First Ascent Asset Management

TEN FACTS CLIENTS NEED TO KNOW TO ACHIEVE INVESTMENT SUCCESS

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10 FACTS CLIENTS NEED TO KNOW

Behavior Determines Success

You can be invested in a portfolio that is perfectly designed to help you achieve your specific goals, but if you don't stay invested, your chances of reaching your goals will be diminished.

Investors usually abandon their portfolios because they were not properly prepared for the experience of investing. They simply don't understand the fundamentals and have unrealistic expectations.

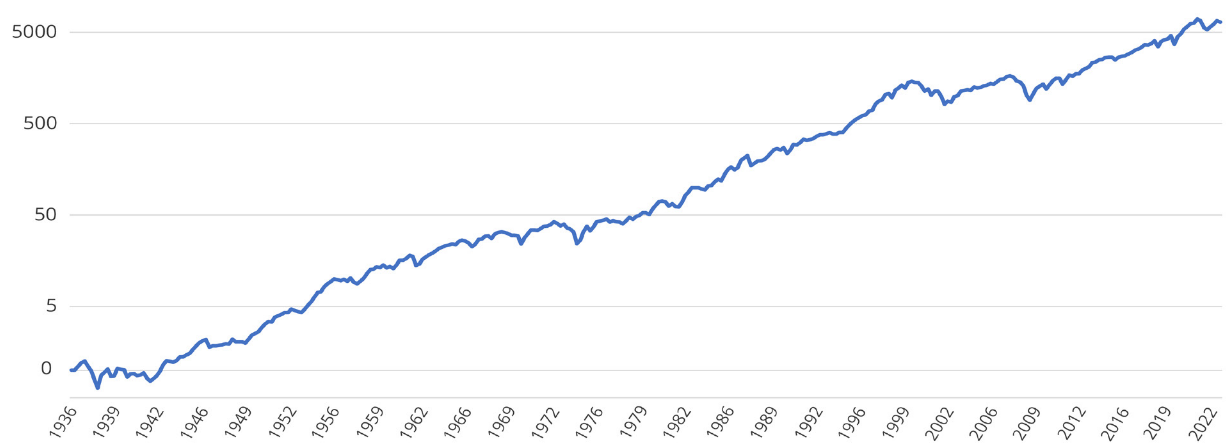
You don't need to become an investment expert yourself to achieve investment success. But you do need to know how to behave as a successful investor to maximize the likelihood of achieving your goals.

Understanding these 10 facts will help you on your journey to a secure financial future.

1. Over Time, the Stock Market Goes Up

From 1951 through 2022, the stock market rose on 53.6% of the trading days[1]. On average, it rises a little more on the up days than it declines on the down days. This pattern has produced a distinctively upward trend over the long-term as you can see from the graphic below showing growth from 19936 through 2022.

Growth of the US Stock Market
1936-2022



US Stock Market as represented by the S&P 500 index. Growth is shown on a logarithmic scale to more clearly highlight growth through history. Data Source: Morningstar.

This is not a coincidence. It reflects the fact that, on average, the earnings of the companies whose shares are traded on the market rise over time. If the humans at those companies are motivated and allowed to grow their businesses, the market will continue its upward trend.

