Planning Perspectives 4Q 2022

Integrity in Investing
Planning Confidently in Unprecedented Times

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PROFESSIONAL FINANCIAL
Purposeful Wealth Management

"Life prepares you for investing and investing prepares you for life."
– **David Booth,** CEO Emeritus and Co-Founder, Dimensional Fund Advisors

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

Key takeaways:

- Big declines in both stock and bond markets at the same time seem unprecedented
- Conventional U.S.-only stock and bond allocations don't seem to work like in the past
- Active management involving timing and tactical shifts don't have reliable investing outcomes
- Global allocation strategies with dimensional tilts can offer you reliable planning outcomes

The only inflation that isn't out there today is inflated stock prices. The performance figures for large and small cap stocks, mutual funds and exchange-traded funds have been down 25% or more year-to-date. Non-U.S. stocks have dropped more. Some who dithered engaging our firm were shocked to discover their "smart" Vanguard U.S. growth funds were down 40% year-to-date and quickly mailed in agreements. Stocks recently restarted upward.

Who predicted back in January that short-term interest rates would rise 3.5% and 10-year would rise 2.3%? As inflation surged, the U.S. aggregate bond index dropped 14.6% through the end of September. "Stocks Decline As Bond Turmoil Spreads," reported *The Wall Street Journal* on September 30th.[1] The byline was, "S&P hits new 2022 low and Treasury yields climb on fresh slowdown concerns." By then, prices already reflected all collective knowledge about inflation.

Who brags today about their formerly fantastic FAANG stocks? Some say they are "cheap," but they can always get cheaper. Companies like Peloton, Carvana and Robinhood are down 80% to 95% from their peaks. Buy the dip, right? Be careful—the persistent mistake is to look backward, not forward. Focus on fundamentals, on prevailing sentiment, and on expected returns. Always remember, there's not much good news near a market bottom. We didn't forget that the firm's cost of capital is the investors return: around September 30th lows, we bought equities for rebalancing.

Conventional "Normal" Allocations Are Dead?

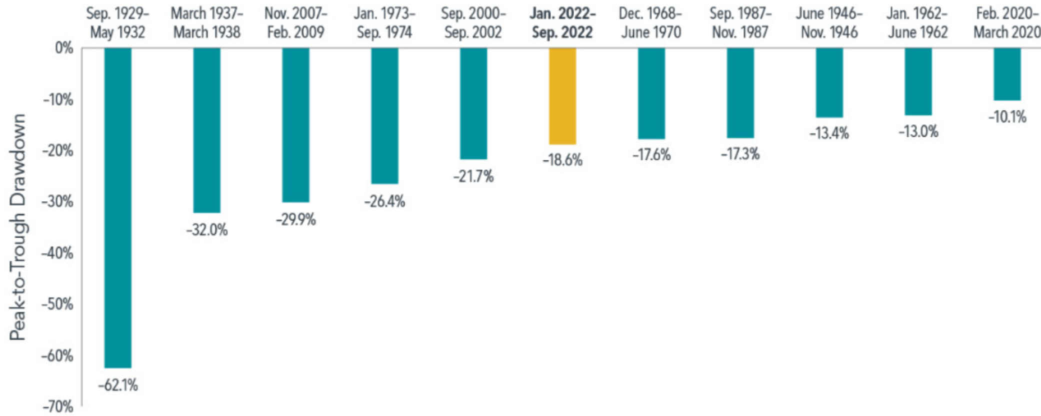
The investing wisdom of veteran investors has been tested this year. On top of a scary bearish stock market, steep losses from bonds holdings[2] particularly surprised conventional expectations. The combined debacle has caused more than a few chastened industry pundits to proclaim that a balanced textbook 60/40 stock/bond portfolio is "dead."

Despite many bond indices having their worst year-to-date in a century, we see a one-year experience for a 60/40 index-level portfolio has still outperformed the worst five historical drawdowns of the past 100 years. A -19% loss of wealth over a year in **Exhibit 1** is not comfortable, but it's only two-thirds of the drawdown investors suffered in a year during the 2008–2009 financial crisis. It is also similar to the one-year lowest return our 60/40 FinaMetrica risk allocation that clients confirm for their Investment Policy Statement.

