Planning Perspectives 4Q 2021

Integrity in Investing
Key Investing Principles for Informed Planning

Paul Byron Hill, MBA, MFP, MSFS, ChFC®, RICP®, CFP®
Wealth Management Certified Professional™ ©2021

PROFESSIONAL FINANCIAL
Purposeful Wealth Management

"A man with money meets a man with experience. The man with the experience leaves with the money, while the man with money leaves with experience."
– **Old Wall Street axiom**

This is part of a series exploring integrity in professional wealth planning

Key takeaways:

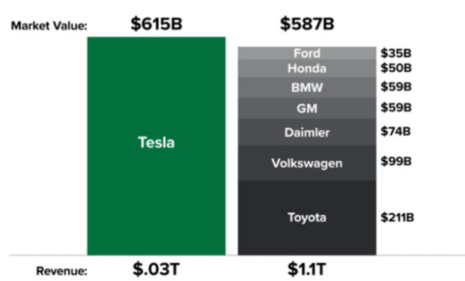
- All investors have knowledge that will be tempered by experience
- True investing depends on a belief that capitalism works and that market prices are fair
- It's essential to know what's important and what you can control in planning and investing
- A successful investing experience will result from following an informed set of principles

Many new investors with money will gain a lot of "experience" by eventually giving back most or all their gains. They will discover too late that their worst enemy due to overconfidence is not a predatory broker or those pretending to be advisors, but themselves. For a successful financial experience, knowledge tempered by experience will separate long-term success from disappointment. As many clients multiplied wealth over long relationships with us, we've discovered that often people we had helped with money problems in the early years, changed to relationships where we were helping money with people problems.

There is no editorial oversight, unlike in media days not so long ago, over what is published on the internet. Amid aspects of market mania, young investors with social media and endowed with government money have come to believe they have special "knowledge" as certain U.S. stocks rise to record highs. As prices surge, social media chat-rooms virally breed over-confidence. The groupthink truly believes "this time is different." As one who has endured a couple bear markets, the imagery of young people trading their way to riches has echoes in memory and admittedly, inspires a pang of envy.

For example, Tesla, the electric car company and media darling whose vehicle ownership conveys status and signals social virtue, at the end of 2020 was worth more than the next seven car manufacturers combined. Recently it passed $1 trillion in value and is worth more than the *next nine* manufacturers. Profits? Protect the planet! Likewise used-car sales platform Carvana was worth more than Volvo, Honda, or Hyundai. IPOs have surged. Margin debt hit new highs. Option contracts proliferate.

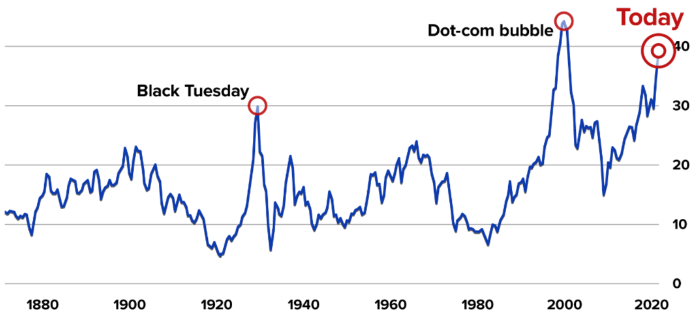
Exhibit 1: Tesla Market Value vs. Top 7 Automakers Market Value
As of December 2020



Source: Daily Mail, *December 2020*

Exhibit 2: U.S. Large Stock CAPE Ratios Today with 1929 and 1999 Tops

From 1876 to September 2021



Source: *https://www.multpl.com/shiller-pe. Nobel laureate Professor Robert Shiller's well-known CAPE (cyclically adjusted price earnings) ratio is the price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years of an index of the S&P 500 companies or a simulation prior to the inception of the index. Vanguard found an R squared predictive value of .43 or only mid-range.*