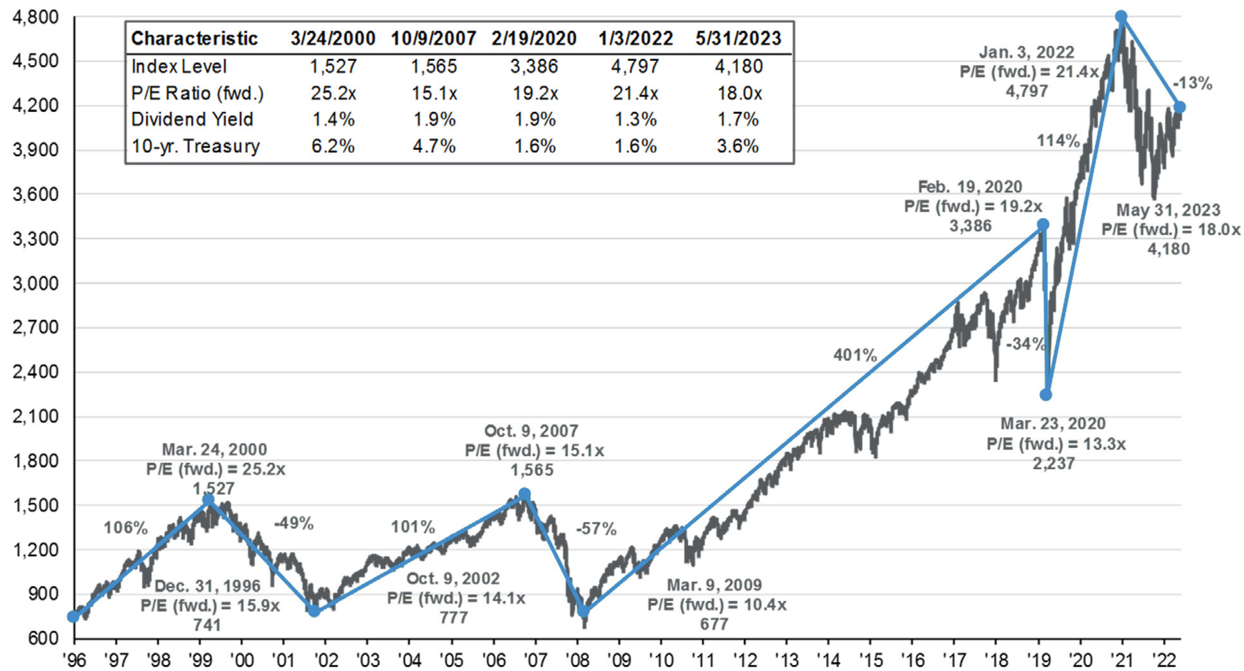
1. Easterling, E. (2023, January 6). Percentage positive and negative days across various periods. https://www.crestmontresearch.com/docs/Stock-Yo-Yo.pdf

2. The Ride Up Is Not a Smooth One

Viewing the upward trend of the stock market from a long-term historical perspective masks an unpleasant reality. A closer view shows that the market line often resembles a jagged saw blade that can cut the heart out of even the most seasoned investor.

Growth of the Stock Market

1996-2022



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	5/31/2023
Index Level	1,527	1,565	3,386	4,797	4,180
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	18.0x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.7%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.6%

Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.

Between 1928 and 2022, the S&P 500 has had 22 bear markets (market declines of at least 20%) and 24 bull markets (market gains of at least 20%). During that period, there have been over 33 "corrections," market declines of between 10% and 20% that occurred during bull markets.[2]

During periods of market volatility many investors forget about the market's historic upward trend. Instead, they become anxious and fearful.

This is understandable from a human perspective. The stress of market volatility triggers our deeply engrained fight or flight response. But it is not conducive to investment success.

Successful investors expect and prepare themselves mentally for the bumps. It's like flying in an airplane. If we travel long enough, we know we will encounter turbulence. But we deal with it because it is an unavoidable part of the journey to our ultimate destination.

2. Yardeni, E., Abbott, J., & Quintana, M. (2022). Stock Market Historical Tables: Bull & Bear Markets. https://www.yardeni.com/pub/sp500corrbeartables.pdf

3. You Can't Avoid the Bumps – You Must Prepare For Them

Everyone dreams of an investment process that has you in the market when it's going up and gets you out when it's going down. But, alas, such an investment process is just that – a dream.

Market timing seems like it should be simple because – like flipping a coin – there are only two alternatives. Either you are in the market or you are out of it.

But securities markets are complex adaptive systems driven by many variables. Economics, politics, acts of God, company-specific results, and human behavior all play a role. It isn't possible to consistently account for all these factors and the impact they have on the markets.

The problem isn't that market timing never works. The problem is that it works just enough to give you hope, but not enough to improve performance over the long-term.

A 2017 study by Wim Antoons, Market Timing: Opportunities and Risk[3], made the point. Antoons reviewed predictions made by 68 market timing gurus between 1999 and 2012. The data showed that 42 of the 68 gurus (61.8%) were accurate less than 50% of the time.

Antoon dug further into the predictions made by those timing gurus for the period 2005 through 2012 – a total of 6,582 forecasts. He found that "after transaction costs, no single market timer was able to make money." He concluded: "There are two kinds of investors: those who don't know where the market is going and those who don't know what they don't know."

