Resolutions for Investing in the New Year

At this time of year, we often resolve to do better in various aspects of our lives. Making promises to eat healthier or exercise more top the list for how we will live better in the new year. But what about our investment behavior? What resolutions can we make to ease financial worries? Below, we explore the top three things that you can to do improve your investment posture in the coming year.

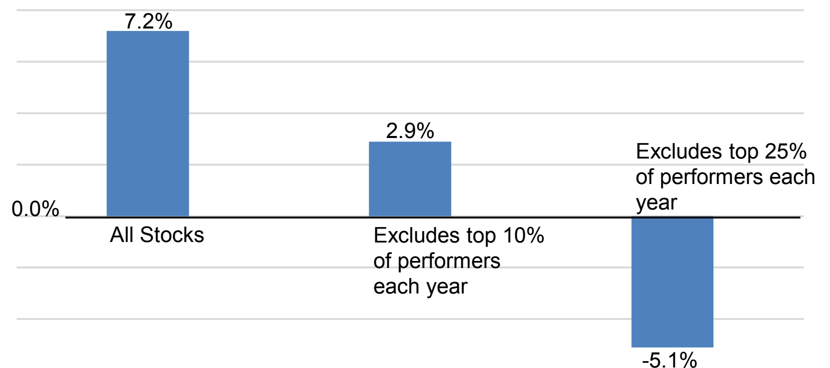
Resolution #1: Don't Chase the Top Performers - Diversify, Diversify, Diversify

A big investment story the last couple years has been the impressive performance of stocks commonly referred to as FAANG – Facebook, Amazon, Apple, Netflix and Google. These stocks have posted outstanding returns since their initial offerings, leading some investors to believe that this particular group has a large influence on the market. It is easy to draw this conclusion. Over the last ten years, the U.S. stock market has returned 13.4% while the U.S. market, excluding FAANG stocks, has returned 12.6%. Nearly one percentage point in overall U.S. market return over this time period is attributable to the gains of just these five individual stocks. [1]

Historically, a small subset of stocks often drives a large part of the overall market returns. From 1994 - 2018, global stocks returned 7.2%. However, when removing the top 10% of performers each of those years, the overall return was only 2.9%. [1] When removing the top 25% of performers, the return turns negative. See chart on next page.

One may think, "I just need to pick those top performers and I'm set." Unfortunately, research has shown there is no way to consistently pick the top performers. ***Since 1994, only one fifth of the top 10% performing stocks were in the top 10% the following year.*** [1]

In fact, in 2018 while the top performers included most FAANG stocks, Facebook tumbled 40% during the second half of the year and has fallen off the pace of the S&P 500 since mid-2018.[2] In 2019 Netflix and Amazon trailed the S&P500 by 8.5% and 10.6% respectively.[2]

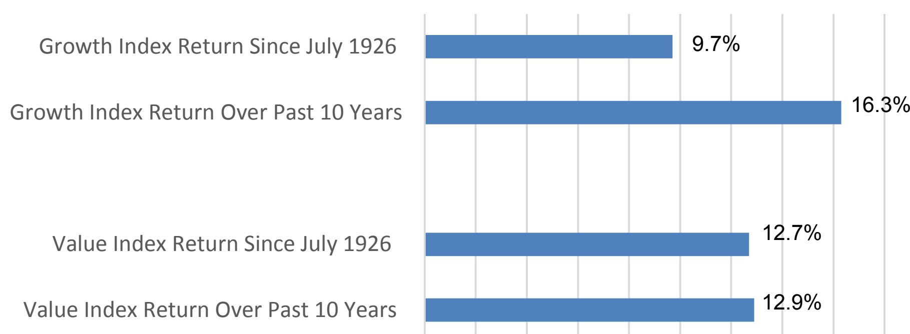


Because the top performers vary from year to year, it is best to hold a diverse set of stocks. In doing so, the likelihood of capturing the overall market performance driven by unknown top stocks increases. Additionally, since different market sectors surge while others fall, it is beneficial to diversify across sectors as well. Resist the urge to chase the today's hottest stock which could be a laggard tomorrow and, instead, continue to keep your portfolio diversified across various stocks and sectors.

