Investor Insights & Outlook

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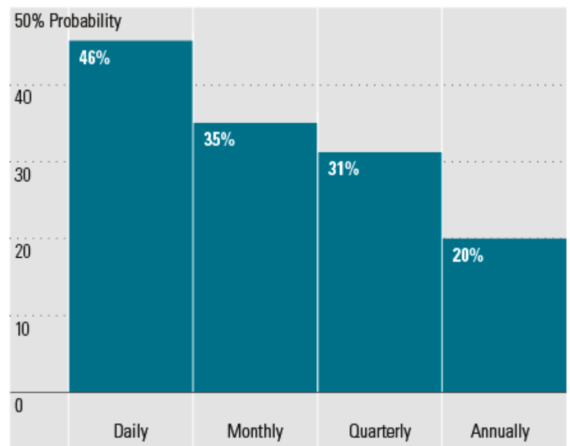
Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market
1994–2013



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

Garner Financial Management

info@garnerfm.com
925-282-5500
http://www.garnerfm.com

Advisor Corner

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Garner Financial Management utilizes global non-proprietary resources in order to design investment portfolios to meet all of your financial needs. We provide a customized and straightforward approach to financial growth, protection and management. Our fee-only structure is specifically designed to avoid conflicts of interest. As an independent advisor we utilize no proprietary investment products, and are free to select from all available investments. This investment process allows us to identify the most appropriate investment strategy and to focus on helping you attain your long-term financial goals.

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How to Beat the Market

Chances are, you've read articles saying that it is impossible to beat the market--that is, to consistently earn higher returns than the stock market averages. At a recent conference for industry professionals in Dallas, the distinguished economist Dr. Horace Brock offered a deep dive into economic theory, and told the audience that there are actually multiple ways to beat the market.

The first and most obvious way is cheating. If you have inside knowledge about a stock that nobody else possess, then you can make more astute trades than everyone else. The Securities and Exchange Commission has managed to catch a number of these criminals. You may have heard of Ivan Boesky, or Martha Stewart's famous phone call to her friend the founder of ImClone. Quest Communications chief Joseph Nacchio dumped more than $50 million of company stock in 2005 before his company went into decline. More recently, police are pursuing a massive insider trading case against a French doctor and FrontPoint Partners, who are accused of netting $30 million while trading on nonpublic knowledge.

Until they were caught, these "investors" (and Galleon Group hedge fund manager Raj Rajaratnam, Charles and Sam Wyly and certain Bear Stearns hedge funds) were making a lot more money in the markets than you and I ever will.

If you're not especially good at cheating, then you can rely on the second way to beat the market: luck. Don't laugh; there's evidence that most of the mutual funds that outperform the overall market in any given year just happen to be lucky. Their luck tends to lead to bad luck for investors, however. Investors have a tendency to assume that the fund managers who had great performance this year are brilliantly astute, move their money out of less-lucky funds, and then lose money when the managers' luck runs out and their funds underperform by roughly what they were outperforming before. Net-net, these managers had exactly as much bad luck as good luck, but many more investors were exposed to the bad luck period than the good luck period. Ouch!

You can also win the lottery, and some people are lucky enough to do so. Their "investment" return on that lottery ticket is astronomical; nobody can deny that.

Brock offered three other ways to beat the market, all of which rest on sounder footing. By way of background, he cited very complicated research by Mordecai Kurtz at Stanford which showed that almost 95% of the short-term market movements can be explained by two things: news and expectations. The news is pretty simple; suppose Intel beats the consensus estimate of its earnings next quarter by two cents a share. This can either send the stock price soaring or tumbling, depending on whether most investors expected the stock to miss its earnings estimate (therefore, the news is better-than-expected and the stock rises), or to beat its earnings estimate by more than two cents (bad news, the stock plunges). Bigger picture, the news might be that Greece has tumbled into default, causing a short-term plunge in stocks around the world.

But longer-term price movements depend on how the world changes more gradually, based on trends that are not obvious and seldom in the news. To take some of the more obvious examples: China abandons communism and gradually becomes the second-largest economy in the world. The Internet is born, and creates entirely new market dynamics. Europe adopts a new common currency, which sets in motion a lot of other changes for good or ill.

