EMPYRION™
WEALTH MANAGEMENT

LOCAL FIRM, NATIONAL PROMINENCE

Issue #2 • Volume 13

The Monthly E-Newsletter

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February 7, 2017

Be a Winner: Be Passive

If I've said it to one client, I've said it to probably 1,000: Form an investment plan appropriate to your goals; make a long-term commitment to your plan; and—most important of all—stay the course.

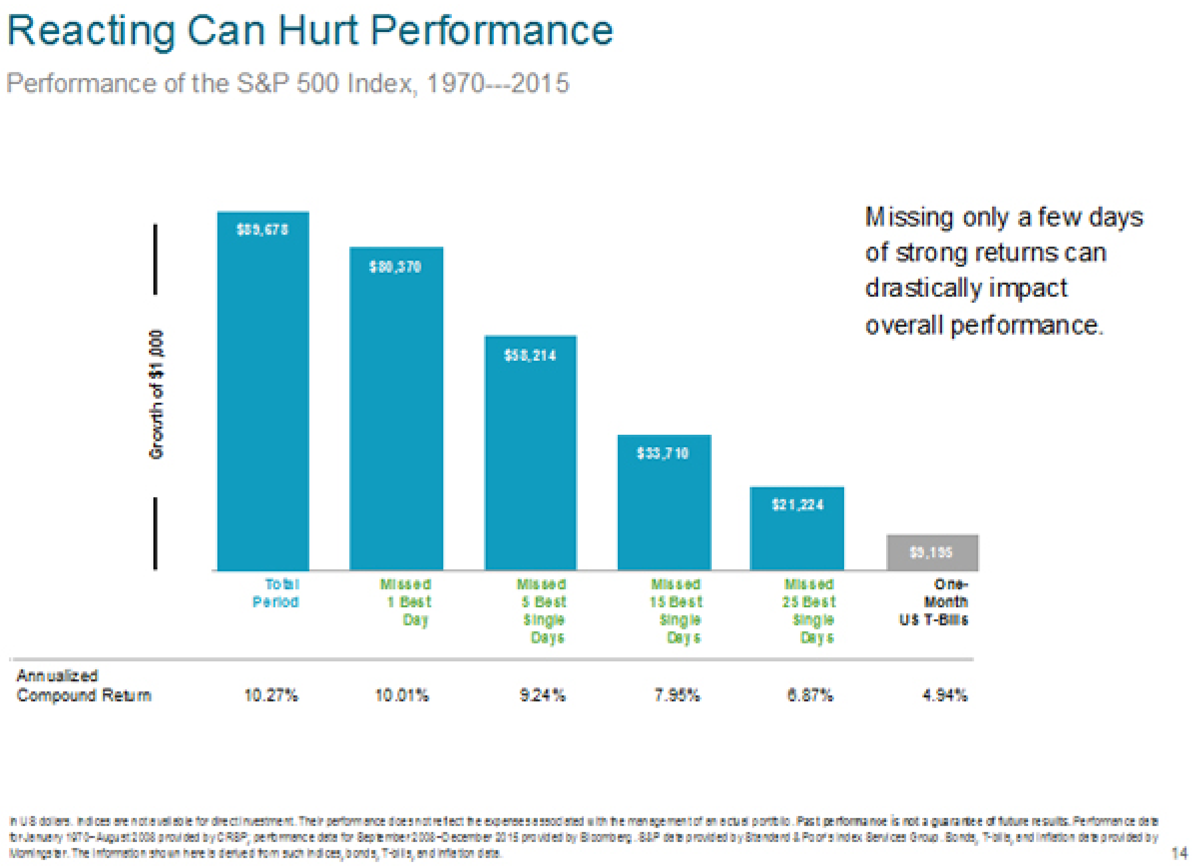
Why do I place such importance on the last step? Because in my experience, the number one reason investors fail to meet their financial objectives is because they fail to keep their focus on their long-term goals and instead succumb to the short-term fluctuations in market value that feed the greed-fear cycle. Invariably, investors who try to either chase a "hot tip" or those who lose their composure in the face of a market downturn will sacrifice dependable, long-term gains.

The Market Is Not the Enemy—We Are

One of the most famous examples of this phenomenon is featured in Wealthy by Design: a

Five-Step Plan for Financial Security (Kimberly Foss, 2013). From 1970 to 2011, the S&P 500 Index achieved an annualized compound return of 9.8%; $1,000 invested in 1970 and left in the market continuously would have grown to $50,662 by the end of the period. But an investor who tried to sidestep downturns in the market and, as a result, missed just a single one of the market's best days would have seen her return decrease to 9.51%, or a total value of $45,431. From there, it gets worse: if you missed the five best days, your return dropped to 8.68%; missing the fifteen best days got you 7.28%, and if you missed the market's twenty-five best performing days, your return dropped to 6.11%, or a total value of $12,068—slightly better than you could have done by just buying one-month T-bills.