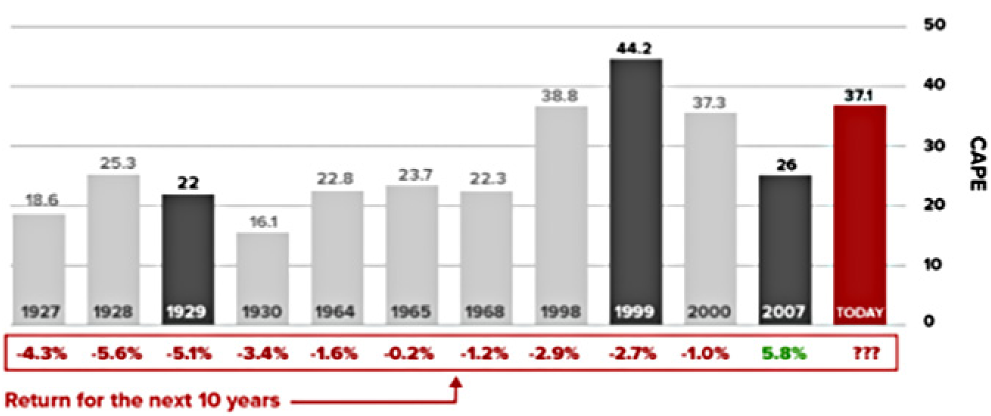
Fundamentals don't matter until they do. Yahoo was once worth $125 billion and AOL $200 billion during the dot-com bubble. Today both are worth 99% less. In 1989 Tokyo real estate sold for as much as $139,000 a square foot—350 times the value in Manhattan. At that price the Imperial Palace was worth more than all the real estate in California (but not anymore!). The frenzy that keeps reoccurring here in the U.S. may well continue for another year or two. But when the selling starts, fear of missing out turns into the fear of losing everything when prices drop as trading algorithms of hedge funds in unison liquidate huge positions faster than you can type "Robinhood." Market impact—what's that? Hot companies of the moment are converting hype into high prices. But True Believers will pay a price.

Prices investors pay relative to future cash flows they expect, drive the expected returns of stocks. The standard valuation model for valuing stocks (or any security) is an equation based on the expected cash flows of a firm or group of firms (such as those comprising the S&P 500 index) divided by a discount rate reflecting the prevailing cost of capital. With near-zero short-term interest rates set by the Federal Reserve as the equation's denominator, markets lack a true north for stock valuations. U.S. markets in effect are navigating turbulent seas with a spinning compass. Vanguard's recent Capital Markets Model projections—not known for sensationalism—imply a real return of large U.S. growth stocks of less than zero for the next ten years.[1]

With interest rates questionable, let's consider other market models that use stock prices for their valuations. Nobel laureate Robert Shiller's CAPE (cyclically adjusted price-earnings ratio) is a ratio of a U.S. large company stock price aggregate, by year, for a term of ten years looking back relative to historical earnings. Today at 38, U.S. large cap equities are relatively valued higher even than Black Tuesday, 1929.

Does that predict imminent market disaster? Not at all, according to Shiller. While a correction could be very fast—in 1987 and 1998 declines were -33.2 and -19.3 in one month, respectively and -56.8% over one and a half years ending in 2009—when declines like these will happen is completely unpredictable. But they *will happen.* Don't assume that drops *will not occur* while the economy appears to be doing well. Bull markets often end during moments of positivity and euphoria when greed without fear prevails. We don't see that broadly yet. In 1995 when valuations passed the peak level of 1966 (see **Exhibit 2**), five more years of gains were still ahead. Yet when the U.S. growth market finally bottomed in 2002, **all** those big gains since 1995 had vaporized.

