Planning Perspectives 1Q 2023

Integrity in Investing
Systematic Strategies: Awakened Alternative for the Newly Woke

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PROFESSIONAL FINANCIAL
Purposeful Wealth Management

"Most investors are overconfident about their ability to identify market opportunities."
– **Kenneth French,** Chaired Professor at Dartmouth College and collaborator of Eugene Fama, Nobel laureate economist

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

Key takeaways:

- Some investor groups recently experiencing large gains gained a costly education in 2022.
- Systematic, informed model strategies successfully mitigated declines within planning ranges.
- Systematic, informed model strategies provide expected positive outcomes despite recessions.
- Model allocations are a useful guide for making decisions about an informed policy and process.

Lesson Topics for Newly Woke Investors: First, investing is risky. Second, the future is uncertain. Third, past performance does not assure future results. And forth, there is no free lunch, as a dead white male economist once famously opined.[1]

Many popular investing themes among social media cyber-traders were stress-tested in 2022. Many groupies "woke up" with an unexpected education from the pain of lost gains in accounts. *Exhibit 1* shows that consumer confidence dropped from the highest highs in early 2020 just before government lockdowns and then fell to near the lowest lows less than two years later after a surprise war[2] spoiled their exciting trading games. Such a bummer.

It's not just about legions of cybertrading groupies crushed by collapsing cryptocurrencies, Fintech, FAANG stocks, Meme stocks, SPACs or other profitless innovations. They rode a big bull market to the highest market levels ever in a cyberworld powered not only by negative real interest rates, but incredibly by trillions of dollars of free government money virtually dropping into their bank accounts. (Real investor losses, not coincidentally, are in the trillions.) Groupies "woke" up from the madness of crowds[3] after examining decimated accounts and then realized that social media "likes" of investing "themes" were often refashioned Ponzi schemes.

Frankly, I "like" the idea of getting rich quick. But years of real-life experience, good and bad, outside the social media echo chamber metaverse taught me that if anyone truly knows how to make a killing with an investing "theme," why should *they* share it with *you* for free or only for the price of a subscription? Economic theory teaches that they[4] will **not** share but they will keep all those big fat profits for themselves.

