HERITAGE PERSPECTIVE

A QUARTERLY PUBLICATION OF HERITAGE INVESTMENT GROUP INC.

FALL 2017

Heritage Update

THE MANY ARE SMARTER THAN THE FEW

The "wisdom of the crowd" is the collective opinion of a group of individuals rather than that of a single expert. Markets work because the wisdom of the investment crowd sets stock prices efficiently. Heritage has generated real wealth for our clients by harnessing the power of that collective wisdom through a globally diversified investment strategy that never relies on market timing.

INVESTING IN OUR COMMUNITY

Heritage employees continue to give back to our communities. November finds us participating in a fishing tournament to benefit Nova Southeastern University (the Halmos College of Natural Sciences and Oceanography) as well as supporting the St. Jude Fall Festival. In December, we will honor our deceased veterans by participating in the annual Wreaths across America event.

HAPPY HOLIDAYS

Heritage would like to wish all of our clients and their families a very happy holiday season! We thank you for allowing us to assist with the things that matter most to you and your family's financial well-being. Yours is a relationship we value deeply, every day of the year.

EMPLOYEE PROFILE

Stacy L. Bliss

Stacy joined Heritage in 2006 as a member of our portfolio management team and he always has a warm welcome for clients and colleagues alike. Stacy lives in Boca Raton with his family; an avid golfer and tennis player, he is also very active in his church and his children's school activities.

ABOUT HERITAGE

At Heritage, we understand that risk and return are inseparable, but we believe that some risks are just not worth taking. The balance exists in taking advantage of appropriate risks, while mitigating the potential for catastrophic downside outcomes. The heart of what we do lies in helping our clients achieve their goals and obtain the peace of mind that a successful plan provides.

Inside this Issue

"Excellence is doing ordinary things extraordinarily well."

—JOHN W. GARDNER

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The Wisdom of Crowds

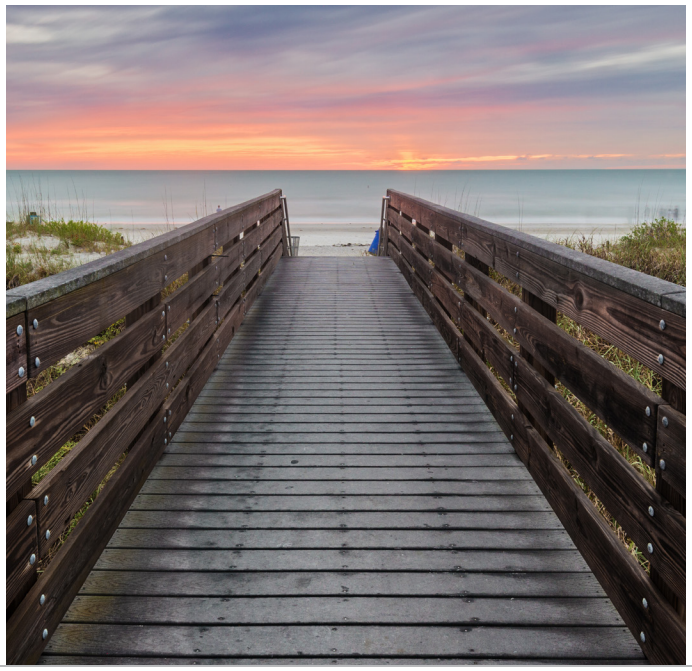
"Nobody goes there anymore. It's too crowded."

– YOGI BERRA

Now that the summer has gone, we Floridians are in transition. We have stopped complaining about the heat and will soon start complaining about the crowds. While it may be impossible to be sanguine about the oppressive summer heat, we should keep in mind that the fall and winter crowds actually provide us with some useful benefits. The crowds of tourists contribute a large share of revenue to the Florida economy, and they help to pay for a significant portion of our state infrastructure. It might be difficult to keep this in mind when your favorite restaurant is booked and the highway looks like a parking lot, but the crowds do take a financial burden off of the locals.

