The Financial Navigator – June Newsletter

With the racehorse *I'll Have Another* making an attempt to win the Triple Crown this weekend at the Belmont Stakes I thought it would be interesting to draw a comparison between betting on the huge favorite such as *I'll Have Another*, or a stock that is perceived to be a sure winner due to its past performance. It might be an interesting topic to you as many experts constantly recommend buying high growth "sure-fire" stocks, based on past performance; but will that approach provide a reasonable return? In addition, I borrowed an article from Weston Wellington of Dimensional Fund Advisors on 401(k) plans that discusses the perception among many in the press and academia that 401(k) plans are a 'failed experiment'. Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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The Cost of I'll Have Another [1]

The winner of the Kentucky Derby and the Preakness, racehorse *I'll Have Another* is trying to become the first horse to win the triple-crown since *Affirmed* completed the task in 1978. Think of *I'll Have Another* as a growth stock with four legs. With a brilliant bloodline and a huge fan base—he even has his own Facebook page— *I'll Have Another* is turning into the most popular racehorse since the legendary *Affirmed*. The horse's owners have now set their sights on the final leg of the Triple Crown, the Belmont this weekend. But unless you own part of *I'll Have Another*, you're unlikely to make much money from placing a bet on his fortunes; the odds of the horse winning are 3-5 to 4-5 depending on the odds maker. This means that for every $2 bet (the minimum bet at most tracks) you will make $1.20-$1.60 if *I'll Have Another* wins; not exactly a great payout.

That's the problem with (perceived) no-risk bets. The high probability of a win means your expected return is very low. It's reminiscent of the stock market. You can choose to buy highly priced growth stocks, the sort of companies in the newspaper every day. In the US, that might be internet retailer Amazon. In the five years from the end of April 2007 to the end of April 2012, Amazon has delivered a total return of nearly 280%, or more than 30% annualized. In the same period, the S&P 500 has had a total return of 5%, or 1% annualized.

According to Bloomberg, Amazon as of mid-May 2012 was trading at an actual price-to-earnings ratio of 185. In other words, it was offering an earnings yield of about 0.5%, which is even less than a five-year US Treasury note. Now, this is not to say that Amazon is incorrectly priced. It just means that, with the information at hand, investors are prepared to put a high price on its expected cash flows. In other words, they are prepared to accept a lower expected return for the perceived lower risk of owning a stock that is growing faster than the wider market.

This is similar to how gamblers in aggregate are prepared to accept a much lower return than the wider field for the perceived lower risk of putting their money on *I'll Have Another* in the Belmont. So why not back the favorite all day? Well, that could be a legitimate decision for some investors, if they are prepared to accept lower expected returns for lower risk.

On the other hand, there is strong academic evidence that there is a long-term premium for tilting your portfolio to lower-priced "value" stocks. You could think of these as the unknown horses—the ones with the wider odds. This is not to equate long-term investment with gambling. With the latter, the "house" always wins in the end. It is a zero-sum game. With the former, just because one investor wins does not mean another has to lose. The other distinction is that, unlike the racetrack, there is more than one winner on the stock market. It is just a question of how much risk you wish to take. Backing past winners means you forgo the chance of earning a bigger dividend on the outsiders.

And keep in mind that even if you put it all on the stock market equivalent of *I'll Have Another*, there is still no guarantee you will be rewarded. Even champion racehorses eventually lose. And by concentrating your bet, you leave yourself more exposed to specific risks related to that one entity. With long-term investment, you are better to spread your risk through diversification. Backing the entire field—or sections of the field—leaves you less prone to the risk associated with individual runners. Even better, you might want to buy shares in the company operating the racetrack. At least that way, you are assured of a share of the winnings.

Ultimately, a great company or champion racehorse is one thing. A great investment is another. *I'll Have Another* comes at a cost.

A "Failed Experiment"? [2]

Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.