A Dimensional investment management approach allows you to outperform the market without outguessing it. While

Exhibit 1: Peak-to-Trough Drawdowns for U.S. Equity/Fixed Portfolio Strategies

Historical 60% S&P 500 Index/40% Five-Year US Treasury: January 1926-September 2022



Source: Morningstar Direct as of September 30, 2022. In USD. The 60/40 portfolio consists of the S&P 500 Index (60%) and five-year US Treasury notes (40%). Rebalanced monthly. Peak-to-trough drawdowns include all periods where the 60/40 portfolio declined by 10% or more from the prior peak. Peaks are defined as months where the 60/40 portfolio's cumulative return exceeds all prior monthly observations. Troughs are defined as the months where the 60/40 portfolio's cumulative return losses from the prior peak are the largest. Five-year US Treasury notes data from Morningstar. S&P data from S&P Dow Jones Indices LLC. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. **Past performance is not a guarantee of future results.**

"Day Traders Go Back to Their Day Jobs as Stock Market Swoons," reports the *Wall Street Journal*,[3] informed clients should be pleased to realize that quarterly reports show your portfolios to be mostly intact, so that getting a job in retirement is optional. Your discipline to stay put not only avoided a possible nightmare but leaves you positioned to participate in any future upward movement. Ironically, market losses of others become gains for informed investors like you.

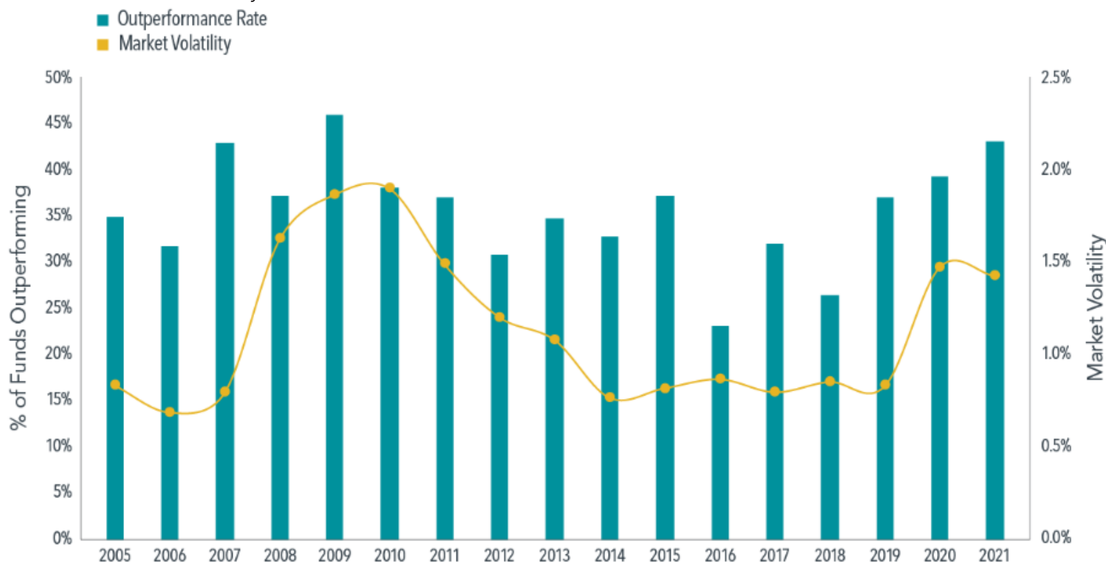
Inflated Claims of Active Managers

The financial news media have sent many mixed messages during this year's mercurial markets to decipher. A recurring message of active fund managers is a perennial insistence that their funds perform better during turbulent times. Those managers actively make tactical shifts through their stock or derivative holdings and allocations as market conditions response to new information to "better position themselves" as they compete against funds or investors doing different versions of the same thing.

Active fund managers use a well-worn argument to justify their higher fees and trading expenses: they make a virtue

Exhibit 2: Stock Market Volatility vs. Active US Equity Fund Outperformance

Rolling Three Year Periods: January 2005–December 2021



Market volatility computed each month using standard deviation of Fama/French Total US Market Research Index daily returns. Monthly volatility observations are then averaged over rolling three-year periods formed at the end of each year. Outperformance rates are computed over the same rolling three-year periods and are calculated as the percentage of active US-domiciled equity funds that survive the period and outperform their respective Morningstar category index net of all fees and expenses. Sample of active managers consists of funds categorized as active US equity by Morningstar. Fund returns are average returns computed each month, with individual fund observations weighted in proportion to their assets under management (AUM). Index benchmarks are those assigned by Morningstar based on a fund's Morningstar category. **Past performance is no guarantee of future results.**

