Philosophy, Strategy and Discipline-Active View

Dear Valued Clients & Friends:

"Luck plays a big role. Athletes, poets and businesses get lucky. Hard work is critical, a good team is essential, brains and determination are invaluable but luck may decide the outcome." Phil Knight, *Shoe Dog: A Memoir by the Creator of Nike*

Philosophy - Lighthouse

An investment philosophy is a set of principles that guides all portfolio decisions. Once established, this philosophy then permeates through each subsequent investment decision. The philosophy becomes the lighthouse that investors look to for guidance. For the sunny good days, the lighthouse becomes a nice thing to have. However, during the stormy, foggy bad days, the lighthouse becomes a necessity. This cannot be a patchwork of ideas scrambled together to give an illusion of stability. It will be tested and it will need to be strong enough to weather some violent storms.

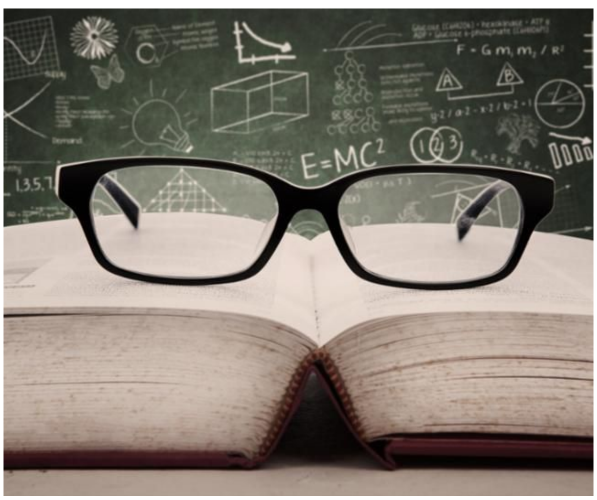
Investors can test the strength of an investment philosophy by how easy it is to explain. Those that have spent considerable time thinking and developing their philosophy will have a much easier time explaining it. We challenge you to think of the most knowledgeable professionals (teachers, doctors, chefs, salesman, etc.) you know. In their subject matter of expertise, we would guess the reason they appear knowledgeable is they can take the most complex ideas and make them simple. They can decipher the noise from the signal. Good investment philosophies should have this characteristic.

Luck and Skill

We continue to find value in using these newsletters to explain our investment philosophy. Yes, we as your advisors want to be seen as part of your lighthouse. However, there is additional benefit to be had by our clients and investors understanding our philosophy. Investors are frequently inundated with investment ideas. Being more knowledgeable helps put other investor strategies into proper context in order to quickly decipher the difference. This allows people to focus their energy on other important things. There is not an unlimited supply of energy and time that we have each day.

We have spent prior newsletters discussing behavior aspects of our philosophy. This month we are going to tackle market return expectations in the context of time periods. Beginning a new calendar year always brings with it forecasts for the future year. We thought this would be a good opportunity to contrast our philosophy with those trying to sell products or those selling the illusion they know what will happen this year in the markets. As the opening quote illustrated, we know what we don't know. We do not know what the market will do tomorrow, next week, or even this year. There is power in that statement. If someone (family member, friend, neighbor, other professional, etc.) tells you different, I would respectfully inquire about what information they have that makes their forecast feel more than a guess. The successful investor understands the limitations of forecasts. Warren Buffett has been quoted as saying, "*Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."*

The reason we stay away from trying to predict tomorrow's, next week's, or next month's market returns is they are heavily reliant on noise and might not be indicative of longer run expectations. We spend time evaluating the current market environment and historical structure of returns to arrive at expected long-term market returns. However, getting the forecast correct in the short-term probably has some degree of luck involved. Then the farther out on the time horizon we go, the more we would expect the realized returns to move towards those expected forecasted returns. Market returns over long periods should reflect the underlying economy.



An analogy I give my kids I think helps put this concept into context. They have an upcoming science test consisting of 10 questions. They study hard and believe they understand 90% of the 20 topics covered in the science book. The teacher can select the 10 questions from any of the 20 topics covered. Let's also assume that Anna and Drew have studied independently. If Drew gets an 80% on the test and Anna gets a 100%, does that mean that Anna knew the material better than Drew did. Or does it mean Anna was "lucky" and Drew "unlucky"?