Exhibit 3: Selected High U.S. CAPE Ratios and Subsequent 10-Year S&P 500 Returns



Source: *https://www.multpl.com/shiller-pe and Dimensional Returns calculations for S&P 500 index simulations. Past performance is no guarantee of future results. Indexes are not available for direct investment..*

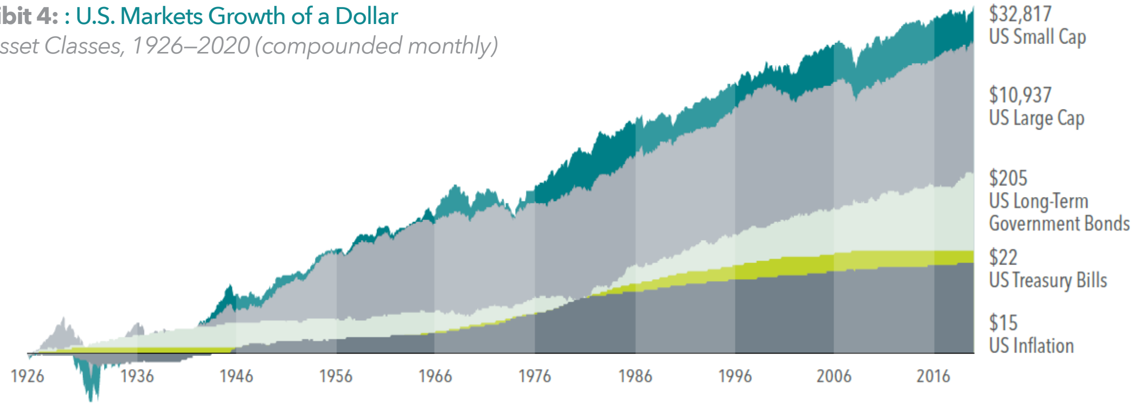
Investing Principles for Successful Planning

When planning reliable outcomes for retirement, these are principles you need to remember for a positive investing experience. If anyone denigrates these, consider someone more experienced:

1. Have an investing philosophy that markets are there to work for you

As an article of faith, believe that markets work, and that

Exhibit 4: : U.S. Markets Growth of a Dollar
By Asset Classes, 1926–2020 (compounded monthly)



Source: *Dimensional Fund Advisors. US Small Cap is the CRSP 6–10 Index. US Large Cap is the S&P 500 Index. US Long-Term Government Bonds is the IA SBBI US LT Govt TR USD. US Treasury Bills is the IA SBBI US 30 Day T-Bill TR USD. US Inflation is measured as changes in the US Consumer Price Index. CRSP data is provided by the Center for Research in Security Prices, University of Chicago. S&P Dow Jones Indices LLC, a division of S&P Global. US long-term government bonds and Treasury bills data provided by Ibbotson Associates via Morningstar Direct. US Consumer Price Index data is provided by the US Department of Labor Bureau of Labor Statistics. Past performance is no guarantee of future results. Indexes are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.*

long-term investors can be rewarded. Financial capital plays a vital role in wealth creation. Investors provide financial capital that makes modern corporations possible. Historically, most capital markets have rewarded those investors with long-term horizons. An investing philosophy grounded in financial science serves as a compass to guide you through turbulent times and helps keep you on course when you stick with a sensible strategy.

Markets function as highly effective information-processing machines in our capitalist economy. Markets are physical and virtual places where corporations aggressively compete for investors' capital. Each day, equity markets worldwide process billions of dollars in trades, buying and selling. That real-time information sets prices that may not be right but are fair. Daily price volatility is an investor distraction that is not important.

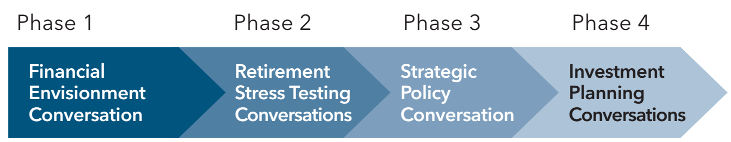
2. Have a strategic investment policy based on modern financial science

Establish a thoughtful investment management strategy specific for your situation, with clear performance

Exhibit 5: Markets Transform Information into Prices

Source: *Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded. Daily averages were computed by calculating the trading volume of each stock daily as the closing price multiplied by shares traded that day. All such trading volume is summed up and divided by 252 as an approximate number of annual trading days.*

Exhibit 6: Investment Planning in the Wealth Management Process



parameters for periodically evaluating outcomes. Guidelines should allow for tradeoffs employing a broadly diversified, tax-efficient portfolio structure emphasizing evidence-based dimensions of higher expected returns.