Joe Nocera is a bright guy. Over the course of a lengthy career, the former Fortune executive editor has won numerous awards for excellence in business journalism and recently co-authored a penetrating analysis of the financial crisis (All the Devils Are Here: The Hidden History of the Financial Crisis). He now hangs his hat at the New York Times, covering a wide range of business-related topics.

Mr. Nocera also stands out for his willingness to discuss the sorry state of his personal finances, a startling admission for a world-class financial journalist. With his sixtieth birthday approaching, he recently revealed to readers that his 401(k) is "in tatters." Some of the culprits are familiar: a concentrated strategy during the technology boom put a big dent in his portfolio, and a divorce several years later inflicted similar damage. A third source of difficulty is harder to fathom—the decision to raid his 401(k) to fund a home remodeling project. Such behavior strikes us as the sort of short-term thinking journalists are so quick to condemn in the executive suite. Mr. Nocera acknowledges that good financial advisors provide sound advice regarding discipline and diversification, but he doesn't appear to have consulted one.

Mr. Nocera found a sympathetic ear in Teresa Ghilarducci, a behavioral economist at The New School. She was not the least bit surprised by his experience—most humans, in her view, have neither the skill nor the emotional stability to be successful investors. She finds the entire concept of a participant-driven 401(k) a "failed experiment."

Prompted by this tale of woe, I dug out twenty-three years' worth of 401(k) statements and surveyed the results for the first time. As a thirty-nine-year-old research director at LPL Financial, I was late to the starting line for the retirement race. I filled out the enrollment forms and devoted about three minutes to the task of selecting my retirement plan vehicles. When I opened my first 401(k) statement in March 1990, it showed a whopping balance of $195.26 from investments in three Putnam Equity mutual funds—two US and one global. (Mr. Nocera says he began putting retirement money away in the late 1970s, so he had at least a ten-year head start.)

After joining Dimensional in early 1995, I liquidated the Putnam funds and placed the rollover balance in Dimensional's 401(k). I don't recall what my thinking was at the time, but with seven equity funds in my account rather than three, it seems plausible that I devoted more than three minutes to the portfolio construction decision. Maybe six.

Over the last twenty-three years I have occasionally been tempted to fiddle with the allocation scheme, usually after some big move in the markets up or down. But I am skeptical of my capacity for self-discipline. What if a tactical decision to underweight small stocks or overweight emerging markets turned out to be right? Would I be tempted to make an even bigger bet the next time? I could find myself on a slippery slope leading to a one-fund portfolio. My preferred strategy, as a result, is to do nothing. Some might argue I have taken this slothful approach to an extreme, having never added a new fund to the lineup (no Emerging Markets Value?!), never tweaked the portfolio weights, and never rebalanced. Call it the Rip Van Winkle strategy—when you get the urge to do something, take a nap.

From a humble beginning, my account has grown to a generous sum over the past twenty-three years, although it hasn't always been smooth sailing. Using quarterly data, the overall value fell 12.8% during the technology stock meltdown (March 31, 2000–September 30, 2002) and suffered a thumping loss of 46.8% during the financial crisis (September 30, 2007–March 31, 2009), despite a stream of fresh contributions. But the recovery was dramatic as well—up 77.5% for the twelve months ending March 2010 and up another 23.5% for the subsequent year. The current balance exceeds the 2007 high water mark by a comfortable margin. This is not an exercise in self-congratulation, just an example of what anyone could have done by harnessing the forces of competitive markets.

Perhaps the 401(k), in its current form, is indeed a "failed experiment" for a substantial fraction of the workforce. Another interpretation is that the 401(k) was never intended as a centerpiece for retirement funding, and the enrollment process cries out for improvement. Participant outcomes might be greatly enhanced if choices were presented in a way that acknowledges persistent behavioral traits leading to poor decisions.

And when it comes to charting one's financial future, it appears even journalists skillful enough to unravel complicated financial puzzles can benefit from an objective second opinion.

Acknowledgments

1. Jim Parker, "Outside the Flags", Vice President-Dimensional Fund Advisors.
2. Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.