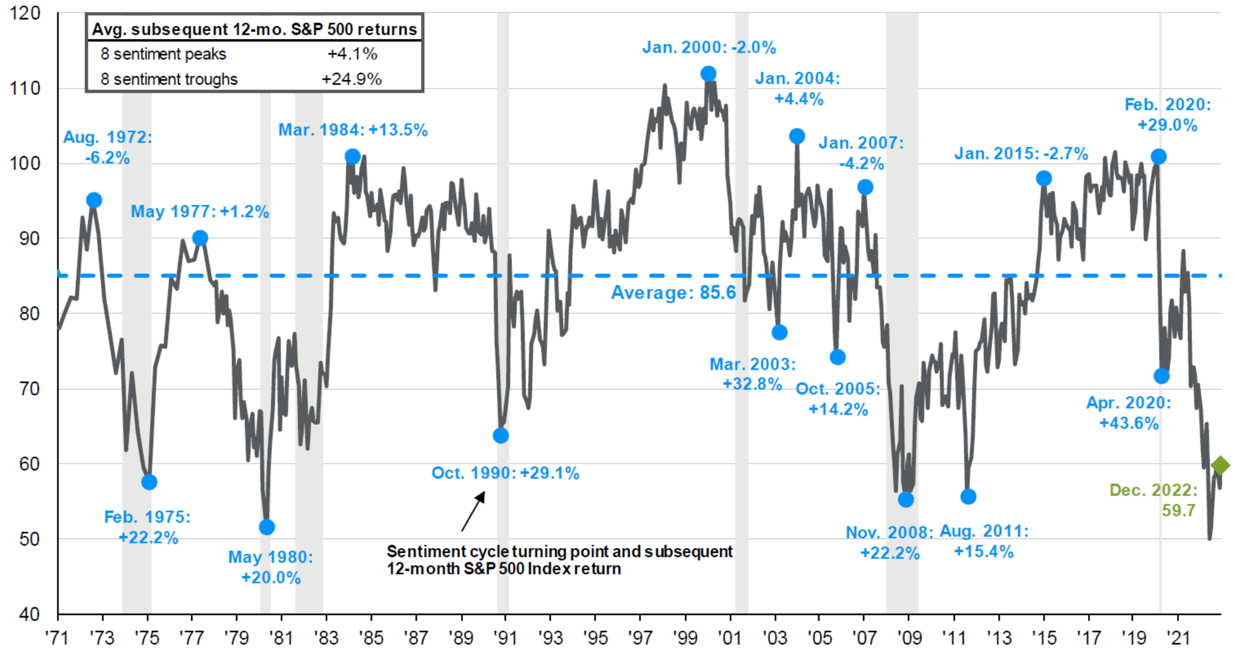
Doubting of an Old Model's Utility

In our bold new attention-deficit cyber world, anyone questioning the traditional status quo will momentarily capture media attention. Clever marketers continually exploit excitable investors using recency bias behavior to get their share of free ink in *The Wall Street Journal* or top Google searches as part of unending efforts to capture hot money in motion.

A recent attention-getter by one of the best-known names in asset management and investment banking, disparages the conventional wisdom of the traditional 60% stock and 40% bond allocation as a model investing strategy.[5] The so-called 60/40 model has been popular in the U.S. since the 1970s with advisers as a conventional conceptual example for investor education and conversations.

Exhibit 1: US Consumer Confidence Volatility with Future Stock Returns

Michigan Consumer Sentiment Index and subsequent 12-month US S&P 500 Index returns



Past performance is no guarantee or a reliable indicator of future results. Source: FactSet, Standard & Poor's Dow Jones Indices LLC, University of Michigan and J.P. Morgan Asset Management. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price only, which excludes reinvested dividends.

Unfortunately, that old model performed unusually poorly in absolute terms for both it's stock and bond sides last year.[6]

BlackRock declared that the 60/40 model "failed" simply because stock and bonds simultaneously had large losses. Yet highly respected firms like Goldman Sachs, another asset management and banking firm demurs, believing that the 60/40 model is still sensible and any modifications should be incremental. Firms and advisers on both sides of the conversation have taken strong positions.

Unsurprisingly, BlackRock sells a lot of private debt and equity, commodities, infrastructure and inflation-linked bonds in their client portfolios for a building block approach. Even though BlackRock manages trillions of dollars in index mutual funds, their fees are miniscule, getting paid mostly through securities lending and selling trade flow data on those portfolios. The building blocks are a prime revenue source for the firm.

How much was the 60/40 model a "failure" in meaningful terms? 2022 was only the first time that **both** the S&P 500 Index of U.S. stocks, which lost -18.1%, and long-term US Treasury bonds (20-year maturity), which lost -26.1%, experienced double-digit declines. (A 10-year U.S. Treasury index would have lost only -12.9%.) 2022 was only the third year—2009 and 2013 were the others – that history shows long-term Treasury securities producing double-digit losses. However, the S&P 500 stock index offset bond losses in both years, returning 26.5% and 32.4% respectively. The evidence available is not sufficient to conclude any "failure."