The hard truth is there are no academic papers or rigorous examinations of market timing calls that support the consistent, long-term success of that approach to investing. There are, however, plenty that point out its shortcomings and document the hurdles to its success.

As legendary investor Warren Buffett put it: "…the only value of stock forecasters is to make fortune tellers look good."

3. Antoons, W. (2016). Market Timing: Opportunities and Risks. SSRN Electronic Journal. https://doi.org/10.2139/ssrn.2983997

4. Stock Market Performance Is Determined By a Few Good Days

A major obstacle to successful market timing is the fact that the stock market's long-term returns are driven by the market's performance on a few very good days. If you are sitting on the sidelines on these few precious days, your portfolio's performance could be decimated.

This graphic illustrates the point. It looks at an investment of $10,000 in the S&P 500 Index over the 20-years from 2003 through 2022, a period that includes over 5,000 trading days.

Effect of Best Market Days on $10,000

2003-2022

January 1, 2003 to December 30, 2022	Dollar Value	Annualized Performance
Fully Invested S&P 500 Index	$64,844	9.8%
Missed 10 best days	$29,708	5.6%
Missed 20 best days	$17,826	2.9%
Missed 30 best days	$11,701	0.8%
Missed 40 best days	$8,048	-1.1%
Missed 50 best days	$5,746	-2.7%
Missed 60 best days	$4,205	-4.2%

Source: J.P. Morgan Asset Management, 2023 Retirement Guide

An investor who remained fully invested during this period would have had an annualized return of 9.8%. Not bad for a period that included the Great Recession, Covid-19, and the largest interest rate tightening cycle in over 40 years.

But missing just the 20 best days (0.4% of the total trading days) would have cut that return by more than two thirds. Missing the 40 best days (0.8% of the total trading days) would have resulted in a negative return for the period. Less than one percent of the total trading days determined the difference between a solid positive return and a loss.

A market timer must correctly call each market downturn and then precisely time getting back into the market to avoid missing the handful of best days that provide most of the market's positive performance. Six of the seven best days occurred after the worst days. This is an impossible task and the consequences of failure are severe.

5. Stock Market Performance Is Determined By a Handful of Stocks

Research has also shown that the performance of the stock market is driven by a very small number of high-performing stocks. This is a counter-intuitive, but profound, revelation.

A paper[4] first published in 2018, and updated in 2023, by Professor Hendrik Bessembinder documented that the best-performing 3.5% of stocks explain the entire net gain for the stock market between 1926 and 2022. The other 96.5% of stocks collectively matched the performance of one-month Treasury bills and most of those lost money. Just five stocks – Apple, Microsoft, Exxon Mobil, Alphabet, and Amazon – accounted for 14% of the market's return during that period.

Other research has reached similar conclusions. A 2013 article[5] by Larry Swedroe states that between 1983 and 2008 the Russell 3000 index, which represents about 98% of the investable market, returned almost 10% annually. Yet during that period, about 40% of all stocks had a negative return and about 20% lost nearly all their value. Two-thirds underperformed the Russell 3000 index. Again, market performance was driven by a small number of stocks.

In the first half of 2023 the S&P 500 index was up almost 17%. Subtract the performance of just six stocks – Apple, Microsoft, NVIDIA, Amazon, Meta and Tesla – and the index was up less than 6%.

The point is clear. Once you understand the dynamics of the stock market's performance, you can see why it is so hard for stock-pickers to "beat the market." Your best bet is to stay broadly diversified to improve your chances of holding the handful of stocks that drive market returns.