3. Align portfolio structure arrangements with your risk tolerance, preferences, and capacity

Your appetite for different investing risks will change over time due to economic, market and social conditions. Attitudes may change due to employment status (are jobs secure or are you retired?), family health, or changing circumstances (will a new home be purchased or is a child entering college?) Depending on systematic cash flow needs in retirement or for contingencies, liquidity reserves or credit lines must be arranged.

4. Employ dimensional drivers of factor returns for portfolio structures

Expected returns are related to market prices and expected future cash flows. This information can be used to build science-based portfolios with dimensionally higher expected returns based on multiple factors rather than only commercial index returns. Dimensional strategies employ highly correlated persistent differences in risk for planning higher expected returns. Do not use active security selection methods that can be expected to undermine asset class exposures and creates higher fees, trading costs and taxes from turnover, thereby reducing portfolio returns.

Exhibit 7: Dimensional Drivers of Expected Returns

EQUITIES

Company Size	Relative Price	Profitability
Market Capitalization	Price/Book Equity	Operating Profits/ Book Equity

FIXED INCOME

Term	Credit	Currency
Sensitivity to Interest Rates	Credit Quality of Issuer	Currency of Issuance

Relative price is measured by the price-to-book ratio; value stocks are those with lower price-to-book ratios. Profitability is measured as operating income before depreciation and amortization minus interest expense scaled by book.

5. Don't "time" structured allocations for outguessing the market

You cannot know for sure each year which market dimensions will outperform. By maintaining a multifactor approach rather than concentrate this year on a factor that outperformed last year, high returns of an unexpected dimension will offset worse returns in other dimensions. Humans are not naturally wired for disciplined investing.

The 2020 global downturn offers a classic example of market unpredictability. Who forecasted a bear market that took just 16 trading days for the S&P 500 to close 20% down from a peak[2] only to be followed by the best 50-day rally in history?[3]

However, take advantage of momentum to rebalance your portfolio during periods of severe market decline.

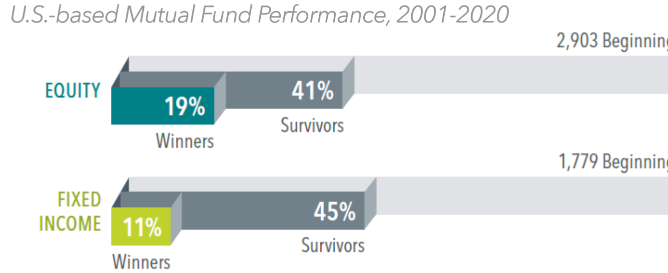
6. Don't outguess structured portfolio allocations with past performance bets

Research shows that prices do such a good job incorporating information, that a dimensionally structured portfolio is likely your best way to allocate a portfolio. No sensible story or compelling empirical research suggests that anyone can consistently outguess the market and get better outcomes just using recent past returns for selection of stocks or funds.

The market's pricing power works against anyone actively trying to outperform through direct or indirect stock picking efforts. Less than 20% of equity mutual funds both survive and outperform their index after only 20 years. That poor outcome by professionals provides little confidence for those methods to plan your lifetime lifestyle.

Exhibit 9: The Issue of Utilizing Active Fund Management for Asset Class Allocations

