The Financial Navigator - April Newsletter

Welcome to the spring edition of the Financial Navigator. In this issue we discuss three topics:

1. Actively managed funds vs. index funds, are the higher fees worth it?
2. Steps to take in a volatile market.
3. Should I buy gold now?
4.

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Actively managed funds vs. index funds, are the higher fees worth it?

There is an ongoing debate in the investment community concerning the value provided by actively managed mutual funds vs. index funds. Actively managed funds are run by investment managers and a team of professionals. Hopefully over time through their extensive research and skillful stock picking they will outperform the market.
Index funds and Exchange Traded Funds, ETFs, mimic an index such as the Dow Jones Industrial Average, the Standard & Poor's 500, or Russell 2000 to name a few common indexes. These funds do not employ teams of analyst and investment managers; the fund blindly follows its respective index regardless of the economic environment.
The essence of the debate concerns the fact that even though actively managed funds charge 6-10 times more in fees than index funds, over time they do not outperform the index. According to numerous studies on investment returns, on average about 75% of investment managers lose to the competing index fund over the time period measured. However, active managers claim now, as in the past, their real value shines during bear markets as they can nimbly pick and chose the right stocks to buy, and avoid, unlike the index fund. Unfortunately the most recent results don't back up these claims, below are the numbers comparing S&P indexes to active managers over the past five years.

- The S&P 500 Index outperformed 68.6% of actively managed large-cap funds.
- The S&P Small Cap 600 beat 77.8% of actively managed small-cap funds.
- S&P's Mid Cap 400 index thumped 75.9% of actively managed mid-cap funds.
- The S&P Global 1200 index beat 70.1% of the actively managed global funds.
- S&P's bond indexes outperformed 75% of actively managed US bond funds.
- The only category where the majority of active mangers beat the index was in the area of emerging market bond funds.

This should matter to you as over time the excess fees you are paying the actively managed mutual fund add up and mean real money out of your pocket. For example, the average large cap actively managed mutual fund charges 1.25% of the assets you invest with the fund, while an index fund like the Vanguard S&P 500 fund charges 0.12%. To put this in context, let's assume you are investing $5,000/year in your 401(k), or IRA, over a 20 year period, and earn the average long-term market return of 10% (long-term being from 1926 to now). Assuming the actively managed fund and the index fund earn the exact same return you end up with the following account values after 20 years: active fund $248,734, index fund $282,501, a difference of $33,767.
The bottom line: consider the dull index fund before you buy into the Wall Street hype and invest in the latest and greatest fund manager as odds are it will likely mean more money in your account at the end of the day.

Steps to take in a volatile market?

Asset classes of all stripes from bonds, equities, and alternatives such as commodities, have declined dramatically over the past year. So what steps can one take now to relieve the anxiety and gain some control of the situation outside of placing all your cash under the mattress and praying? Below we offer a few simple planning rules that have proven to make a positive difference over time.

- Don't try and time the market as the evidence shows that most investors consistently get it wrong. According to a study conducted each year by Boston based financial research firm Dalbar, over a 20 year rolling period the average US equity-fund investor earned an annualized return of 4.5% vs. the S&P 500's 11.8% return. This is due in a large part because investors, chasing performance, shift money out of lagging funds and into hot ones at the wrong times. Or they sell at or near market bottoms and get back into the market when 'things look better'. In other words, investors tend to consistently buy high and sell low.
- Don't invest money you will need in the next 3-5 years if you can't afford to lose it. The down payment for the house, the car payment, or the college tuition payment that you need in a couple years should be in cash like instruments, not the stock market.
- Do add new money steadily over time, in good markets and bad, so that you "dollar-cost average" new cash into the market. This forces you to buy more when prices are low and less when they're high, thus avoiding the typical US investor 'buy high – sell low' approach.
- Don't let excessive fees eat into your returns, see above.
- Do pay attention to the after-tax returns of investments located in taxable accounts.
- Do diversify your portfolio mix with fixed income bonds, and other assets classes. Reduce the risk in your portfolio as you get closer to retirement by increasing the fixed income portion of the portfolio.
- Do develop an asset allocation appropriate for you and consistently rebalance your portfolio on a periodic basis. Rebalancing means that you are bringing the allocation back to its original state by selling asset classes that have increased in value and buying those that have decreased in value; in essence you are selling winners to buy the losers. Most investors in fact do the exact opposite as indicated by the Dalbar study.

Should I buy gold now?

Recently a lot people have asked about gold as an investment to buy now based on future inflation concerns. Curiously, there currently seem to be a lot more advertisements on the radio and TV promoting gold. It brings me back to mid 2008 when a lot of ads appeared for oil investment strategies as oil prices peaked in the $150/barrel range. Interestingly, 0il is now in the $50/barrel range and the ads have disappeared. Why do ads and articles in financial magazines promoting a specific asset class appear like clockwork **after** the particular asset class has had a significant increase?
Anyway back to gold, historically it has done well during times of extremely high inflation; however, it doesn't have a good track record of keeping up with moderate increases in consumer prices over the long haul. For example, today gold trades around $900 an ounce, little more than the price it commanded in 1980. If it had kept pace with inflation, gold would be selling at more than $2,000 an ounce today. Moreover, gold prices are very volatile; in the past year, they went from a low of $650 to over $1,000, and then fell halfway back again. And over the long run gold has been more volatile than the S&P 500 while providing a lower rate of return.
I can't predict whether inflation will be dramatically higher in the future, or whether gold will prove to be a profitable investment if purchased today. However, I would suggest that instead of dealing with a highly volatile investment like gold, a safer way to hedge against inflation is to buy Treasury Inflation Protected Securities (TIPS). TIPS are US government bonds that adjust the interest payment based on the consumer price index (CPI). As the CPI rises, so do the interest payments. You can invest in a mutual fund that specializes in TIPS, or buy directly from the Treasury at treasurydirect.gov.

For more information on these topics and more contact Azimuth Financial Planning at (603) 373-8793. Ask about our Rapid Assessment, a financial plan targeted specifically at your retirement and investment goals and focused to get you back on track.

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Azimuth Financial Planning LLC is an independent Fee-Only Financial Planning and Investment Management firm based in Portsmouth, New Hampshire. The principal financial advisor, Bill Simpson, is a Certified Financial PlannerTM (CFP®) and a member of the National Association of Personal Financial Advisors (NAPFA) an organization of fee only financial planners. As a fee-only advisor we are not paid commissions or fees of any kind by any product provider, mutual fund, or insurance company; we are paid solely by the client. This allows the firm to work for its clients in a fiduciary capacity; therefore, we will act in good faith and in the best interests of the client at all times as required by the NAPFA Fiduciary Oath we have signed.