4. Bessembinder, H. (2017). Do Stocks Outperform Treasury Bills? SSRN Electronic Journal. https://doi.org/10.2139/ssrn.2900447
5. Swedroe, L. (2017, June 7). Perils Of Owning Individual Stocks. etf.com. https://www.etf.com/sections/index-investor-corner/swedroe-perils-owning-individual-stocks

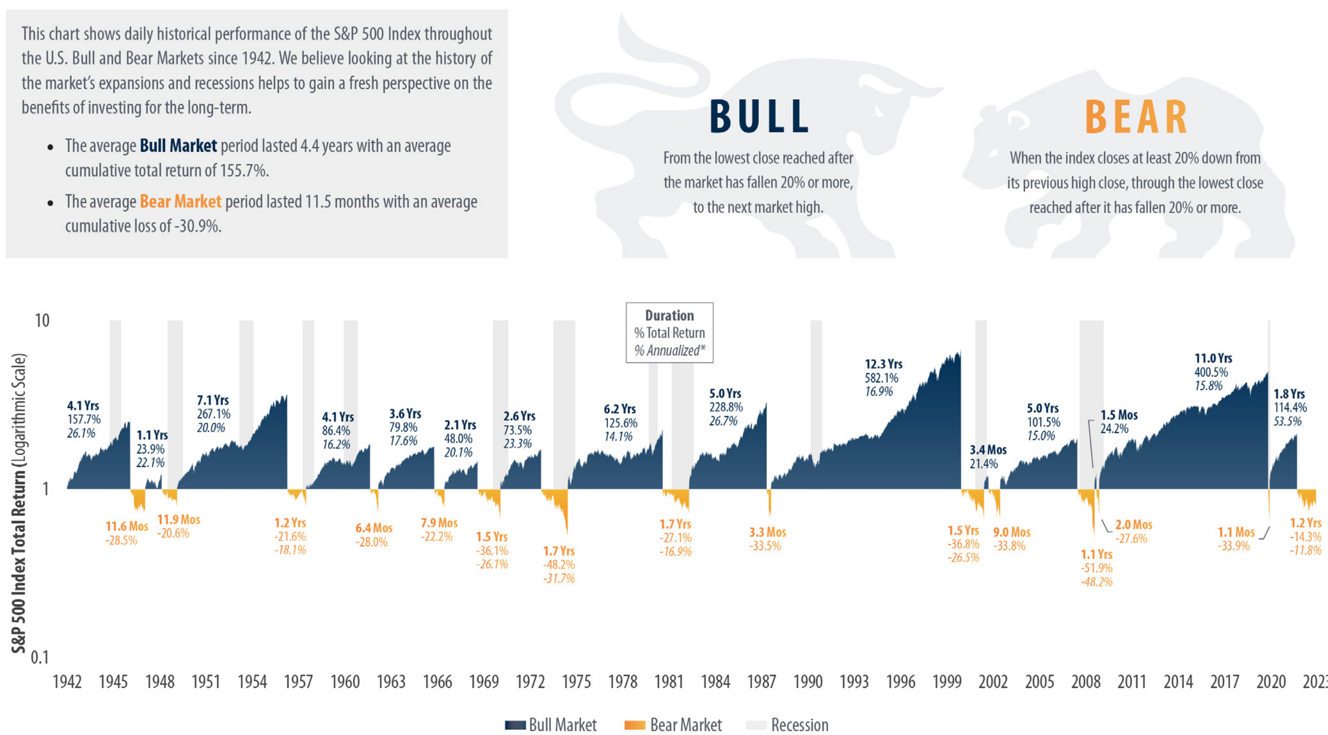
6. You Must Be Present To Win

The market timer's focus on missing the bad days puts the focus in the wrong place. It's far more important to be in the market when it is rising than to avoid the infrequent periods of market decline.

Although it may not be true in real life, in the investment world, bulls are bigger and more powerful than bears. The average bear market since 1942 lasted just 11.3 months. The average bull market lasted 4.4 years. Average losses from bear markets were a cumulative -32.1%. Average gains from bull markets were a cumulative 154.9%. The graphic below paints the picture.

A History of Bull and Bear Markets

1942-2022



Source: First Trust Advisors L.P., Bloomberg. Daily returns from 4/29/1942 - 3/31/2023. *No annualized return shown if duration is less than one year. Past performance is no guarantee of future results. These results are based on daily returns–returns using different periods would produce different results. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future.

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Simply put, bull markets last far longer than bear markets. The losses in bear markets are much smaller than the gains in bull markets. Painful as it may be, you are better off suffering through the down markets than missing the longer, stronger up markets.

7. Diversification Helps

Diversification means spreading the assets in a portfolio among different investments. Diversification works in two ways.