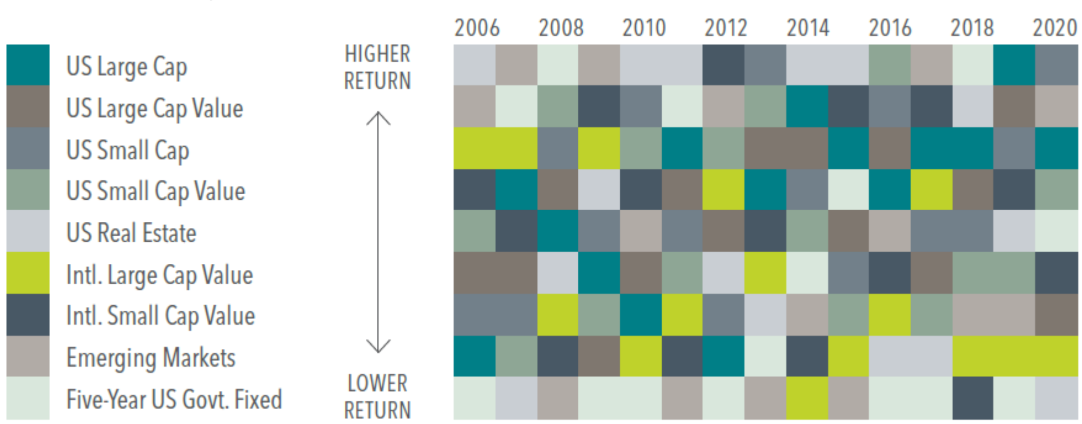
U.S.-based Mutual Fund Performance, 2001-2020



Source: *Dimensional Fund Advisors and data provided by Morningstar. The sample includes funds at the beginning of the 20-year period ending December 31, 2020. Each fund is evaluated relative to its primary prospectus benchmark. Survivors are funds that had returns for every month in the sample period. Winners are funds that survived and outperformed their benchmark over the period. Where the full series of primary prospectus benchmark returns is unavailable, non-Dimensional funds are instead evaluated relative to their Morningstar category index. See Dimensional's Mutual Fund Landscape 2021 for more details. Past performance is no guarantee of future results. Index performance does not reflect the expenses associated with the management of an actual portfolio.*

Exhibit 8: Illustrating the Randomness of Return from Past Performance

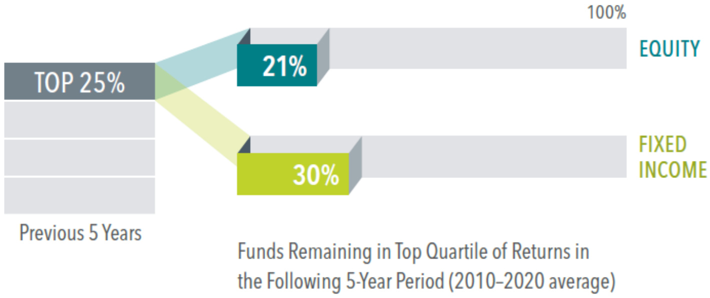
Annual Returns by Market Index, 2006-2020



Source: *Dimensional Fund Advisors. US Large Cap is the S&P 500 Index. US Large Cap Value is the Russell 1000 Value Index. US Small Cap is the Russell 2000 Index. US Small Cap Value is the Russell 2000 Value Index. US Real Estate is the Dow Jones US Select REIT Index. International Large Cap Value is the MSCI World ex USA Value Index (gross dividends). International Small Cap Value is the MSCI World ex USA Small Cap Value Index (gross dividends). Emerging Markets is the MSCI Emerging Markets Index (gross dividends). Five-Year US Government Fixed is the Bloomberg Barclays US TIPS Index 1–5 Years. Past performance is no guarantee of future results. Indexes are not available for direct investment. Chart is for illustrative purposes only.*

Exhibit 10: The Challenge of Selecting Active Fund Management from Past Performance

Percentage of Top-Ranked Funds That Stayed In Top 25%



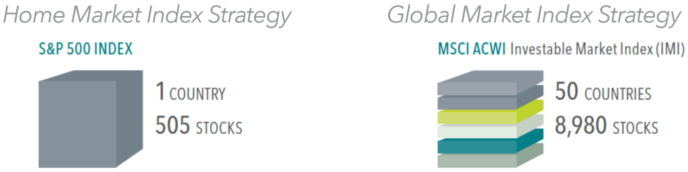
***Source:** Dimensional Fund Advisors and data provided by Morningstar. This study evaluated fund performance over rolling periods from 2001 through 2020. Each year, funds are sorted within their category based on their previous five-year total return. Those ranked in the top quartile of returns are evaluated over the following five-year period. The chart shows the average percentage of top-ranked equity and fixed income funds that kept their top ranking in the subsequent period. See Dimensional's Mutual Fund Landscape 2021 for more details. Past performance is no guarantee of future results. Index performance does not reflect the expenses associated with the management of an actual portfolio.*

When people follow natural instincts, they tend to apply faulty reasoning to investing decisions. Many believe they can select mutual funds based on published records of superior past return results. Yet, evidence shows that past performance or "star" rankings offer little insight into future returns. For example, most funds in the top quartile of previous five-year returns did not maintain that top quartile ranking in the five years that followed.