Exhibit 3: World Market Capitalization by Percentages

As of December 31, 2021

Source: Dimensional Fund Advisors. In USD. Market cap data is free float-adjusted and meets minimum liquidity and listing requirements. Dimensional makes case-by-case determinations about the suitability of investing in each emerging market, making considerations that include local market accessibility, government stability, and property rights before making investments. China A shares that are available for foreign investors through the Hong Kong Stock Connect program are included in China. 30% foreign ownership limit and 25% inclusion factor are applied to China A-shares. Many nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. Data by Bloomberg.

of their costly rapid trading activity, asserting that their performance improves during market volatility due to "nimbleness". They get out of "bad" stocks and into "good" or at least "better" stocks, bonds or cash at the "right time." Their funds are supposed to be like financial insurance policies. However, returns analysis of active US-domiciled equity funds finds no meaningful relation between market volatility and fund outperformance. All the activities of these funds likely *increase* investor stress during market uncertainty as investor worries increase due to *decreased* returns, and thereby resulting in frequent fund switching.[4]

The orange line in **Exhibit 2** traces market volatility over the last sixteen years. Volatility last year was at its highest since the 2008 financial crisis, and still higher this year. The outperformance rate by rolling three-year by active US equity funds (blue bars) compared to the orange rolling three-year market volatility line show little correspondence with levels of market volatility.

The fund outperformance rate relative to the year-by-year changes of market volatility is highly inconsistent. For example, the exhibit shows relatively level daily volatility rolling averages from 2014 to 2019. However, the percent of outperforming active funds in those years ranged widely from 23% to 37%. Most importantly is that at **no point** over that 16-year period did average outperformance rate exceed 50%. *Performance of active managers to the market overall never exceeded positive results gained just by chance.*

Dimensional's annual signature study on the fund industry, The Fund Landscape, shows that only 26% of equity funds had **both** outperformed their benchmark **and** survived over a 10-year period. Outperformance reduced to 23% for 15-year time periods, and just 18% for 20-year time periods.[5] The odds of identifying and sticking with a actively managed fund that would outperform a simple index fund are vastly less than those of a simple coin flip. The study further shows that underperformance figures become worse as fund expense ratios and higher turnover increases.

If financial markets are informationally "efficient," this is what we would expect. If markets did not do a good job incorporating information into security prices, opportunities would regularly arise for "smart" active managers who could skillfully identify and exploit mispriced securities—thereby "beating the market," in industry jargon. Such managers would attract vast amounts of money. But studies beginning in the 1960s[6] show that does not happen. Consequently, rather than incurring high costs to do the impossible, better outcomes can be achieved more reliably by using information already contained in security prices from around the globe by working closely with firms like Dimensional Fund Advisors.

Exhibit 4: World Investment-Grade Bond Market by Percentages

As of December 31, 2021

Source: Dimensional Fund Advisors. In USD. Data is from Bloomberg Global Aggregate Bond Index. Index excludes non-investment-grade securities, bonds with less than one year to maturity, tax-exempt municipal securities, linked bonds, and floating-rate issues. Treasury sector includes both nominal and inflation-linked native currency debt issued by central governments, which are backed by full faith and credit of a central government. Government-related sector groups are issuers with government affiliations, including agencies, sovereigns, supranationals, and local authorities. Corporate sector categorizes issuers based on primary lines of business, revenue streams, and operations used to service debt, including industrials, financial institutions, and utilities. Securitized sector is designed to capture fixed income instruments whose payments are backed or directly derived from pool of assets protected or ring-fenced from credit of particular issuer (either by bankruptcy remote special purpose vehicle or bond covenant). Underlying collateral for securitized bonds can include residential mortgages, commercial mortgages, public sector loans, auto loans, or credit card payments. Many nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. Data by Bloomberg.

Global stock and bond markets offer a world of opportunity. By pursuing your investing by diversifying globally, your opportunity set increases and, contrary to popular perception, portfolio risk reduces. Given bad actors in Russia or China doing bad things, you may wonder why 40 percent or so of your portfolio may be invested in companies based in and doing business far beyond familiar U.S. borders.

The tendency of Americans is to prefer investing in "America First." Such familiarity or "home bias," as it is called, is common in most countries.[7] However acting on such a bias not only limits your opportunity set, but also limits your benefits from diversification. Allocating among many countries, depending on when you start, can lead to more reliable and better long-term outcomes for lifetime planning.