First, by putting our eggs in many baskets we reduce the impact on our portfolio of anything negative happening to any one of them.

Secondly, by intentionally combining investments with different performance characteristics, like stocks and bonds, declines in the value of one investment can be minimized or offset by smaller declines or even gains in another.

Diversification means there will always be some investments in the portfolio that are performing better than others. The components of the portfolio will cycle in and out of favor over time with each contributing during different market cycles.

It's natural to focus negative attention on the underperforming investments. Yet, it's more productive to focus on the performance of the overall portfolio. Investors reach their goals based on the performance of the sum of the parts, not the performance of any one of them.

The primary goal of diversification is to smooth out the returns of the portfolio. For most investors, a smoother ride increases their willingness to stay invested. Staying invested dramatically improves the likelihood they will achieve their long-term investment objectives.

8. Active Managers Rarely Generate Persistent Outperformance

Long-term investment portfolios are commonly constructed using mutual funds, exchange-traded funds (ETFs), individual securities, or some combination of them. Both the portfolios and their components are managed using one of two approaches: active or passive.

Passively managed portfolios are typically managed to track the performance of an index. For example, there are dozens of funds and ETFs that track the performance of the S&P 500 Index.

Passively managed portfolios make no effort to outperform the indexes they track. They simply purchase all or some of the stocks in the index they are tracking in an effort to mimic the performance of the index. They don't make qualitative judgments about which stocks to hold.

Actively managed portfolios have defined investment objectives and their managers have broad discretion in how to reach those objectives. Active managers make decisions about which securities to include in their portfolios and which to exclude. They make judgments about the future.

Both approaches to investing can have a place in helping investors reach their long-term financial goals. But investors should not expect active managers to outperform relevant benchmarks or their peers on a consistent basis.

For years, academics have studied whether superior past performance by active managers accurately predicts superior future performance. They found no evidence that it does.

In their SPIVA Scorecards, Standard & Poor's regularly tracks the persistence of active manager performance. As of June 30, 2023, S&P found that over the preceding year, 72% of all domestic equity funds had underperformed their benchmarks after fees. Over the preceding five years, 89% of all domestic equity funds had underperformed. Over the preceding 10 years, 90% underperformed.

Active managers that outperformed in one period were not necessarily the ones who outperformed in subsequent periods. Less than 1% of the domestic equity funds that were in the top quartile of performance for the one-year ended June 30, 2018 remained in the top quartile over the ensuing five one-year periods. Consistent outperformance is very rare.

Morningstar found that for the year 2022, only 43% of active mutual funds outperformed their relevant benchmarks after fees[6]. Morningstar also studied active mutual fund performance over two non-overlapping five-year periods. They found that a majority of the top quintile managers in the first period failed to qualify for the top quintile in the second.

That doesn't mean active managers can't add value, but it does mean that yesterday's top managers are unlikely to stay on top going forward.

6. Morningstar. (2022). "U.S. Active/Passive Barometer Year-End 2022"

9. Focusing On Low Fees and Expenses Makes a Huge Difference

Investment costs add up and compound over time. You don't just lose the amount you pay in fees – you also lose all the growth that money would have generated for years into the future.

Every mutual fund or ETF in a portfolio has an "internal expense ratio." This is the amount charged by the fund company for managing the fund. Those expense ratios can vary widely.