The Conventional 60/40 Model Origins

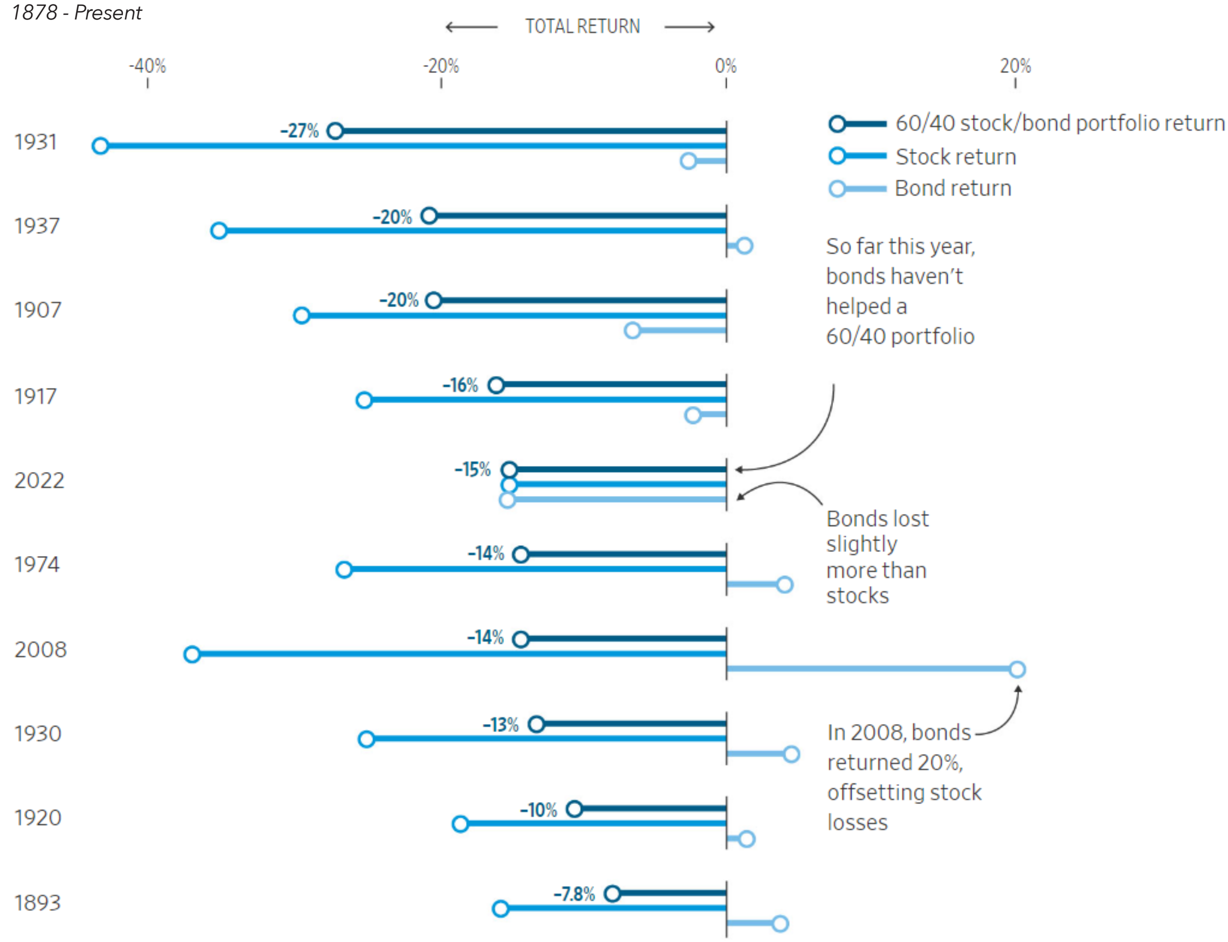
The 60/40 split originated out of uses applied to Modern Portfolio Theory's old capital asset pricing model (CAPM) back from the 1960s. The "Separation Theorem" of portfolio choice was applied by advisors to a hypothetical sequential series of risky and risk-free asset allocations to develop an "efficient frontier." Standard deviation was treated as the only risk of a diversified portfolio. The optimum portfolio along the frontier provides the theoretical highest return for the lowest standard deviation, maximizing an investor's "utility." Implementing Tobin's[7] theory involves two phases:

- Establish an "efficient frontier" of risky and risk-free allocations sequentially.
- Determine the optimum risky and risk-free asset tradeoff for the greatest "utility."

William Sharpe devised an intuitive concept derived from the theory termed the "Sharpe Ratio." At that time, detailed historical market data was extremely limited for advisors. But in the 1970s Roger Ibbotson and Rex Sinquefield began compiling annual U.S. stock, bond, T-bill and inflation returns going back to 1926. Suddenly model efficient frontiers could be

Exhibit 2: 10 Worst Calendar Year Returns for U.S. 60% Stock/40% Bond Model

1878 - Present



Past performance is no guarantee or a reliable indicator of future results. Stock return refers to an S&P 500 proxy. Bond returns refer to 10-year U.S. Treasury note. Indexes are not available for direct investment. **Source:** Leuthold Group.

developed after personal computers were introduced, and calculating Sharpe ratios was easy. Substituting stock and bond index returns for theoretical CAPM allocations and the "60/40 model" emerged as an industry heuristic after noticing where the "optimum" tradeoff from calculations for models most often occurred. It had an air of sophistication, and CAPM was simple to explain.

MPT, CAPM, Sharpe ratios and such are still widely taught today and still used by Morningstar, the industry leader in securities research and analysis. But research in financial economics is an ongoing activity. A young Eugene Fama along with other economic researchers of the 1980s got access to improved price data and more powerful computers. They empirically tested the CAPM one-factor model and found it did not work. Standard deviation alone did not explain the behavior of market prices. By the 1990s Fama and a colleague Kenneth French introduced a market model with three stock factor dimensions (market, size, and relative price) and later added dimensions (term and default) for bonds, as we see in *Exhibit 4*.[8] Later a profitability factor dimension was added. In 2013 Professor Fama was awarded a Nobel prize for his life's work in financial economics.