Following the Global Financial Crisis back in 2008-2009, American stocks have dramatically out-performed non-U.S. stocks for over a decade, growing from about 50% to 60% of global market in world capitalization.[8] When the Great Tech Bust ended less than a decade before that crisis, however the U.S. global proportion of capitalization was only 40%. Stocks of roughly 18,500 companies operating outside America represent nearly 40% of the world's $88 trillion equity market. All markets function in an equilibrium, so not participating worldwide will miss out as the pendulum swings.

Global Market Ups and Downs

Investing in thousands of established and emerging companies worldwide better positions you to capture returns from a global investment strategy. Countries outperforming from year-to-year varies widely, just in the same way it is problematic to guess which stocks, sectors, or premiums will outperform each year. Yet the randomness within diversification reduces portfolio risk and volatility.

By globally diversifying with a sufficiently informed allocation approach, you can better capture greater equity returns from thousands of companies around the globe and reasonably hope to offset weak performance in one market with stronger returns elsewhere. For the period between 2002-2021, the average return of the best-performing developed market country was approximately 32%, while the average return of the worst-performing country was approximately -15%.[9]

While strong returns won't happen every year, investing globally reduces concentration and currency risks, mitigating financial disappointment. By diversifying, you are *unlikely* to have either the best or the worst outcome, but it also means

you are *likely* to achieve a more consistent outcome and avoid catastrophic losses that can accompany investing in a single country. (Before World War I, Russia was one of the largest stocks markets in the world; afterward it was gone.)

Returns in 2022 exemplify this phenomenon:[10] The US stock market tumbled 21.3% (through June), but non-US developed markets like the UK (–8.8%) and Hong Kong (–2.9%) performed relatively better. And, in emerging markets, Chile soared 8.9% and Turkey gained 0.5%. Similarly, in fixed income markets, neither yields or total returns move together and vary widely across the globe. As a result, bonds from different countries and currencies offer a range of yields and expected returns, which could be positive for U.S. investors even with negative bonds yields in the issuing country using a variable maturity yield strategy.

The Paradox of Market Size

A country's size, population, or gross domestic product says little about that country's investment opportunities. **Exhibits 3** and **4** are arranged as world maps sized by equity and bond market capitalizations. Japan, for instance, is relatively small in landmass but accounts for 6% of the world's equity market value—representing more than 2,500 companies, including familiar names like Toyota and Sony—as well as 13% of the investment-grade bond market. Even a tiny country like Switzerland is home to publicly traded giants like Nestlé and two of the world's biggest pharmaceutical firms. Therefore, their sizes in the two exhibits are much larger than those countries appear in an atlas.

Exhibit 5: Comparing U.S. & Global Asset Class Index Returns by Decades *January 2000 – December 2019*

Asset Classes	Total Cumulative Returns (%) Jan 2000 - Dec 2009	Jan 2000 - Dec 2019
S&P 500 Growth Index	-25.3	196.6
S&P 500 Index	-9.1	224.2
MSCI World ex USA Index (net div.)	17.5	97.2
MSCI World ex USA Value Index (net div.)	39.5	98.5
MSCI World ex USA Small Index (net div.)	94.3	321.2
MSCI Emerging Markets Index (net div.)	154.3	264.9
MSCI Emerging Markets Value Index (net div.)	212.7	284.1
ICE BofA US 6-Month Treasury Bill Index	39.6	50.3

Source: Dimensional Fund Advisors, MSCI, ICE/Bank of America, and S&P 500 data, S&P Dow Jones Indices LLC. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. **Past performance is no guarantee of future results.**

An informed investment management strategy includes not only stocks, but also bonds of companies in the U.S. and other developed countries like Germany, Japan, Switzerland, the United Kingdom, Australia, Canada, Denmark, Sweden, and others with good credit histories. The investment-grade bonds in the Bloomberg Global Aggregate Bond Index are valued at more than $68 trillion—and most of that debt is issued outside the U.S. and in currencies not denominated in dollars. That can lead to higher fixed income returns with less volatility for investors employing an informed process.

