PREMIER ASSET MANAGEMENT
Caring for you and your future

CRAIG PULLIAM CFP®, AIF®, CLU, REBC | MICHAEL R. COMSTOCK CFP®, AIF®
WWW.PREMIERCARES.NET

April 2015

"On Beating the Market"

By Craig Pulliam, CFP® and Michael Comstock, CFP®

If we wagered that your portfolio didn't beat the market (the S&P 500 Index*) in 2014, we'd probably be right. Last year, the S&P was up over 13% (with dividends reinvested), yet *your* well-balanced portfolio would have been doing well to gain even 5%. Most of you would have been up 2-4%. So how do you feel about that?

The S&P 500 popped over 40 new highs last year, and we've been sitting in client reviews telling them that 3.9% was "actually pretty good." Really? How can that be? What happened to the other 10%?

Well, that missing 10% couldn't be had, not for anyone in a properly diversified mix (stocks, bonds, international, large-cap, mid-cap, small-cap, etc.). And since all our clients have portfolios that are diversified and are managed to mitigate risk, not a one of them approached that 13% mark of the 100% U.S. S&P 500 Index. Is that a failure on our part? We contend not, and our clients appear to understand this. Over any given period of time, certain parts of the global markets can be red hot, while others are tepid or even cold. Such was the case in 2014.

"[In 2014] . . . anyone owning some foreign stocks and bonds would have seen the return of their 'diversified portfolio' dampened considerably"

As stated, the S&P 500 returned 13.7% last year. Mid-caps did well too, up over 11%, and domestic small-cap stocks did so-so at about 5% (getting all that growth in the last quarter, though). But 2014 was largely a story of U.S. stocks only . . . the global EAFE Index* (Europe, Australia, Far East) was off -4.5% (FactSet), as most countries outside the U.S. (except India) were down, due in part to adverse currency exchange rates (the strong dollar hurt the exchange of local currencies).

Even the bond market was a U.S. success story compared to other global bond markets. The broad domestic bond market was up almost 6%, while global fixed income (ex-U.S.) was off -2.21% (Barclays Capital). Outside our borders, equity and fixed income were by no means a blood bath, but anyone owning some foreign stocks and bonds would have seen the returns of their "diversified portfolio" dampened considerably.

So, if you believe as we do that the U.S economy continues to improve (housing, job growth, retail sales, consumer sentiment, etc.) ,and that there are no discernable economic bubbles lurking whose bursting would send the markets into a freefall . . . why not consider putting all your chips on big U.S. companies? If the S&P 500 continues its run, then you'd be right there at the front of the pack, and not worrying about how strong the dollar is or what foreign bonds are up to. There is a certain allure to that logic . . . just go "all in", pick a cheap index investment or two, and kick back.

But the problem with this approach lies with what happens when things go wrong, when the U.S. markets falter, which they will surely do again at some point. History guides us on this point: if you were "all in", 100% in U.S. stocks, during the recession of 2000-2003, your account would have been down about -37% (S&P 500, Morningstar), and you needed 59% growth to get back to where you started. In 2008-2009 things would have been even worse . . . your 100% stock portfolio would have slid by -46% (you needed 86% growth to get back to where you were). In 2011, during the debt ceiling "crisis" and Greek economic meltdown, you'd have been down close to 19%.

Contrast the above with investing in a much more moderate and diversified mix which tries to reduce "down-side" risk (we use as a proxy the Dow Jones U.S. Moderate Portfolio Index**, Morningstar). The drawdown in such an investment from 2000-2003 would have been just -9% (versus the -37% above), and you needed only 10% growth to recoup. In 2008-2009, you'd have been down close to 30% in the moderate mix, needing 43% growth to get back to where you'd been at the start of that mess. But growing 43% to climb out of your deficit is a whole lot more palatable than needing 86%. JP Morgan reports that – after the 2008/2009 recession- an "asset allocation portfolio" would have recovered its pre-financial crisis value in under two years, while an "equity portfolio" (S&P 500) took three years.

This is why we don't get overly anxious about short-term underperformance. When compared to equity markets, we *expect* a diversified mix to have returns that are less volatile on the upside *and* on the downside. We will not be lulled into false confidence when things are good, trying to load up on what's hot (invariably the hot stuff cools off just as you buy it, it seems). Rather, by staying the course with a lower volatility, well-allocated mix, you increase your odds of getting better returns by having less damage done in down markets (not guaranteed, but historically this has been the case). Over the last 15 years, - even paying management fees of 1%- you'd have averaged 5.89% in the DJ Moderate Portfolio Index (Morningstar) versus 4.24% for the S&P 500 (with no management fee). An initial investment of $100,000 in the moderate mix was worth $236,000 at the end of 2014, while the S&P 500 investment would have been worth about $180,000 (had it been invested in a low cost index fund).

Theoretically, putting together a nice, lower volatility portfolio is not a very difficult exercise. But "simple" doesn't mean that it's easy to manage long-term. There is too much information and too many voices vying for investor attention. It's too easy to get thrown off track, listen to the wrong voices and make the wrong turn. Maybe you look at a period where you think you underperformed (say 2014) and you figure, "I've got to make that up." So, you dramatically shift your portfolio. With good intentions, you charge full speed ahead . . . just in time for Lucy to snatch the ball away, and you fall flat on your rear end, Charlie Brown. Maybe a major correction hit just as you went 90% stocks (we *are* sort of overdue for one). And when that happens, you figure, "I can't take any more losses" and go to cash . . . without realizing that –in the last 20 years- *6 of the 10 best days in the market occurred within two weeks of the 10 worst days* (Lipper data). And you miss them. Such lack of discipline is fuel to the portfolio death spiral that too many investors find themselves in.

". . . in the last 20 years- 6 of the best days in the market occurred within two weeks of the 10 worst days."

Trying to control only that which you *can* control is what's critical. We can't control markets, and we can't time them. If your goal is "beating the market", the odds are against you. You may have fleeting success, but as Terrance Odean of the Berkeley Haas School of Business stated, "The less you tinker with the details, the less you have the opportunity to screw them up." We can't pick the tops of markets, and we can't pick the bottoms, so why try? If you control your spending, control your saving, try to control portfolio risk by proper allocation/diversification, *and control yourself* . . . you will find that a happy consequence of all this is that –as you ride up market peaks and down troughs- you have a good chance of reaching your destination, and maybe even beating the markets occasionally.

**All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges, or expenses. Past performance does not guarantee future results.*

***The DJ U.S. Moderate Portfolio Index is a benchmark designed to assist in asset allocation, and tries to take no more than 60% of the down-side risk of the Dow Jones Aggressive Portfolio Index. It cannot be purchased directly by investors.*

Diversification does not assure a profit or protect against loss in declining markets, and diversification cannot guarantee that any objective or goal will be achieved.

Craig Pulliam and Michael Comstock are CERTIFIED FINANCIAL PLANNER™ professionals practicing at 112 Westwood Place, Suite 310, Brentwood, TN. They own Premier Asset Management and are registered representatives and investment adviser representatives with/and offer securities and advisory services through Commonwealth Financial Network: A Registered Investment Adviser, Member FINRA, SIPC. Fixed Insurance products and services offered by Premier Asset Management are separate and unrelated to Commonwealth.

We can be reached at 615-777-2125.
Back issues of our Commentary may be found at www.premiercares.net