Resolution #2: Stick with a strategy based on proven factors

At Sharper Granite, our portfolio models follow a proven strategy of emphasizing small and value stocks within portfolios. The investment benefit of these two factors is highly researched and supported by numerous studies. Eugene Fama, Nobel Prize Winning Professor of Economics at the University of Chicago, has proven that small-company risk is well compensated with additional returns. And by holding many of these stocks within low-cost ETFs and mutual funds, we also diversify away company-specific risk and lower the costs and tax effects of owning several companies.

Despite the long-term benefit of holding small and value stocks, value stocks – those trading at a low price relative to book value – have underperformed over the last ten years relative to growth stocks, those trading at a relatively high price compared to book value. The annualized compounded return from June 30, 2009 to June 30, 2019 for value stocks was 12.9% while for growth stocks it was 16.3%.[3] Does this mean that is time to abandon the value strategy?



Looking at a larger window of time provides a more consistent historical view. Since July 1926, the average compound annual return for value stocks has been 12.7%. This is consistent with what we have experienced over the past ten years. Growth stocks, however, have had an annualized compound return of only 9.7% since 1926.[3] See chart at left.

When it comes to investing, consistency matters. Consistent returns lead to larger portfolio growth over time due to the compounding effect.

Additionally, while stock returns are unpredictable, performance trends can change quickly. Consider the "techboom" and bust of the early 2000s. Growth stocks were similarly outperforming value stocks during that time. As of March 31, 2000, growth stocks had outperformed value stocks over the prior one, five, ten and 15-year periods. But exactly one year later, value stocks began a trend whereby their returns exceeded those for growth stocks in each of those periods. [4]

Despite the recent lag in performance for value investing, paying a lower price than the underlying value of a company translates to higher expected returns over time. History bears this out over the long term. Furthermore, switching strategies late may lead to missing out when the inevitable turn takes place.

Resolution #3: Ignore the noise, be confident in following your plan

Not only are we at the beginning of a new year, but we are also at the beginning of a presidential election year. The trade conflict with China continues, and a firm BREXIT is now pending. All this uncertainty coupled with boundless media predictions means you could be more likely to question your financial plans. Don't.

The market dislikes uncertainty, so we expect more volatility in times like these. And uncertainty of events is accounted for in your plan. The specific events may not be known, but effects on the market have been studied for decades.

> ***"…anyone using public information for investment decisions can expect a payoff 12% lower than those using no media information"***
>
> - John Morgan, Economics Professor
> UC Berkeley Haas Business School

And as each year turns, countless stories emerge on where markets are headed. While the media is touting the latest investment idea, it may be challenging to stick to your plan. FOMO (fear of missing out) is a strong psychological driver for action. However, countless studies show that switching course based on news and other public information leads to lower returns over time. In fact, U.C. Berkeley economics professor John Morgan has demonstrated that investors using public information for investment decisions can expect a payoff of 12% less than those using no media information. [5]

So, the next time you read a financial tip, trend or new way to invest, remember it is best to ignore the noise. With a little discipline, following these three resolutions will increase financial fitness throughout the new year.

Notes and Acknowledgements:

1. Dimensional Fund Advisors, “How Markets Work and the FAANG Mentality,” November 2019
2. Total return on GBTC and indexes: MSCI ACWI, S&P 500, S&P Technology, S&P Energy, S&P Homebuilders, MSCI China, MSCI Japan, MSCI India, Barclays Aggregate U.S. Bond, December 31, 2019
3. Value stock performance is measured by the Fama/French U.S. Value Research Index. Growth stock performance is measured by the Fama/French U.S. Growth Research Index.
4. Dimensional Fund Advisors, “Value Judgements: Viewing the Premium Performance through History’s Lens,” October 2019
5. “Undermining Investor Decisions,” U.C. Berkeley Haas, 2016; “Experiments on the Social Value of Public Information,” 2012, Professor John Morgan, U.C. Berkeley Haas School of Business

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance. [Winter 2020]