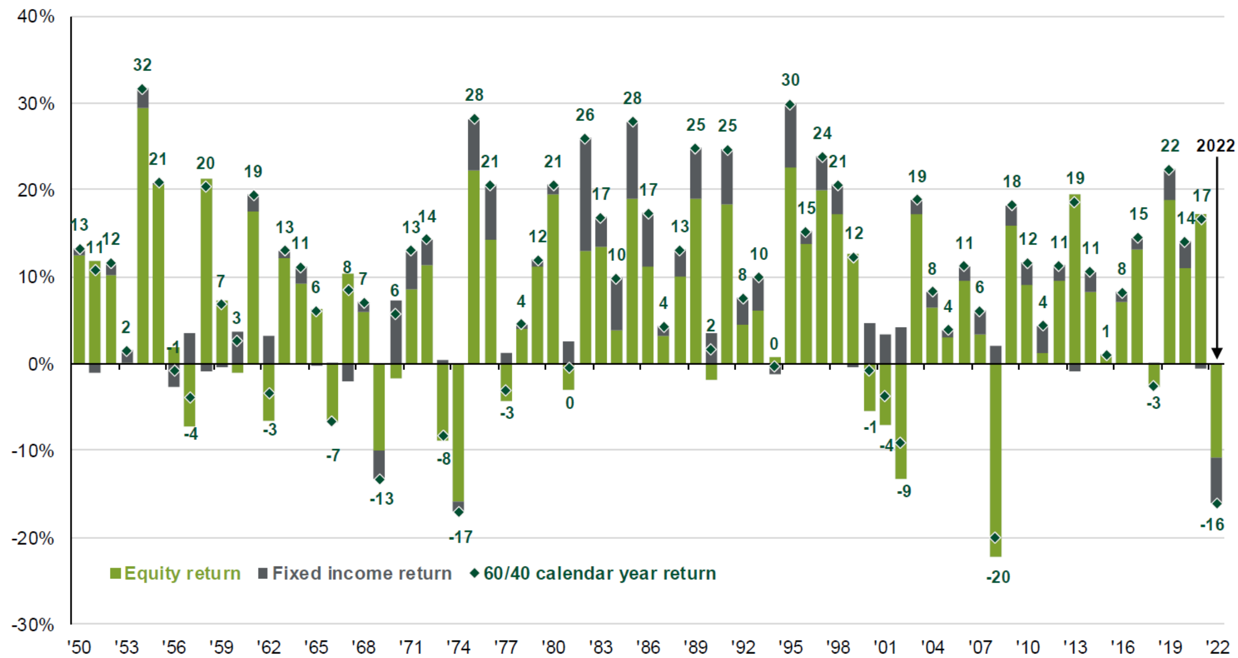
Limits for Trusting Model Outputs

While no model is perfect, it can have useful applications. Let's illustrate what we mean with a familiar model used every day: the daily weather forecast. Using the best satellite and field data on current and past weather conditions, a meteorologist makes numerous assumptions to estimate weather conditions for the day and the week. His model can help you decide whether to plan a picnic outing this weekend. However, as anyone caught unprepared in a rain shower will know, reality is often different than the model's prediction.

All models are fiction. Models are a simplification of reality. Instead of asking, "Is this model true or false?" (to which the answer is always false), it is better to ask, "How does this model help me better understand the world?" Then, "In what ways can the model be wrong?" The saying "garbage in, garbage out" applies to models and the inputs used. That

Exhibit 3: Hypothetical 60/40 U.S. Equity/Fixed Model Returns by Year

Decomposition of retroactive blended portfolio returns yearly, 1950 - 2022



Performance shown represents past performance and is not guaranteed. Source: FactSet, Standard & Poor's, Robert Shiller/Yale University, Ibbotson/Strategas, and J.P. Morgan Asset Management. This 60/40 portfolio model is assumed invested in the S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 to 1970 are estimated using the Shiller S&P 500 Composite. U.S. fixed income total returns from 1950 to 1975 are estimated from Strategas/Ibbotson data. Rebalanced annually. Indexes are not available for direct investment. This model has been developed with the benefit of hindsight and pretends that index funds were available prior to 1975. For educational purposes only.

is, a model's output can only be as good as its input. Poor assumptions also lead to bad outputs. However, even with what seem sensible assumptions, a model user who blindly places faith in inherently imprecise inputs is exposed to nonsensical outputs. A model produces numbers with precision, but "art to science" requires judgement based on a well-informed understanding of that model's limitations and of its inputs, together with humility, to sensibly interpret what the numbers may mean.