So how do you beat the market? If you are slightly more astute about understanding the business implications of these trends than the average person, Brock told his audience, then it is possible, over the long-term, to position your assets more advantageously. Your secret sauce is thinking and reading--or investing with very thoughtful money managers who take a long-term view of gaining returns.

Beat the Market...(cont)

You can also beat the market by not following the herd. Brock said that new mathematical models of market bubbles and busts allow for what he called "the uneven distribution of mistakes," a world where most investors can be wrong about their expectations or evaluations, all in the same direction. Remember how people were flipping houses in 2007 and Wall Street firms were betting the world that housing prices would never go down? Remember the technology mania leading up to the 2000 Tech Wreck?

You can beat the market by holding a diversified portfolio (which will keep pace with the market) and systematically rebalance your investments regardless of what fearful or euphoric cries other investors are screaming outside your window. That way, when the distribution of mistakes is nearly 100% on the side of euphoria, you will be holding fewer stocks than the average investor and participating less in the inevitable bust. And when the distribution of mistakes is on the side of fear and nobody wants to own stocks, you're participating in the market and benefiting from the inevitable recovery.

These last two methods of beating the market are not nearly as exciting as cheating or winning the lottery. So if you want excitement, you can turn to the last way that Brock said markets can be beaten. Every Wall Street firm has active traders who stare at six or eight computer screens all day long, with their finger hovered over a buy or sell button. They house their trading servers in the same building as the mainframe servers that process orders for the New York Stock Exchange and Nasdaq, so their buy and sell commands will arrive milliseconds ahead of the competition. They study expectations, and then, as soon as news arrives, that instant, they make a trade that will be thousandths of a second ahead of other quick-twitch traders--and, probably, a few days ahead of the trade that you and I would eventually be tempted to make.

This quick-twitch trading arrangement doesn't always work out exactly as planned, however, which greatly adds to the excitement. Bruno Iskil, otherwise dubbed "The London Whale," managed to trade away more than $6.2 billion (with a "b") of the assets of JPMorgan in 2012, while Brian Hunter's quick reflexes on the keyboard ultimately cost hedge fund investors in Amaranth Advisors a total of $6.4 billion in 2006. Baring Brothers Bank collapsed in 1995 thanks to the fast and furious futures and options trading activities of Nick Leeson. Yasuo Hamanaka at Sumitomo Bank ($2.6 billion in losses), Jerome Kerviel at Societe Generale Bank ($6 billion), Toshihide Iguchi at Daiwa Bank ($1.1 billion) and Kweku Adoboli at UBS ($2 billion) all generated their share of excitement for the institutions that employed them.

The good news here is that it appears, based on sound theoretical evidence, that people CAN beat the market in a variety of ways. Some of them are legal, but only a few are safe. The safest methods also happen to be pretty boring--and, alas, they don't come with guarantees.

ETFs Versus Actively Managed Funds

Do we have a winner? Ever since passively-managed funds like exchange-traded funds (ETFs) came into being, there has been much debate about active management versus passive management. Research published by industry professionals presents different arguments. Some studies show that only a fraction of active funds beat their respective benchmarks. Other studies show that, while active funds have failed to beat their benchmarks, they do provide added-value when a disciplined approach is adopted over longer periods.

