Heritage Perspective

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Stock Returns Are Driven by Risk, not Economic Growth

The recurring argument that strong long-term stock market returns are a thing of the past has cropped up again, with noted bond investment manager Bill Gross recently calling the stock market a "Ponzi scheme."

He argues that U.S. stocks returned 6.6 percent per year above inflation during the last century, while gross domestic product, a measure of changes in the country's production of goods and services, has grown by only 3.5 percent per year. "Somehow stockholders must be skimming 3 percent off the top each and every year," Gross writes. He believes the stock market cannot continue to offer such high investment returns in the future.

But GMO, an international investment firm with its U.S. headquarters in Boston, argues that stock prices do not necessarily coincide with GDP. In fact, the inflation- adjusted return of about 6 percent is reward for the pain of the occasional stock market crash, which usually comes at the worst possible time.

Stocks are inconvenient

The most likely explanation for the substantial premium that stocks seem to pay over inflation is the "extremely inconvenient times that equity markets tend to lose investors' money," writes Ben Inker, head of asset allocation for GMO. He says severe market drops tend to occur in "recessions (bad), financial crises (very bad), depressions (very, very bad), and major wars (not good at all)." These are precisely the times when investors are least equipped to stomach the decline in the value of their investments. In other words, stocks must offer higher returns in order to compensate investors for the unfortunate fact that stocks tend to have their worst periods of performance at the worst possible times.

Growth and low return

Investors have long been convinced that strong GDP growth in a particular country should correspond with strong stock growth. Inker says that was not the case in the 20th century. Japan, for instance, had the strongest GDP growth during that 100 year period, yet its market returns were below that of the United States, Australia, and Sweden, all of which had much lower GDP growth. This has occurred even though it seems to make sense that a growing economy would produce higher corporate profits, which would be reflected in higher stock prices.

Why then do stocks offer higher returns? Because "workers invest to fund their retirements," Inker says. In that case, they demand a high return to compensate for the risk that their portfolios will decline precipitously just at the wrong time.

Inker notes that the internet bubble of 2000 was the worst point of overvaluation in the S&P 500's history, and says the declines in valuation over the last 12 years "have been part of an essential healing process for U.S. equities." He says the idea that historic equity returns are no longer relevant is wrong. "Equities are very likely to be priced to deliver strong returns into the indefinite future," he concludes.

Heritage Investment Group would like to thank all of our clients for their continued support. If you have any friends or family members who could benefit from our disciplined investment process, we would welcome the opportunity to speak with them. Please contact us at (954)785-5400.

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Buffett's Investing Rules Stand the Test of Time

We admit to being suckers for advice from Warren Buffett, mostly because he has turned a small investment pool into one of the largest portfolios in the world since the late 1950s. Back in 1962 he sent one of his now-famous letters to the investors in his limited partnership. That letter contained advice that is still valuable today.

Predictions unnecessary

"I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20 percent or 25 percent, a few when it is minus on the same order, and a majority when it is in between," he wrote. "I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor."

Keeping cool was as relevant then as it is now. In 1962 the world was beset by the Cuban Missile Crisis, and investors saw the U.S. stock market drop by 23 percent in the first half of the year, including a 6 percent drop in one day. "Six months' or even one year's results are not to be taken too seriously," he wrote. He added that investors should judge "over a period of time, with such a period including both advancing and declining markets."

> *"...Buffett warned his investors that it was better to let their money grow than to spend it."*

Buffett is a long-time practitioner of value investing; buying stocks or companies at bargain prices so that they can be sold at a profit later on. He advised investors in 1963 to buy at a deep bargain, so that even a lousy sale price would bring a profit.

Let it grow

In the letter Buffett warned his investors that it was better to let their money grow than to spend it. "In no sense is any rate of return guaranteed to partners. Partners who withdraw one-half of one percent monthly are doing just that – withdrawing."

Buffett also noted that the key to avoiding permanent risk of capital loss lay not in hiding from market volatility, but in investing wisely "by obtaining a wide margin of safety in each commitment and a diversity of commitments." Buffett started investing in 1956 with $105,000; in 2012 Forbes placed his wealth at $44 billion.

Dollar-Cost Averaging vs. a Lump-Sum: Which Creates More Wealth?

One of the oldest tricks in the investment book is dollar-cost averaging (DCA). This technique suggests that investors will do well over time by slowly investing fixed sums of money into the markets at regular periods. By doing so they will take advantage of the low buying points while not putting too much money in at any one market top.

This is how many employees end up investing through their employers' savings plans; a specific percentage is deducted from each of their paychecks and invested into their accounts. Although many investors have been taught to invest this way over the years, its value is now being questioned by research conducted by the Vanguard Group, which runs the nation's second largest mutual fund company.

