stocks before a period of increased volatility, and getting back in after things have cooled off?

A: Yes, that would be better. However, the more appropriate question is: can it be done reliably? Based on evidence, it appears very difficult. The professionals that manage mutual funds go to work every day trying—and they fail miserably.

If we look at all of the managers* who were in charge of US stock mutual funds in 2002 attempting to buy better stocks or be in the market at the right time, fifteen years later, over 50% of them did so poorly they went out of business! Only 17% succeeded in producing better returns, worse than we'd expect by pure chance. And the top performers never stayed at the top. Less than 25% of stock managers who outperformed over one period maintained that outperformance in subsequent periods (75% went on to underperform)—so the temporary outperformance was mostly luck.

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Q: What about now? Is this a good time to invest?

A: It's always a good time to invest if you own a portfolio that is designed to achieve your goals. That is not to say that you will never lose money when you invest, but that we cannot predict when the portfolio will decline.

Fortunately, it doesn't appear that short-term losses affect the long-term returns of well-diversified portfolios. Since 1973, there have been 12 different months (about one every four years) where a diversified stock index portfolio** declined in value by over 10%. If we look at the next ten years, starting with the month where stocks dropped, we find the average return for each of these 12 periods was +12.5% a year. That is only 1% a year less than the +13.5% annual return that a diversified stock portfolio earned over the entire 1973-2017 period.

By funding your plan, or staying fully invested, you might not get the result you want right away, but the odds are higher that you will get to where you need to be eventually.

> "It's always a good time to invest if you own a portfolio that is designed to achieve your goals."

Q: With what you are saying, there doesn't seem to be much need for investors to work with a professional advisor. If you can't tell us how to react to recent events, how to avoid losing money, or even whether it's a good time to invest, what good are you?

A: I agree that a financial advisor should admit that they won't be able to do any of these things, but I don't think that means we cannot help investors in other ways.

Instead of trying to predict the future, we can get to know our clients, their unique goals and what resources (contributions and future returns) will be required to achieve those goals.

We can educate our clients on how markets work—something very few people fully understand. We can help them appreciate the relationship between risk and return, the long-term return behavior of different asset classes and show them how we can apply these historical relationships to the design and management of an investment portfolio that should achieve their goals.

Most importantly, we can stay in touch with our clients, ensure they are comfortable with their investment plans and portfolios and that they stay disciplined and committed to the process.

These services are more valuable to investors because they can give them greater peace of mind and more time to spend on other, more rewarding aspects of life so they aren't focusing on short-term market returns and investing decisions. And these services, unlike predicting the future, that advisors can perform successfully.

Q: So what does worry you?

A: It isn't what the markets are going to do or not do. This is not something we can predict or control.

What concerns me is that too many investors misunderstand why they invest and what the risks are—I hear all the time that people cannot afford to lose money, so they commit too much to "safe" but low returning investments that won't achieve their long-term goals. Or they try to time or beat the market and wind up with a return far less than what is possible and what they need.

I worry that too many investors expect that financial advisors are in business to pick stocks or winning managers, time the market or forecast the future. Upon learning that we can't do that very well, they give up on the idea of getting professional advice because they never discovered there was a different and better way.

I worry that investors focus too much on irrelevant short-term market returns and headlines that financial networks spend all day/every day reporting. This takes a toll on them in the form of unnecessary stress and anxiety. Worst of all, it results in an inferior outcome and an investment experience far worse than what they deserve.

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* **Source:** Dimensional Fund Advisors 2017 Mutual Fund Landscape

** **Diversified Stock Index** = 21% S&P 500, 21% DFA US Large Value Index, 28% DFA US Small Value Index, 18% MSCI EAFE Value Index (MSCI EAFE Index prior to 1975), 12% DFA Int'l Small Cap Index. *Rebalanced annually.*

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