Models for investment management are best used to gain insights to make better investment decisions. Models are not a substitute for advisory judgement. Sophisticated quantitative research models can use vast amounts of information to gain insight. Smart models can provide a competitive advantage in marketing. Debates about the value of different models are found in industry journals. But users of any commercially developed model or those that Morningstar might provide must remember that no model fully "explains" any portfolio. Salespeople tout their firm's "great" investing models—but just try to get a benchmarked performance report going back decades[9] Models are too often treated as more important than the execution.

Exhibit 4: Dimensional Drivers of Expected Returns in Excess of Market

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.

Rethinking the 60/40 Controversy

The 60/40 model dispute forgets the original heuristic purposes. There were no index funds to buy when the model was devised; it could not be implemented precisely. For general educational purposes to compare and contrast against other portfolio holdings or potential portfolios, and to frame possible outcomes under different historic markets conditions, the 60/40 model has value for long-term planning purposes. Investment theorists have called the 60/40 model the "center of gravity." When surveying a systematically descending series of index asset allocations—such as we produce for reviewing and comparing investment policy strategies—60% equity allocations invariably show returns only slightly lower than all-equity allocations. The 40% allocation to fixed income moderates stock declines for those unable to tolerate the deepest downturns seen over the decades. And if the 60/40 history of gains and losses does not work for a client planning strategy, then return strategies for 50/50 or 40/60 model allocations with lower volatility can be readily evaluated.

Our concern with the conventional 60/40 model for actual client investing is two-fold: first, investible markets have expanded enormously globally in the decades since the 60/40 model originated. Over half the world's investible assets today are outside the U.S. A U.S.-only approach misses the opportunities and risk-reducing diversification from allocations outside the U.S. Second, time horizons selected by many advisors showing 60/40 model return periods are too short and don't extend back far enough, say back to 1970, that more useful information about risks. Further implementation of model allocations are substituted with alternatives dissimilar to its indexes and with different risks than only volatility.

The outcomes of 2022 stood out in a way that nominal market returns alone don't show. Taking inflation-adjusted 60/40 model market returns into account, in *Exhibit 5* from Professor Edward McQuarrie, 2022 was the fourth worst 12- month experience for a hypothetically diversified investor, worse even than in legendary 1929. Using data from 1970, a U.S. 60/40 model extreme outcome such as last year's has a probability of occurring only once every 130 years.[10] For any who may be fearful of a near-term recurrence, statistically the odds of such a recurrence are less likely than those of you dying in an automobile crash *during your expected lifetime* (101:1, Visual Capitalist and National Safety Council).

Framing Informed Planning Decisions

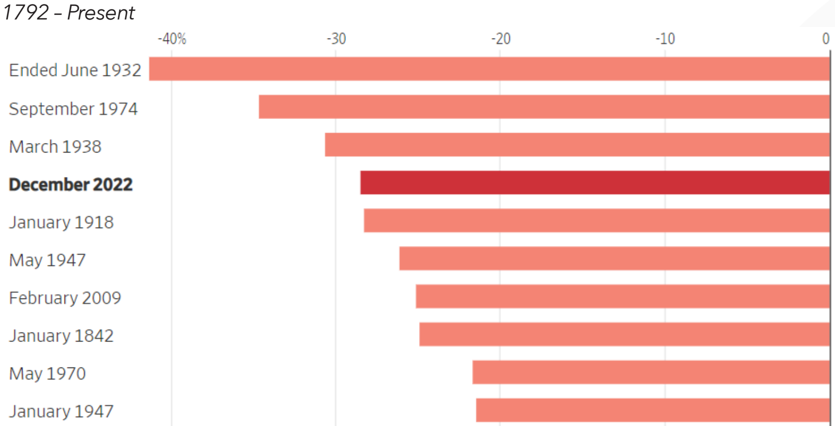
Looking beyond rare events, modeling informed allocations and potential range of outcomes is essential for choosing the right portfolio allocation strategy for estimating your expected returns, so you will not be surprised or distracted when large variation in returns and for longer periods occur occasionally. **Exhibit 6** shows the averages and the extremes for a hypothetical balanced 50/50 U.S. equity and bond index allocation with indexed stock and bond components.