And the principle still holds true. Take a look at the following chart, which updates the information I just presented for the period 1970â€“2015:



<<caption: Courtesy Dimensional Fund Advisors, used by permission>>

"But," you say, "there's no way I could be unlucky enough to be out of the market on the single day that was best-performing." Well, that depends; want to guess when the single best day of returns in the S&P occurred, from 1970 to 2011? It was October 13, 2008. Does that sound familiar? It should, because on October 10, 2008, the Dow plunged nearly 700 points, to its lowest reading in more than five years. It recovered slightly by the end of the day, closing down "only" 120 points, but this came at the end of a week when the DJIA had lost some 1,900 points: the worst decline in points and percentage of value, in the history of the exchange.

Now, imagine yourself, just three days later, facing the prospect of buying stocks—or even buying a stock-index mutual fund. How do you think you would have felt? If you answered, "Scared to death," you would be, by far, in the majority. And indeed, thousands upon thousands of investors missed the single best day in the market for the last four decades at that time, because fear of a market meltdown kept their money on the sidelines.

Let's look a little more market history. The best one-month return for the S&P during the period above was October 1974, which immediately followed the second-worst one-year period in the market's history. Nine of the twenty-five best days in the market fell between September 2008 and February 2009, a period during which the S&P fell 41.8%. Needless to say, this was a time when "the common wisdom" dictated that investing in the stock market was pretty close to financial suicide.

Do you still feel confident in your ability to be invested at the times of peak market return? The fact is, very few people possess the ability to keep emotions out of their investment decisions. After all, our emotions have evolved over thousands of years in order to keep us alive. When a large carnivore suddenly appears, that burst of panic and adrenaline can keep you from becoming dinner. But that same sense of fear and panic rarely helps you make a sound financial or investment decision.

That is why I counsel my clients, over and over again, to "stay the course"—which some might refer to as "passive investing." But in this case, "passive," over the long haul, most often means "successful." By forming a plan that fits their goals, by diversifying their portfolios in appropriate ways, and then by staying invested and maintaining regular, disciplined evaluation, my clients can avoid the most common pitfalls of emotion-driven investing.

Is Passive Investing Anti-Capitalist?

A recent AllianceBernstein client note took aim at so-called passive investing. Titled "The Silent Road to Serfdom: Why Passive Investing Is Worse Than Marxism," the article equates passive investing—especially the "indexing" approach that seeks to create portfolios that mirror market indexes like the S&P 500, the Wilshire 5000, or the NASDAQ—with the philosophy of central economic planning, such as that practiced in communist countries, since such an approach supposedly divorces the movement of capital from any active attempt to determine or judge actual value. This reflects the classic debate that often takes place among financial theorists, typically after a few beers: "If everyone is a passive investor, what's the point of having a market?" In other words, if everybody is just "buying the market," the market has no meaning.

Now, we're a long way from this rather abstract theory having any real influence in the day-to-day world of investing. First of all, by current estimates, only about a third of all investing is indexed. Given the fact that index funds have been around since 1975, we've obviously got quite a way to go before we need to start worrying about passive investors smothering the markets. In fact, according to Vanguard—the firm that launched the first index fund, back in 1975—on any given day, something like 5â€“10% of trading volume comes from index funds.

The other important thing to consider is that most often, those who warn of the evils of passive investing are also in the business of selling investment research geared toward active investors. In other words, as Clifford Scott Asness suggests in his article, "Indexing Is Capitalism at Its Best," when somebody tells you that you really need a haircut, you might want to see if that advice is coming from a barber.

"Passive" and "Active": Two Sides of the Same Coin?

In real life, no investor is 100% passive, just as no investor is 100% active. At various times, for various reasons, every investor will be "active" at some point, if for no other reason than the need to rebalance a portfolio in order to maintain an allocation strategy or to make a strategic liquidation as part of a financial plan. On the flipside, every investor will pursue a "passive" strategy for some period of time, simply because most trading strategies dictate at some point that certain holdings should be retained in order to maximize value. In a May 31, 2016, interview with Barry Ritholtz, Burton Malkiel, author of the classic A Random Walk Down Wall Street, says, "That's the wonderful thing about capitalism. If you have free markets and somebody can jump into the markets if there is an opportunity, you can count on the fact that somebody will â€¦ If in fact it was the case that markets were getting less and less efficient in reflecting information, believe me, there would be a profit motive for somebody to jump in."

The bottom line, and what I continually stress to my clients, is that you should have a plan, and you should stick to it. Most often, "staying the course" in this way involves an approach that could be characterized as "passive": avoiding emotionally driven moves, and instead continuing to pursue the agreed-upon strategy until the goal is achieved.

Most would probably call this "passive." My clients call it "winning."

Stay Diversified, Stay the Course!

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