Case Study – A Tale of Two Decades

The extent of opportunity cost for not diversifying globally is exemplified by the period from 2000 to the end of 2009. At the beginning was the Tech Bust and the end was the Global Financial Crisis, both unpredictable events. Termed a "Lost Decade" for U.S. stocks, the S&P 500 Index recorded one of its worst 10-year performances. The total cumulative return was -9.1%. The S&P 500 Growth Index at -25.3% was even worse. Risk-free Treasury bills issued by the U.S. government cumulatively returned 39.6% during those years. *That was 6500 bps better than growth indices.*

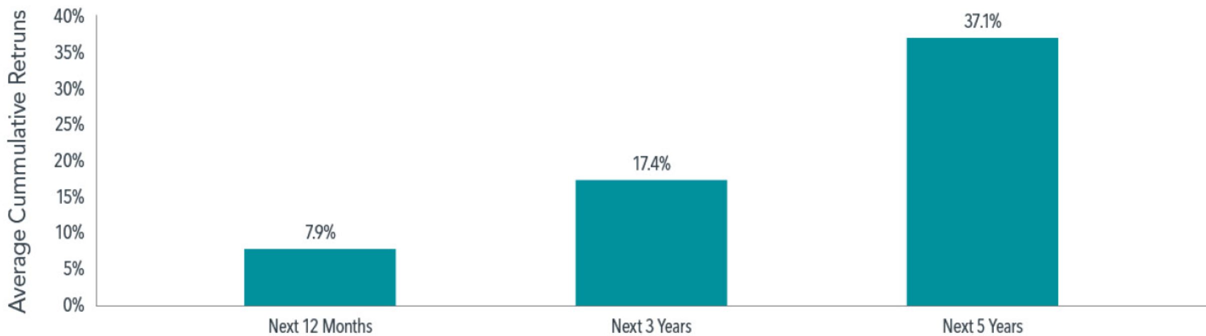
Investing outside the U.S. during the Lost Decade, in **Exhibit 5**, certain allocations in non-U.S. and emerging market equity allocations were highly advantageous. If a client was equally weighted U.S. and non-U.S. stocks, together with value and size tilts and stayed the course through ups and downs, damaging U.S. large stock returns would have been substantially offset during that painful decade. Historically, for each of the 12 decades starting in 1900 and ending in 2020, the US market outperformed the world market in six decades and underperformed in the other six.[11]

From 2009 onward was an extended period of unprecedented U.S. equity market growth. That growth was stimulated and re-stimulated by a series of equally unprecedented central bank "Quantitative Easings." Interest rates in real terms due to stimulus and central bank policy were driven to zero and below. Relative to global markets, U.S. equity markets surged by a huge margin. That decade of high growth was ended by a prolonged COVID lockdown, and a shift to a new global era where we are now.

What is most notable from Exhibit 5 is that even a decade of enormous growth in the U.S. equity markets *did not offset* their losses from the previous decade and the big head start that non-U.S. stocks due to their strong returns, avoiding a sustained period of losses. In the recent decade, we can infer that developed non-U.S. equities suffered, relative to U.S.

Exhibit 6: Recovery Returns for U.S. Equity/Fixed Portfolio Strategy (10% or More)

Historical 60% S&P 500 Index/40% Five-Year US Treasury: January 1926-September 2022



Source: Morningstar Direct as of September 30, 2022. In USD. The 60/40 portfolio consists of the S&P 500 Index (60%) and five-year US Treasury notes (40%). Rebalanced monthly. Drawdowns include all periods where the 60/40 portfolio declined by 10% or more from the prior peak. Peaks are defined as months where the 60/40 portfolio's cumulative return exceeds all prior monthly observations. Returns are calculated for the one-, three-, and five-year look-ahead periods beginning the month after the 10% decline threshold is exceeded. The bar chart shows the average cumulative returns for the one-, three-, and five-year periods post decline. There are 10, nine, and nine observations for the one-, three-, and five-year look-ahead periods, respectively. Five-year US Treasury notes data provided by Morningstar. S&P data by S&P Dow Jones Indices LLC. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. **Past performance is no guarantee of future results.**

growth stocks. But investor behavior in the face of prolonged poor returns must be considered: how many U.S.-only investors would have stayed invested to be properly positioned for the prolonged recovery after 2009? How many got out and only re-entered years later into the U.S. stock recovery, and several years of positive returns? A globally informed approach positions makes sticking with your plan simpler, so capturing the cumulative outcomes necessary for realizing lifetime goals more reliably.

A Case for Optimism

It is essential when planning your strategy, and particularly in these turbulent times, to pay attention not on what your returns have been recently but what they most likely will be long-term. Behavioral "recency bias" causes many of us to focus on this year's decline and forget the large gains experienced over the previous decade. **Exhibit 6** shows historically strong 60/40 returns that you may reasonably expect over one-, three-, and five-year periods following a period of 10% or greater declines. The case for sticking around and waiting for those future returns is strong. For retirement and legacy planning within reasonable horizons, markets have proven resilient.