Exhibit 6 has several surprises. For instance, we see historically a full ten years when U.S. stocks returned only a negative one percent annualized, and another ten years where bonds returned only a positive one percent. On the other hand, there were decades of 19% and 16% returns annualized, respectively. Balanced stock/bond strategies work for planning only if you maintain market indexes. For a midrange 50/50 split annually rebalanced, the average outcome was 8.7% annually (inflation was 3.5% for the time period). While estimated averages are important for planning expectations, an index model provides a reassuring worst case outcome for those investors who stick with their balanced allocation: it's 5% annualized at 20 years. Not only could the balanced allocation avoid the negative 1% all-equity 10-year disaster, but the worst 20-years for stocks only provided 6% annualized and the 1% disaster of only holding bonds. Of course, while we all would like to see the upper end 20-year 14% annualized return, that's not a sensible planning assumption.

Investors are troubled not only by inadequate planning, but they are excessively influenced by recency bias. For instance, interest rates have ranged from 1% to 0% for the last two decades. Retirees back in 2000 based on the prior two decades hoped for 6% or so from bank accounts or "safe" bonds. Without a balanced portfolio like 60/40 or 50/50 and being able to expect normal stock risk of what turned out to be a "Lost Decade" for

Exhibit 5: Worst 12-Month Return Periods for 60% Stock/40% Bond Allocation, Inflation-Adjusted

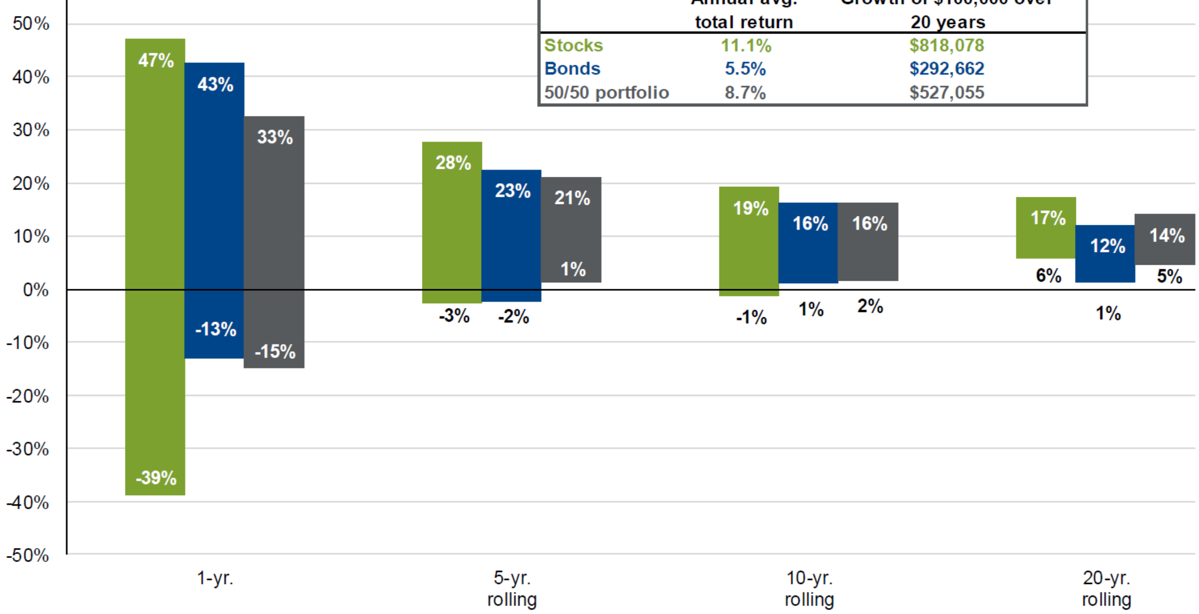
1792 – Present



Performance shown represents past performance and is not guaranteed. Source: Edward McQuarrie, Santa Clara University. Pre-1926 returns calculated by Edward McQuarrie; 1926-2021 returns for U.S. stocks, long-term Treasurys, and inflation from Ibbotson Associates; 2022 returns proxied by Vanguard Total Stock Market ETF and Vanguard Long-Term Treasury ETF; 2022 inflation through November 30. Indexes are not available for direct investment. This model has been developed with the benefit of hindsight and pretends that index funds were available prior to 1975. For educational purposes only.

Exhibit 6: Hypothetical U.S. Stock, Bond and 50/50 Allocation Rolling Return Ranges

Annual total returns, 1950 - 2022



	Annual avg. total return	Growth of $100,000 over 20 years
Stocks	11.1%	$818,078
Bonds	5.5%	$292,662
50/50 portfolio	8.7%	$527,055

Performance shown represents past performance and is not guaranteed. Source: FactSet, Standard & Poor's, Robert Shiller/Yale University, Ibbotson/Strategas, and J.P. Morgan Asset Management. Calendar year stock returns from 1950 to 2021 are estimated using the Shiller S&P 500 Composite. U.S. fixed income total returns from 1950 to 2010 are estimated from Strategas/Ibbotson data and the Bloomberg U.S. Aggregate Total Return Index thereafter. This allocation has been developed with the benefit of hindsight and assuming that diversified index funds were available for investing during the entire period. Growth of $100,000 is based on the annual average total returns from 1950 to 2022. The blended 50/50 model allocation has been developed retroactively with the benefit of hindsight. For educational purposes only.