7. Manage diversification by structuring your allocations globally

Investment opportunities exist all around the world. By broadening your investment universe, a well-structured portfolio can capture dimensions of returns worldwide for more reliable planning outcomes. Smart diversification cushions the ride during bumpy times for a smoother experience, reducing risk without reducing expected returns. Moreover, diversification reduces vulnerability to those many risks that do not compensate you.

Exhibit 11: U.S. Only Compared to Broad Global Diversification



Number of holdings and countries for the S&P 500 Index and MSCI ACWI (All Country World Index) Investable Market Index (IMI) as of December 31, 2020. S&P Dow Jones Indices LLC, a division of S&P Global. MSCI data © MSCI 2021. International investing involves special risks, such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Past performance is no guarantee of future results. Indexes are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

8. Understand how your structured portfolio strategy is implemented

You need robust risk management controls for structured portfolio strategies, but a close review of implementation usually is delayed until turbulent market times. Aspects to review are rebalancing triggers, tax management, asset location, liquidity for contingencies, and sequence of return risk for systematic withdrawals. Financial vehicles for additional review include ETFs, mutual funds, REITs, alternatives, and options. Avoid hedge funds.

The fixed income portion of your allocation is a ballast, providing critical downside portfolio protection. Dimensional's approach to managing fixed income is transparent. Higher returns are pursued while staying tightly within portfolio guideline guardrails. Dimensional's market-informed credit assessment provides a more complete picture of an issuer's credit quality in real time than credit ratings indicate, so in stressful times portfolios behave in a way that is commensurate with the intended credit risk exposure. Many investors chasing higher fixed income yields have discovered during turbulent times that what they believed were "safe" fixed income products, were not.

9. Employ a flexible process for robust daily trading and especially during volatile times

Investment and trading process must be designed to function robustly and account for high volatility in stressful conditions, rapid changes in available liquidity, and sharp market movements. Continuous focus is essential for daily and short-term robust risk management, to deliver outperformance across many different asset classes, to provide daily liquidity to portfolios, use momentum to advantage and to add further value to end investors by flexible selections from multiple buy/sell candidates having similar characteristics to keep trading costs low, unlike index funds constrained by their specific, fixed security sets.

10. Discipline your emotions to stick with your strategy and have confidence in your planning

Many struggle to separate their emotions from their investment holdings. Watching your portfolio more often than quarterly or annually likely causes unnecessary stress and worry. An investment policy does not work if it is not followed throughout a full market cycle of 5 to 10 years.

Market downturns are unpleasant for everyone. When faced with heightened short-term volatility, some lose sight of how staying invested with benefit them long-term. Adopting a long-term perspective can help change how you view market

Exhibit 12: Dimensional Management Process Focuses on Higher Expected Returns

volatility. If some promoter's scheme to get rich quick seems too good to be true, mostly likely it is.

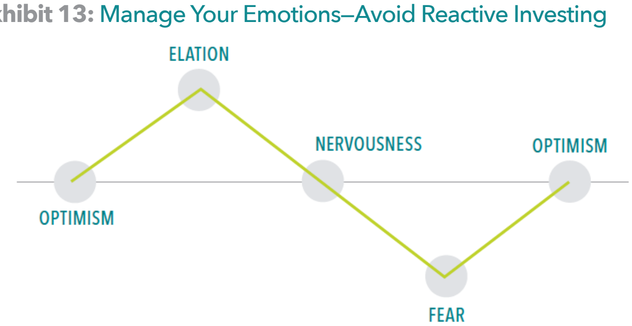
Look beyond media headlines and your Google mailbox and consider the source. Read the newspaper to be an informed citizen, not for advice on how to navigate the financial waters. Many messages are intended to stir anxiety about the future to increase readership, while others are tempting you to buy into the latest investment fad.