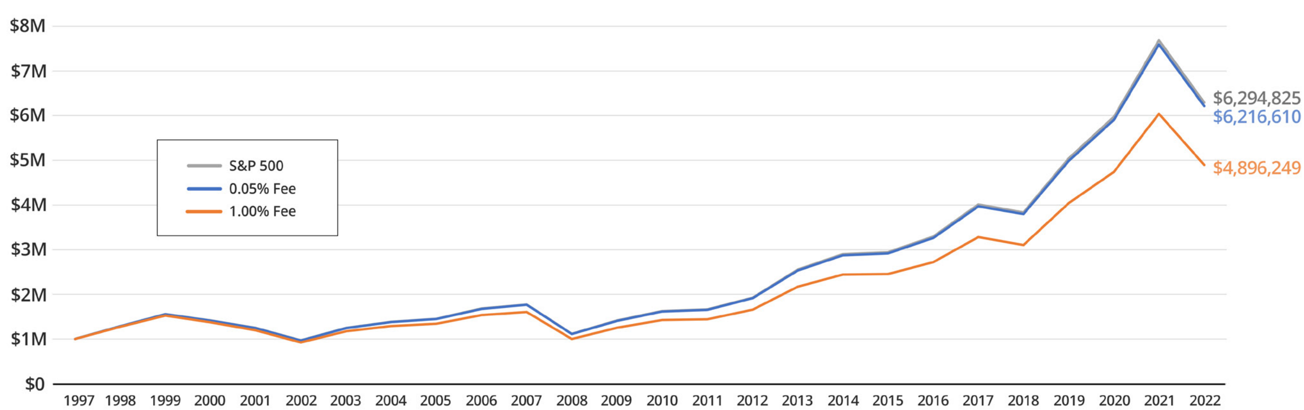
Mutual fund and ETF expense ratios are also a very strong predictor of future fund performance. A 2016 study by Morningstar[7] and a 2020 study by Vanguard[8] showed that, on average, in every asset class over every time period, the low expense funds outperformed the high expense funds.

Trading costs are also a drag on performance. Those costs may be highly visible, like commissions, or less obvious, like the spread between a bid and an ask price, but they are there, nonetheless. The more a fund buys and sells securities, the greater those costs.

Here's an example that illustrates the importance of minimizing fees and expenses. Dozens of funds in the Morningstar database track the S&P 500 Index. Many have internal expense ratios of 0.05% or less, while others have internal expense ratios of 1.00% or more.

The chart below shows the growth of $1 million invested in the S&P 500 index over the 25 years ending in 2022. It also shows the return you would have received if you had invested $1 million in an S&P index fund with a 0.05% expense ratio vs. a fund with a 1.00% expense ratio.

Growth of $1M
25 Years



Source: Morningstar and First Ascent Asset Management

The difference between investing in the low-expense versus the high-expense fund – $1,320,361 – comes out of your pocket. It could fund years of retirement!

7. Kinnel, Russel. (2016). "Predictive Power of Fees: Why Mutual Fund Fees are So Important"
8. The Vanguard Group. (2020). "Vanguard's Principles for Investing Success"

10. Nothing Works All the Time

There are general rules and sound approaches to investing that make sense over the long-term.

But none of them work all the time.

Regardless of the approach you take to investing, there will be times when even the best-constructed portfolio fails to achieve its objectives. When this happens, you may doubt the wisdom of your strategy. But it's important not to get frustrated and abandon your strategy.

Investing is a probabilistic exercise. You take actions that are designed to improve your odds of success over the long-term. But there are no guarantees, particularly in the short-term.

A good example is investing in the stock market. As we have seen, there are many times when the market declines in value. Some of those declines are quite dramatic.

Holding stocks during those periods feels terrible and can create doubt about the wisdom of that strategy. But the market has always turned around and rewarded the patient investor.

Here's another example. Over time, stocks provide higher returns than fixed income securities. But that is not always the case. Over the 13-years from 2000 through 2012, one-month Treasury bills outperformed the S&P 500 Index 2.1% vs. 1.7%.

There is also abundant research to suggest that so-called "value stocks" outperform "growth stocks." However, from 2002 through 2022, growth stocks outperformed value stocks.

In the short-term, there are no hard and fast rules – no sure things. But over the long-term there are approaches to investing that are more likely than others to produce positive outcomes. Be prepared for deviations from historic norms, some of which last a long time.

And Finally, Some Advice

Understanding the 10 facts above will help you develop the mindset of a successful investor. Here's some advice to go along with those facts.

You can't control the direction of the markets, but you can control how you react to them. Be patient and disciplined. Don't act based on emotion.

It takes knowledge and experience to develop and manage a solid investment strategy tailored to one's goals. But don't view investing as an intellectual exercise where the smartest person in the room wins. You can't outsmart the securities markets. However, by understanding how those markets work, you can learn how to behave in a manner that will improve the likelihood of a positive investment outcome.

Stay focused on your own personal goals. Don't worry about beating the market (or your neighbor), following the crowd, or acting on the latest hot tip from today's most popular guru. If you are making good progress toward your goals, you are a successful investor.