U.S. stocks, it became a slow-moving disaster for those seeking "safe" income. Later bets went badly. But *Exhibit 6* shows how sticking with a simple 50/50 indexed model strategy long term could have returned over 5% annually in a 2% inflationary period, 2022 included in the worst case.

Our clients are better positioned than most for strong recoveries this year. Those who crashed without informed planning have little hope. Our portfolio strategies echo the 60/40 model with a multifactor global approach. Our planning is grounded in economic theory and backed by decades of empirical research. We structure broadly diversified portfolios with global allocations, not focused only in the U.S., that emphasize the dimensions of higher expected returns, with solutions that address implementation tradeoffs. It is a less subjective, more consistent systematic approach that clients can understand and stick with, even in challenging times.[11]

Plan Ahead, Not Looking Behind

The Fed's long experiment in a zero-interest-rate policy and quantitative easing came to a painful stop last year. Many fear a recession. One may already be here. Legislative negligence and political gamesmanship over U.S. spending and deficits can last only so long due to fiscal realities. "If something cannot go on forever," economist Herbert Stein once observed about the 1970s inflation in the U.S., "it will stop." Yet if we revisit the depressed level of consumer confidence looking back at *Exhibit 1* we have some hope.

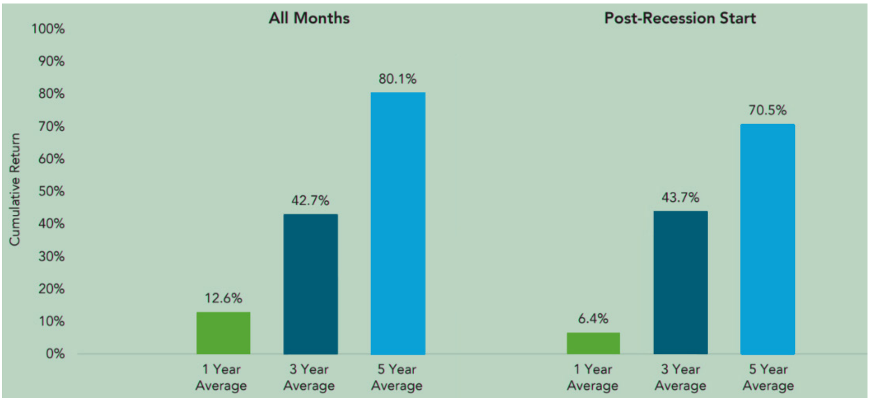
Recall the valuation theory model: The firm's cost of capital is the investor's return. That means, for an informed, diversified and globally-allocated client, your expected returns for planning have gone up, not down. *Exhibits 7* and *8* help us for near-term planning expectations. U.S. stock and bond markets show historical return averages for periods 1-, 3- and 5 years immediately looking ahead. Adjacent with each exhibit are a return set that begins from recession start dates. Surprisingly, both sets of returns are highly attractive. Five-year returns for both stock and bond indexes are close to the historical average returns regardless of whether recession conditions exist.[12]

Conclusion

Recency bias is a pernicious behavior that imposes your recent experience on how you view the future. So many events are outside of our control. Given life's uncertainty, most of what happens in our life's experiences will be unpredictable. Yet we know that uncertainty also brings with it opportunity and possibility.

Exhibit 7: US Stocks All Months and Post-Recession Returns Compared

US S&P 500 Index returns, January 1947 – December 2022



Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Returns data based on monthly S&P 500 Index returns from January 1947 to December 2022. Returns are calculated for the 1-, 3-, and 5-year look-ahead periods for all months and post-recession start months. The sample start date is based on quarterly US gross domestic product data, a key measure used to identify changes in economic activity across the business cycle, that is first available starting in 1947. Business cycle recession dates sourced from the National Bureau of Economic Research (NBER). S&P data by S&P Dow Jones Indices LLC, a division of S&P Global. **Source:** Dimensional Fund Advisors.