11. Focus attention primarily on what is important AND what you can control

At the core of informed wealth management, as in effective time management, is an ongoing focus on right priorities. It sounds easy, but our attention keeps being drawn away from what truly matters. One well-known tool offering a useful framework to prioritize tasks and stay focused is the so-called Eisenhower Box. President Dwight D. Eisenhower, who was also the supreme commander of all Allied forces during World War II, is attributed to have said, "What is important is seldom urgent and what is urgent is seldom important."

Sound financial planning and wealth management require emphasizing important controllable priorities while resisting distractions that divert limited attention, time, and resources away from what is essential for realizing your lifestyle and legacy goals with a high degree of confidence. Our wealth matrix decision box, (see **Exhibit 14**) along with suggested priorities and non-priorities we included to get you started on your own box, can help you keep better focus on your planning responsibilities and what should be the focus of your annual evaluations of your progress through good markets and bad.

Exhibit 13: Manage Your Emotions–Avoid Reactive Investing



QUADRANT 1: IMPORTANT AND CAN CONTROL

Effective wealth management focuses on the first quadrant—those things that are most important for a successful outcome and within your personal control. These include diversification, asset structure, tax efficiency, spending and savings, and retirement target date. These are areas and opportunities to progressively grow your wealth and also should be areas for Professional Financial to concentrate its efforts. Although your decisions control which policies you want, our guidance and expertise help inform them, and provides analysis and monitoring for making better decisions as personal, social and economic situations and conditions change, such as when you get close to you retirement target date.

QUADRANT 2: IMPORTANT AND CAN'T CONTROL

These matters are important but out of your control. They still need to be monitored, since they inform the decisions that must be made in Quadrant 1 from time to time. Changes in inflation, interest rates, tax rates, and realized returns are a few examples of what will significantly impact your key planning decisions, requiring periodic course corrections and require our ongoing advice for how to modify planning for your financial goals, objectives, and resources.

Exhibit 14: Wealth Matrix Decision Box

	Can Control	Can't Control
Important	1 1. Diversification 2. Asset Structure 3. Tax efficiency & location 4. Saving & spending 5. Retirement target date	2 1. Inflation 2. Long-term returns 3. Interest rates 4. Tax rates 5. National debt & spending
Not Important	3 1. Benchmark tracking 2. Comparing index returns 3. Dividend & yield emphasis 4. Market timing 5. Complexity	4 1. The news media 2. Short-term returns 3. Economic forecasts 4. Latest financial fads 5. Your brother-in-law's returns

For illustrative purposes only.

QUADRANT 3: NOT IMPORTANT AND CAN CONTROL

This quadrant is full of distractions that capture your attention and waste your time and energy and likely cost you money. These things are all within your control—but they aren't important for a successful financial outcome and could easily be detrimental. They can keep you busy, but little to show for all your time and effort. For example, you may search for securities offering higher dividend income, but an informed strategy can provide income with less risk. Maybe you compare your investments against some index, but which one is right? You can't spend time tracking errors and could be tempted to quit a dimensional approach too soon. Finally, don't make your investments too complicated: follow Albert Einstein's advice and make things as simple as possible—but not simpler.

QUADRANT 4: NOT IMPORTANT AND CAN'T CONTROL

Things in the "noise" quadrant captures investor's and causes the most emotional distress, leading to disarray of common behavioral mistakes. The news media, economists' predictions, short-term market or sector returns, the bitcoin craze and the allegedly big winners of that obnoxious brother-in-law are all distractions both not important and uncontrollable. Forecasts into the future for predicting market or stock movements can be irresistible for many. This breeds "return envy," and ruinous temptations.