Investment markets also reap the benefits of crowds, and the wisest investors embrace the investment crowd because, as a whole, the crowd provides us with very valuable information regarding the fair pricing of assets. In fact, the investment crowd generates a peculiar and universally beneficial phenomenon known as the *wisdom of crowds.*

The wisdom of crowds is defined by Investopedia as "the idea that large groups of people are collectively smarter than even individual experts when it comes to problem solving, decision making, innovating and predicting." In an investment context, this means that, when attempting to determine the fair price of a stock or bond, the aggregate estimate given by the crowd (the current market price) tends to be the best estimate of the fair price. In other words, it is very difficult for any single investor, even an expert, to be wiser than the wisdom of the crowd.



This phenomenon may seem odd or difficult to believe at first, but consider this: For every buyer of a stock, there must be a seller. So, by definition, half of the market participants think the stock is a good buy and half think it should be sold. With billions of shares being bought and sold each day, the diverse opinions of thousands of investors are fairly reflected in the resulting stock price (this is what your high school chemistry teacher would cite as an example of "equilibrium"). This equilibrium price reflects all of the information available to the crowd, so, in order to beat the market, it is not enough to simply outguess the average investor; you (or the expert you are paying) need to outguess *the collective wisdom of all other investors in the market,* and this is truly a Herculean task.

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The wisdom of crowds is more than just an interesting idea; there is strong data supporting it. For instance, a 2017 study conducted by Dimensional Fund Advisors indicates that only 17% of stock fund managers and only 18% of bond fund managers were able to beat their respective markets over the latest 15-year period. In addition, the study indicates that those few managers who do outperform over a given time period tend not to outperform in future time periods. Thus, there is very little consistency around any ability to outperform the wisdom of crowds, and it is likely that most of those experts who did happen to outperform the crowd did so due to luck rather than skill.

The failure of the experts to beat the crowd has profound implications for an industry in which the experts are paid large sums of money for their purported ability to do precisely that. As more and more investors have embraced the wisdom of the crowd instead of the experts, an investment style known as "index investing" has grown in prominence. Instead of attempting to *beat the market*, an index strategy simply *owns the market* by holding all of the stocks or bonds in a particular market sector. Indexing is a low cost, effective strategy that has a high likelihood of outperforming the more expensive "active" strategies of the experts.

Index investing is like taking the train into Manhattan every day: It is boring and not at all sexy, but it gets the job done reliably and you arrive on time. Active investing is like foregoing the train and driving into the city: You might look more fashionable along the way, and if *everything* goes right you might arrive a bit earlier, but if *anything* goes wrong, you will be late, and possibly very late. If you are like most people you are not willing to trade a small chance of getting slightly ahead for a large risk of falling far behind; you should take the train to work and you should invest with an index strategy.

In the end, the choice is a simple one: Why would you pay one expert for his or her opinion of the fair value of a stock when you can get the aggregate opinion of all of the experts in the crowd just by looking at the stock's current price? By choosing an index investment approach, you are benefitting from all of the research and brain power of every analyst in the field on every security in the market, and the cost is far less than an active approach. You are embracing the wisdom of crowds and allowing the power of markets to work for you to generate real wealth over time. Try to keep this in mind when you are caught in traffic this winter; the crowd provides benefits too.

The original version of this article was written by Heritage for the September 2017 edition of The Light, a local magazine serving Broward County, Florida.

Bonds Have More Fun

After having achieved great financial success as an entertainer, Groucho Marx went on a tour of the New York Stock Exchange. As he was walking around the floor, one of the traders asked him, "Groucho, how do you invest your money?" He answered, "I keep my money in Treasury bonds," to which the trader replied, "But Groucho, they don't make you much money." And Groucho responded, "They do, if you have enough of them!"

The financial media follows the minute-to-minute gyrations of stocks with rapt attention, but it largely ignores bonds. When investors talk about "the market" they tend to mean the stock market, and the most popular investment themes at any given time usually involve stocks. The stock market is entertaining and popular, but the often-ignored bond market is more than twice as large and is a more influential component of global economics than the stock market is ever likely to be.