Let it all ride

Vanguard compared the dollar-cost averaging strategy against a "lump-sum" strategy in which all of a portfolio's assets are immediately invested up-front. Vanguard says its simulations of lump-sum vs. dollar-cost averaging in the U.S., British, and Australian stock markets since 1926 give the edge to lump-sum investing.

Vanguard said that, over a large number of simulated trials, investing the lump-sums immediately would have resulted in bigger portfolios two-thirds of the time. This seems to work because stock and bond markets rise on more days than they fall, Vanguard said. "We conclude that if an investor expects such trends to continue, is satisfied with his or her target asset allocation... the prudent action is investing the lump-sum immediately to gain exposure to the markets as soon as possible," the study's authors wrote.

The study compared two methods of investing. In one, the lump-sum is immediately invested into a portfolio of stocks and bonds. In the second, the money is invested in equal monthly increments over periods ranging from six months to 36 months. When each portfolio's results over the next ten years were compared, the lump-sum approach often did better, Vanguard says.

Why did this occur? Vanguard said it seems to be because when dollar-cost averaging into the markets, the temporarily non-invested portion is held in cash accounts. Over time stocks and bonds have beaten cash accounts, so holding money out of the market for any period of time tends to result in lower portfolio returns.

> *"...investing the lump sums immediately would have resulted in bigger portfolios two-thirds of the time."*

Vanguard noted that these results do not invalidate dollar-cost averaging within an employer savings plan. In that case the other alternative would be accumulating the small regular contributions to the plan into cash, and then at some point timing the market and investing it all. When investing through a retirement plan "investable cash becomes available only in relatively small amounts over time, which makes DCA a prudent way to invest," Vanguard says.

Emotional balance

However, it should also be noted that lump-sum investing works best when the investor can maintain an emotional balance for an extended period. If the investment of a lump-sum would cause regret if it was followed by an immediate market decline, and that regret would make an investor discard his original plan, then it might be safer to dollar-cost average the money into the market in order to keep the investor emotionally comfortable with the long-term plan.

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The Top Ten Money Excuses

Human beings have an astounding facility for self-deception when it comes to our own money. We tend to rationalize our own fears. So instead of just recognizing how we feel and reflecting on the thoughts that creates, we cut out the middle man and construct the façade of a logical-sounding argument over a vague feeling.

"The world is full of experts, many of whom recycle stuff they have heard elsewhere."

These arguments are often elaborate, short-term excuses that we use to justify behavior that runs counter to our own long-term interests. The following is a list of ten common and costly excuses that can have an adverse impact on our long-term financial success:

1. "I just want to wait until things become clearer."
It is understandable to feel unnerved by volatile markets. But waiting for volatility to "clear" before investing often results in missing the return that accompanies the risk.

2. "I just cannot take the risk anymore."
By focusing exclusively on the risk of losing money and paying a premium for safety, we can end up with insufficient funds for retirement. Avoiding risk can also mean missing an upside.

3. "I want to live today. Tomorrow can look after itself."
Often used to justify a reckless purchase. It is not either-or. You can live today and mind your savings. You just need to keep to your budget.

4. "I do not care about capital gain. I just need the income."
Income is fine, but making income your sole focus can lead you down a dangerous road. Higher income yield always implies higher risk.

5. "I want to get some of those losses back."
It's human nature to be emotionally attached to past bets, even losing ones. But, as the song says, you have to know when to fold 'em.

6. "But this stock/fund/strategy has been good to me."
We all have a tendency to hold on to winners too long. But without disciplined rebalancing, your portfolio can end up carrying much more risk than you bargained for.

7. "But the newspaper said..."
Investing by the headlines is like dressing based on yesterday's weather report. The news might be accurate, but the market usually has reacted already and moved on to worrying about something else.

8. "The guy at the bar/my uncle/my boss told me..."
The world is full of experts, many of whom recycle stuff they have heard elsewhere. But even if their tips are right, this kind of advice rarely takes your individual circumstances into account.

9. "I just want certainty."
Wanting confidence in your investments is fine. But certainty? You can spend a lot of money and forego a lot of opportunity trying to insure yourself against every possible outcome. A better strategy is to simply diversify your investments.

10. "I am too busy to think about this."
We often try to control things we cannot change, like market and media noise, and we neglect areas where our actions can make a difference, like the costs and allocation of our investments. The latter are worth the effort.

Because human nature drives us all to pull the wool over our own eyes, it can pay to seek independent financial advice from someone who understands your needs and circumstances and who holds you to the promises you made to yourself in your most lucid moments. Call it the "no more excuses" strategy.