The Wealth Matrix Decision Box can guide you in focusing on the major planning priorities, and not wasting time with the minors. Think "inside the box" with a matter when it comes to your attention before even thinking about deciding. If it belongs in boxes 3 and 4, trash it. Accumulate box 2 items to discuss at our progress meetings. You will discover that only a few things really matter for successful planning, but those few things matter a whole lot. With all the time saved, you can get them done. And play more golf.

At the core of the Wealth Matrix Decision Box is your strategic investment policy based on market principles, informed by financial science, and tailored to your specific needs, goals, risk tolerance and capacity. Your investment policy should incorporate all the items in Quadrant 1—all the ones that really matter. As CFP wealth professionals, we can help keep your attention on those actions that add the most value to investing outcomes, such as retirement planning and tax management, as well as provide valuable investment management services and annual/quarterly reporting. Equally important, we help you ignore the uncontrollables and noisy distractions of Quadrant 4 so your planning stays on course and have peace of mind.

Experiencing a Planning Outcome with Confidence

All investors start with some money as well as some knowledge. What markets give us, especially dreaded bear markets as we had recently, is experience. If we made money during last year, then it shows we likely learned something from a previous bear market. Every great investor has a set of rules or principles they follow. The purpose of rules is to live with market risk. No one likes risk; it may change form, but it never goes away. While financial economists have a different definition, it seems to me that "risk" has a different definition as it applies for ordinary investors. The famous Howard Marks once wrote:

> If I ask you what's the risk in investing, you would answer "the risk of losing money." But there actually are two risks in investing: One is to lose money, and the other is to miss an opportunity. You can eliminate either one, but you can't eliminate both at the same time. So the question is how you're going to position yourself versus these two risks: straight down the middle, or more aggressive or more defensive.

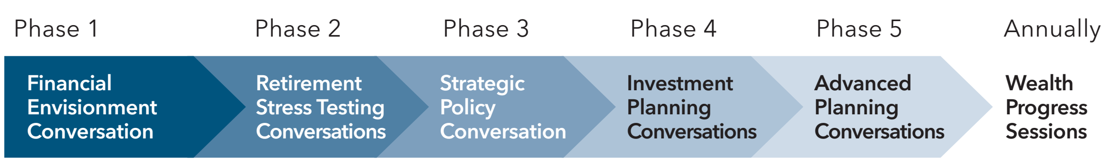
Most of our clients are typically positioned, in varying degrees, somewhere along the middle, and that is best.

Professional Financial has provided those clients who were committed to our wealth management process both an experience and money. We've aligned our investing strategies with Dimensional Fund Advisors since the late 1990s. Dimensional managed only about $4 billion in those days. We were among the first to work with them. Our "fee-only" firm was very small. Colleagues told me it was a mistake. But as a young CFP professional and an MBA graduate of the Simon Business School, I had a belief and dream that let me see a better future could be possible for all.

Dimensional Fund Advisors then as now, applies insights from financial science to the practical world of investing. Their investment approach is grounded in economic theory and backed by decades of empirical research, working closely with leading financial economists, some of whom are now Nobel laureates. Today Dimensional has over $660 billion under management in a ruthless and unforgiving competitive marketplace. Fools don't last long. It ranks among the top ten of mutual fund and ETF providers. The naysayers I knew back then are all gone; I am still here with a firm larger than I ever imagined, working with a group of wonderful clients that are enjoying both their experience and their money. But it's more than that.

The experience Professional Financial offers you and every other client is peace of mind and confidence about the future with a truly informed and transparent process backed by decades of research that empowers our investing decisions. For over thirty years, our financial planning and wealth management has made a positive difference in so many lives, allowing families to live better not just years from now to realize their dreams and goals, but today.

Exhibit 15: The Professional Fiduciary Wealth Management Process



Endnotes

1 Vanguard Investment Strategies Group, *Market Perspectives: October 2021*

2. Beth Kindig, "Algorithms sped up selling, leading to the fastest bear market in stock market history," *Market Watch* (March 26, 2020).

3. Pippa Stevens, "This is the greatest 50-day rally in the history of the S7P 500," CNBC (June 4, 2020).