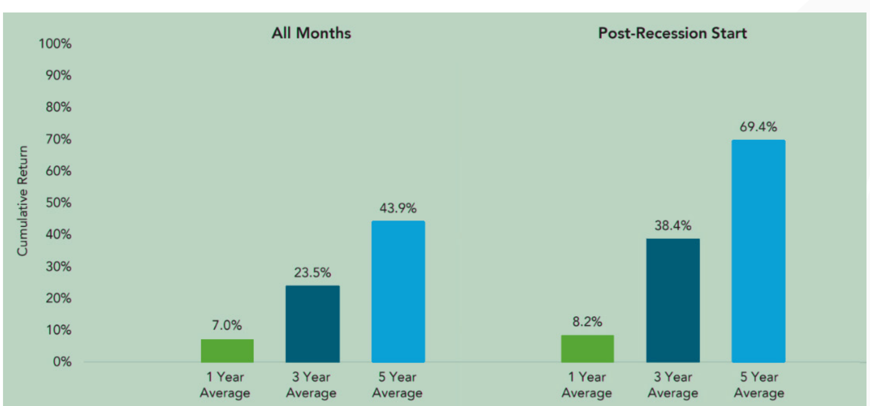
We can live our lives successfully without knowing for sure what will happen, or exactly how our hopes and plans will be impacted. Many decisions you made in the past turned out well, but you could not be certain when you made them. Judge your choices by the quality of the decisions you make and not by their outcomes.

There is a big difference when we plan between following a model blindly and making judicious decisions based on it. Informed planning ignores noise about the "latest and greatest" products. Working with a process grounded in modern financial science, you can take advantage of our firm's professional judgment and experienced implementation. If your choice is to stay disciplined based on an informed planning models, your certainty of fulfilling your hopes and dreams is likely to increase, although maybe in ways that you could not have predicted.

No one likes disappointing returns. But as trusted CFP professionals, we guide you in making well-informed choices for your family, your circumstances, and your goals. An informed decision-making process will take life's uncertainty into account. Embracing uncertainty's risks with a professionally planned process will help you and your family wake up each day more confidently not just for a better tomorrow but for a better today.

Exhibit 8: US Bonds All Months and Post-Recession Returns Compared

Bloomberg U.S. Aggregate Bond Index, January 1976 – December 2022



Past performance is no guarantee of future results. Short-term performance results should be considered in connection with longer term performance results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. In USD. Returns data based on monthly Bloomberg U.S. Aggregate Bond Index returns from January 1976 to December 2022. Total returns are calculated for the 1-, 3-, and 5-year look-ahead periods for all months and post-recession start months. Business cycle recession dates sourced from the National Bureau of Economic Research (NBER). There are 6, 5, and 5 observations for 1-, 3-, and 5-year post recession periods, respectively. Bloomberg index data provided by Bloomberg. **Source:** Dimensional Fund Advisors.

ENDNOTES

1. A Google search shows that Nobel laureate economist Milton Friedman said it–who died both famous and rich.
2. For those living outside the Metaverse, Vladimir Putin, a self-styled Russian Czar is tyrannizing the Ukraine.
3. See Robert Menschel, *Markets, Mobs & Mayhem* for a modern look at the madness of crowds (Wiley, 2002).
4. Notice my Woke pronoun usage by avoiding a sexist "he" or "she."
5. James Mackintosh, "BlackRock, Goldman Are at Odds Over 60/40 Portfolio's Relevance," *Wall Street Journal* (January 17, 2023) B1.
6. *The Wall Street Journal*, where else? Their news staff has space that must be filled every day, just like all media.
7. James Tobin, "Liquidity preferences as behavior towards risk," *Review of Economic Studies*, XXV(2): 65-86, February 1958. HB1R4
8. Eugene F. Fama and Kenneth R. French, "The Cross Section of Expected Stock Returns," *Journal of Finance* 47, no. 2 (June 1992). See also "Common Risk Factors in the Returns of Stocks and Bonds," *Journal of Financial Economics* 33, no. 1 (February 1993)
9. See Paul Byron Hill, "Informed Strategy: Models and the Art of Science," *Planning Perspectives* (3Q 2017).
10. Jason Zweig, "Your Investing Strategy Just Failed. It's Time to Double Down," *Wall Street Journal* (January 6, 2023).
11. See Paul Byron Hill, "Key Investing Principles for Informed Planning," *Planning Perspectives* (4Q 2021) for review.
12. Even more encouraging is to keep in mind that U.S. markets historically perform unusually well the year following a mid-term election. See Paul Byron Hill, *Views from the Hill* (December 2022)

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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