SERVO
WEALTH MANAGEMENT

A Smarter Approach For Serious Wealth

FACTORS IN FOCUS

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The Very Best of Something

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The FIFA World Cup, soccer's biggest tournament that is played just once every four years, concluded in July. This year's championship saw France beat Croatia 4-2 in a match that wasn't as close as the score would indicate. Four years ago, however, the championship game was very different—Germany needed a goal in extra time to defeat Argentina, just minutes before going to a penalty shootout.

A July article from Dougal Williams at Vista Capital Partners in the *Portland Business Journal* cited interesting statistics on penalty kicks. In 2007, researchers studied nearly 300 penalties taken in men's professional soccer matches around the world. They found that 85% of shots reached the back of the net, while only 15% were saved or missed. They reported that goalkeepers tended to dive left most often—49% of the time. They dove right 44% of the time and 6% of the time they simply stayed in the middle. This 6% figure might surprise you, as standing still seems to be akin to giving up on the shot, not trying to save it at all. But that's not the case.

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Don't Just Do Something, Stand There!

When researchers studied where the shots actually went, they found that a goalkeeper had a 14% chance of saving a shot if he dove left, 13% if he dove right, but 33% if he simply stayed in the middle. The goalkeeper had more than double the chance of saving the kick if he simply stood still!

Why then, wouldn't goalkeepers stay in the middle (stand still) more than 6% of the time? Probably because standing still looks like they are not trying, like they aren't doing anything. Diving right or diving left appears to be giving it their best effort, even if they land on the other side of the goal from where the shot ultimately goes. Economist John Maynard Keynes had it right when he said "worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

As a financial advisor, I don't worry about reputation, I'm concerned with results—your results. Specifically the strategy and advice that will allow you to achieve the results you need. That advice sometimes seems as withdrawn from reality as standing still during a penalty kick.

Consider our "Asset Class" investing approach. After deciding on an appropriate mix of stocks and bonds, and sufficient diversification (mainly through global small cap and value asset classes) within stocks, virtually all that is left to do is rebalance the portfolio periodically back to target until your goals change. Often, portfolio inflows or outflows can be used to rebalance the portfolio such that no trading beyond facilitating contributions and withdrawals are necessary. More than one observer of this approach has said, "So you (basically) do nothing?"

Should We Try To Be More Tactical?

As we learned from the soccer example, standing still isn't "doing nothing." An alternative is to shift money back and forth between asset classes when one appears poised to outperform and another to underperform. This sounds smart, seems proactive, worthwhile to pay for, and should work better. But it doesn't. Short-term returns are mostly random and we don't know how to predict which asset class will do better or worse in the near term.

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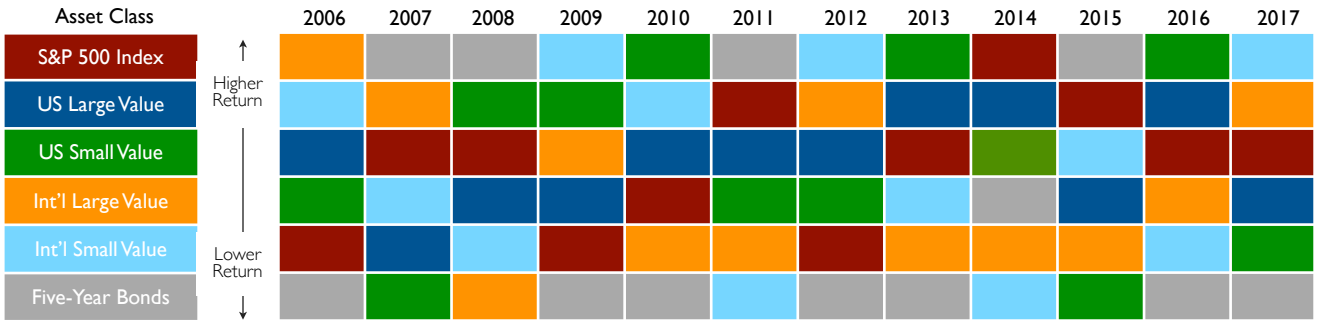

S&P 500 = Standard & Poor's, ***US Large Value, US Small Value, Int'l Large Value, Int'l Small Value*** = Dimensional Indexes, ***Five-Year Bonds*** = Ibbotson 5-YR T-Notes

Consider the table above ranking the annual returns on six core stock and bond asset classes from 2006-2017. Do you see a pattern? Do you believe that there's some system to identify future winners while underweighting or excluding the losers? Of course not—short-term returns are chaotic. The best way to deal with this reality is to rebalance, sell some of the recent winners to purchase more of recent losers, as it appears those assets on bottom will eventually find their way back to the top, and vice versa. Even if they don't, keeping the portfolio balanced assures that we get the full returns of the assets we've chosen, instead of potentially less if we hold too little when one goes on an unexpected run.

Reacting Risks Missing Big Returns

Not all ill-advised actions are intentional like tactically shifting a portfolio back and forth. Others are reactionary. I talk frequently about temporary losses and bear markets because these relatively rare periods are when clients are most at risk of abandoning their plans and experiencing sub-par returns.

One way to illustrate the risks of getting out of stocks is to show a chart of how missing just a few of the *best* days significantly reduces long-term returns. Often this evidence is met with skepticism—what if an investor instead misses only the very *worst* days? Won't they be even better off? Of course they will!

The reality is that investors don't tend to sell stocks or abandon their plans at random times. Tactical managers don't go to cash out of the blue. Typically it takes an extreme decline to prompt action; trying to guard against future losses seems sensible. But what has happened in the days and weeks after big stock market *declines*? Big stock market *gains*! If you've gotten out after a decline, trying to preserve principal, but missed out on a bounce back, you have lost wealth in another way—a potential gain you deserved but never earned.

During significant stock market declines, which are an unavoidable part of investing, not reacting in haste, but instead doing nothing, can be the most profitable move of all. At the very moment you're worried about losing more money you should be focused on how to make back what you've lost. Stocks have a history of recovering from even the worst declines, and more quickly than we expect.

Biggest One-Day S&P 500 Gains and Losses (1987-2015)

Date	S&P 500 Loss	Date	S&P 500 Gain
10-16-1987	-5.2%	10-20-1987	+5.3%
10-19-1987	-20.5%	10-21-1987	+9.1%
10-26-1987	-8.3%	10-29-1987	+4.9%
10-27-1997	-6.9%	10-28-1997	+5.1%
8-31-1998	-6.8%	9-8-1998	+5.1%
10-7-2008	-5.7%	10-13-2008	+11.6%
10-9-2008	-7.6%	10-20-2008	+4.8%
10-15-2008	-9.0%	10-28-2008	+10.8%
10-22-2008	-6.1%	11-13-2008	+6.9%
8-8-2011	-6.7%	8-9-2011	+4.7%
Source: Brandies Institute		8-11-2011	+4.6%

I've come across countless investors who were able to get out before losses intensified; I can't remember anyone who knew how to get back in before markets were much higher. I refuse to let Servo clients suffer a similar fate. Another quote, this time from Winnie the Pooh in the recent *Christopher Robbin* movie, summarizes my thoughts on investment decision making: "Doing nothing often leads to the very best of something."

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