While both U.S. and non-U.S. equity asset classes offer positive expected returns, you must expect allocations by location to perform differently in different periods. The global professional strategies we manage sufficiently diversify your portfolio for greater confidence of capturing potential returns whenever and wherever they occur.

What I have learned, and what we know is that a globally diversified portfolio will never be the best or worst performing during any interval of time compared to the components that individually make it up. Planning is based on uncertain horizons, and consider uncertainties related to health, career, and family. Fundamentally, the entire point of diversification is to *reduce* extreme, potentially terrifying negative returns and *increase* the likelihood of successfully realizing essential investing outcomes over your lifetime of planning for retirement and wealth goals.

Invest Better – Live Better

Uncertainty about the future and about the many decisions you must make along the way to get ahead, causes stress. The cumulative impact of making smart and informed decisions related to planning and investing, however can dramatically compound wealth over time. Many good decisions can overcome a few bad ones, as long as they are kept small. As you learn from making good decisions over the years with a trusted advisor, the learning curve reduces, and you can plan with increasing confidence of success.

Guided by decades of economic science and research, adhering to fundamental planning principles and a systematic wealth process with an experienced team of CFP® professionals should help make the present time more tolerable. Maintaining a well-diversified global strategy and sticking around for the returns, the pain you feel looking at your account reports today will be exchanged by your happiness when you see the outcome of all that discipline. Just as in past, working with us, you have a strong hope of realizing the returns you need to meet your important family goals.

ENDNOTES

1. Hannah Miao and Chelsey Dulaney, *Wall Street Journal* (September 30, 2022), page A1.
2. Source: Morningstar Direct as of September 30, 2022.
3. Peter Rudegeair and Gunjan Banerji (October 20, 2022), https://www.wsj.com/articles/day-traders-go-back-to-their-day-jobs-as-stock-market-swoons-11666148094.
4. See Wes Crill, "Active Management hasn't Shined in Volatile Markets" (Dimensional Fund Advisors, July 2022)
5. *The Fund Landscape 2022*: *A Study of US-Domiciled Mutual Fund and Exchange-Traded Fund Performance* (Dimensional Fund Advisors, 2022 version, updated annually)
6. This goes way back to Michael C. Jensen, "Performance of Mutual Funds in the Period 1945-1964," *Journal of Finance*, Vol. 23, No. 2, pp. 389-416, 1967. Industry marketers have suppressed research like this for decades.
7. For more information on home bias, see the following: "Home Bias," Corporate Finance Institute, September 18, 2020; Eduard Gaar, David Scherer, and Dirk Schiereck,"The Home Bias and the Local Bias: A Survey," *Management Review Quarterly* 72 (November 2020): 21–57; and "The Randomness of Global Stock Returns" (Dimensional Fund Advisors, June 2019).
8. Based on the free float-adjusted market capitalization.
9. From "The Randomness of Global Equity Returns," *Matrix Book 2022* (Dimensional Fund Advisors, 2022)
10. MSCI country index performances, year to date as of June 20, 2022. MSCI data.
11. Source: Annual country index return data from the Dimson-March-Staunton (DMS) Global Returns Data, provided by Morningstar, Inc.

Paul Byron Hill, MBA, MFP, MSFS, ChFC®, RICP®, CFP® is a nationally recognized Wealth Management Certified Professional™ and Certified Financial Planner™ professional, written about in *Fortune, Forbes, Bloomberg Businessweek,* and *Money*. Paul is the co-author of *Retire Abundantly*. Reuters AdvisePoint once recognized Mr. Hill as one of 500 "Top Advisers" in the U.S. and featured him in an interview on their website.

Paul founded Professional Financial Strategies, Inc. in 1993 as one of the first fiduciary planning firms that specializes in retirement and wealth management for affluent and aspiring families. Paul is a personal chief financial officer acting in best interest of clients. He brings together a proven process and a network of specialists for making informed decisions for systematic strategies, secure income, mitigating taxes, protecting assets, and preserving wealth for family and purposeful causes.

Mr. Hill received a BA with distinction from the University of Rochester and later an MBA in finance from its Simon School of Business. He earned an MS in financial services from The American College along with his Chartered Financial Consultant and Retirement Income Certified Professional designations, and then received an MS in financial planning from the College for Financial Planning (now at the University of Phoenix). The College for Financial Planning appointed him as adjunct faculty, and he taught at St. John Fisher College. Who's Who presented Paul with the Albert Nelson Marquis Lifetime Achievement Award, and featured him with others in *The Wall Street Journal* and other publications.

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