In the aftermath of the 2016 US presidential election, the rally in stock prices garnered most of the media attention. However, at the same time there was a dramatic increase in US interest rates which sent shockwaves through global bond markets but went largely unnoticed by individual investors. Yields on the 10-year US Treasury bond rose from 1.86% the day before the election to

"The bond market will quietly have a more profound impact on world economies."

2.45% at the end of 2016. And, while higher interest rates may sound like good news for bond investors, the fact is that when interest rates rise, existing bond prices *fall* in response.

Here's why: Suppose Bob buys a bond that pays him a fixed 3% annual interest rate for two years. What will happen if the prevailing rate of interest suddenly rises to 4%? Clearly, Bob will want to sell his 3% bond and invest the money in a new 4% bond. The problem is, no reasonable person would buy Bob's 3% bond at its full face value when the going rate is now 4%. So, Bob must either sell his bond at a discounted price or keep it and earn a lower coupon payment for two years. Furthermore, if Bob owns another 3% bond that carries a longer, five-year maturity, the price of that bond will have to fall even farther to entice a buyer because it will pay Bob a below market rate for a longer period of time. So, while a higher interest rate means a higher *future* yield for bond investors, it also means a lower current price for their bonds.

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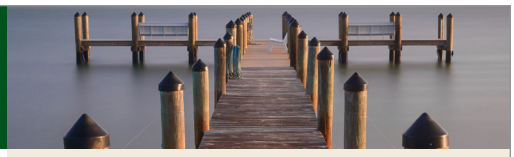

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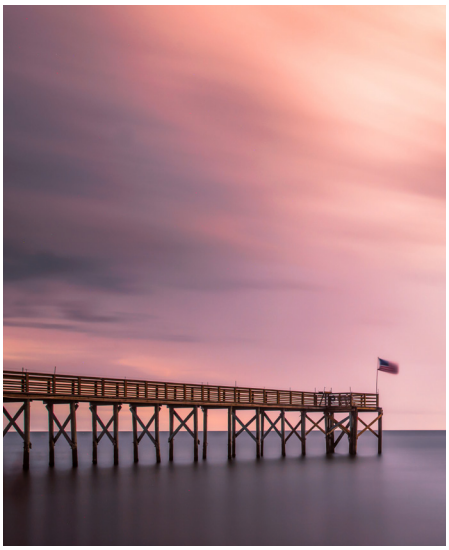
Why does this matter to you now? Well, if you have a company retirement plan or a managed brokerage or IRA account, you probably own bonds, either directly or through a mutual fund. Given the current market environment, there are a few things you must consider: First, although interest rates have been low for a very long time, this does not necessarily mean they must rise sharply in the near future. The bond market has already incorporated the policy goals of the Trump administration and any expected action from the US Federal Reserve, so future increases in interest rates must be driven by future surprises.

Second, low interest rates on high-quality bonds often entice investors to seek out higher yields elsewhere, but this is a potential trap that you need to be aware of. Any bond that offers high income does so only in return for higher risk, usually because the issuer of the bond has a significantly higher probability of not being able to pay you back. Buying risky bonds is acceptable if you understand and accept the risk you are taking; just keep in mind that there is no such thing as a "free lunch" in the bond markets.



Third, although bonds are currently offering low yields and they have risks that merit consideration, bonds are still an integral part of a well-diversified portfolio. Bonds tend to be far less risky than stocks and they provide income and stability during times of extreme volatility in the stock market such as the crisis of 2008.

Given this backdrop, what does the future hold for bonds? As global economics, politics, and interest rate policies play out, the capital markets will respond to any surprises. The media will faithfully report on the reaction of the stock market, but the bond market will quietly have a more profound impact on world economies. Higher interest rates in the US would likely be a signal of stronger domestic economic growth, but also of higher inflation expectations and larger budget deficits; lower rates would indicate the opposite.

Bonds are not quite as simple as they seem. However, as Groucho recognized decades ago, a well-constructed bond portfolio can add value through cash flow and protection of your portfolio. This remains true today, even if you don't own a lot of them.

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Heritage Investment Group would like to thank all of our clients for their continued support. We are here to help you plan for your future. If you have any family members or friends who might benefit from our help, we would welcome the opportunity to speak with them. Please contact us at 954-785-5400.

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