Being an objective parent, I would tell them that if they only understood 90% of the material, their scores were very much in line with my expectations. By leaving 10% (2 of the 20 topics) of the material unknown, they were taking the risk that they might only know 8 of the 10 questions. Their score could be as low as 80% (miss 2 out of 10 questions). On the flip side, they could get "lucky" and have no questions on the unknown topics and get a 100%. I could tell Anna that her skill was worth 90% and luck provided the other 10% of the score. Drew's skill was worth the same 90%, however, luck cost him 10%. With fewer opportunities, the two students with the same skill arrive at very different results due to luck. If the teacher had asked 100 questions on those same 20 topics, I would expect Drew and Anna to receive very similar scores and begin to move to closer to their skill of 90%.

Investors are thus faced with a choice. The first option is to invest the funds based on projected short-term movements in the market and on current fears or excitement. There is no shortage of individuals and other professional advisors who will offer up their opinion on this short-term guessing game. Some of course will be right, which is what you would expect in a coin tossing experiment. Some will choose market higher (tails) and some will choose market lower (heads). The historical probability of the stock market rising in a day is about the same as flipping a coin or 50%. As you can see, this option's outcome is heavily reliant on luck. Trying to guess on a daily basis does not improve the odds either.

The second option is to do your long-term due diligence planning and create a plan based on long-term expected rates of return. This is done with the knowledge that in the short-term there might be higher ups and lower downs than the projected long-term average. However, the historical probability of the stock market having a positive return over 20-year rolling periods is 100%[1]. The "skill" of understanding long-term capital markets begins to overweight the short-term role of luck. Thus, achieving a negative return in this scenario could happen, but would seem to be very unlucky.

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[1] The worst S&P 500 Index 20-year annual rolling return from 1926-2016 was 1.89% (1926-1946). Data provided by Returns Web through Dimensional website. Indices are not available for direct investment and performance does not reflect expenses of an actual portfolio.

Strategy

Investments should not be classified as risky or conservative without considering the investing time horizon. As we have just illustrated, stock markets become much safer the farther out your investing time horizon is. Cash in the short-term is a very conservative asset. However, idle cash (not emergency cash reserve) in the long-term can become a risky asset. A risky asset being defined as an asset's ability to maintain purchasing power and not volatility. If the goal for the investment is to increase with inflation, cash begins to lose its value the farther out the time horizon you go.

Most investors understand that stocks can be risky. What they fail to understand is that diversified portfolio of stocks can become the more conservative inflation-adjusted investment the farther out on the horizon you are planning for. We hear from investors that are interested in becoming clients describe their portfolio as being "very conservative" over the years when in fact after adjusting for inflation they have had a risky portfolio.

Not all investors have a long-term horizon as their goal. They have personal constraints (funding certain project, expense, etc.) that have a shorter time horizon. The portfolio strategy will thus have to be adjusted accordingly for these types of expenses.

Not knowing what the future holds for you personally or what the short-term markets are going to do can cause inaction. It is easy to throw up the hands in frustration and saying why try if everything is unknown! However, this is not a strategy. Investors might get lucky and get a positive result. However, most likely that "lucky" result will lead to problems down the road. Not recognizing that the initial result was lucky, usually gives perception of skill when there was none. This leads to luck reversing itself and ending up in a worse position than the start (think dot-com investors in the 1990s).

Discipline

Having decided on a philosophy and strategy for investing, the final point is discipline. Discipline is not created in isolation. The best discipline is created well in advance of the good or bad times. It is built through the philosophy and strategy process.

- Do you know where the investment plan is the most susceptible to trouble?
- Under what circumstances would you doubt the integrity of the plan?
- What factors would cause you to change the plan?

Summary

As we begin a new year, it is important to reevaluate whether there has been a change in your personal circumstance that could change your strategy. Whether it is a change in your family, health or financial situation, this would warrant a review discussion.

Please do not hesitate to reach out to us if there is something you would like to discuss between normal meeting times. We appreciate your business and your willingness to share these personal insights with us in order to create, monitor and adjust your personal financial plans.

Finally, for those that are interested, we have posted on our website a more in-depth review of the 2016 stock and bond markets. This is a great resource showing specific market performance while also giving a broad overview of the past twelve months. To read that review, click here. We are looking forward to a healthy and successful 2017!

Matt Miler, CPA, CFP®