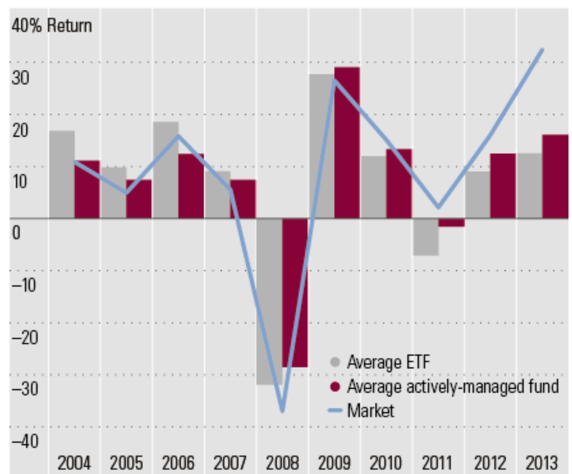
An exchange-traded fund strives to achieve a return similar to a particular market index. The ETF will invest in either all or a representative sample of the securities included in the index that it is seeking to imitate. ETFs provide passive diversification, are tax-efficient investment vehicles and have cost advantages. However, the return on an ETF is capped by the return of the index it tracks. Active managers, on the other hand, attempt to pick the best investments in the market and, if well executed, their performance is not limited by the return on an index. However, active funds are prone to style drift—the tendency of a fund to deviate from a particular investment style over time to improve performance. These modifications in investment style may be attributed to changing trends in the market environment.

Let's take a look at how the "average" ETF and "average" active fund performed over the last decade. The image compares the performance of the "average" ETF with the "average" actively managed mutual fund during the past 10 years. As evident from the image, in periods of poor market performance (2008 and 2011) when the market experienced negative or very low returns, the "average" actively managed mutual fund performed better than its passive counterpart. When the market experienced strong positive performance, ETFs fared better in some years (2004 to 2007, for example). In other years, actively-managed funds performed better (2012 and 2013).

Why is this, you may ask? One reason for this behavior is the underlying structure of active and passive funds. Passive funds like ETFs are designed to track a particular index or benchmark. This means that when the benchmark experiences poor performance, the ETF also fares badly. On the other hand, active managers may be able to quickly adjust their portfolios depending on the underlying market conditions. This may be one reason for better performance in down markets.

Making a choice between active and passive investing isn't an easy one. When deciding which style of management is better for you, it is important to take into account several factors, such as costs, style, risk, transparency of investments, manager performance, and tax implications. Consult your financial advisor to learn more about investing in ETFs and actively managed funds.

Performance Over the Past 10 Years



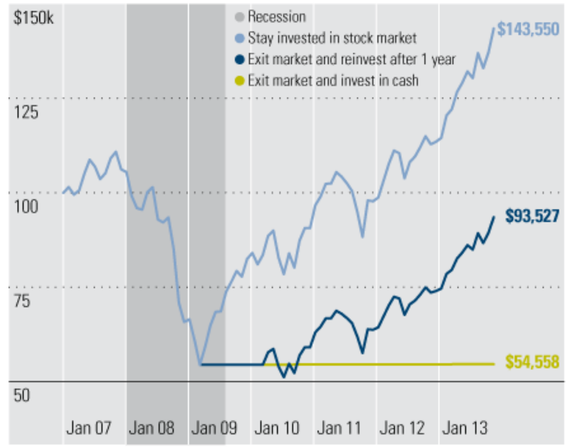
This information is for illustrative purposes only and not indicative of any investment. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Investors should read the prospectus and consider this information carefully before investing. ETFs are subject to similar investment risks as common stocks. An ETF's performance may not be exactly that of its underlying index. Past performance is not a guarantee of future results; holding a portfolio of securities for the long term does not ensure a profitable outcome. Investing in securities always involves risk of loss. An invested cannot be made directly in an index.

Source: The market is represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Average ETF and average mutual fund performance from Morningstar's open-end database.

The Importance of Staying Invested

Investors who attempt to time the market run the risk of missing periods of positive returns. The image illustrates the value of a $100,000 investment in the stock market from Jan. 2007 to Oct. 2013, which included the global financial crisis and the recovery that followed. The value of the investment dropped to $54,381 by Feb. 2009 (the trough date). If an investor remained invested in the stock market, the ending value would be $143,550. If the same investor exited the market at the bottom to invest in cash for a year and then reinvest in the market, the ending value would be $93,527. An all-cash investment would have yielded only $54,558. The continuous stock-market investment recovered its initial value over the next three years, and provided a higher ending value than the other two strategies. Investors are well advised to stick with a long-term approach to investing.

Ending Wealth Values After a Market Decline
January 2007–October 2013



Source: The market is represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Cash is represented by the 30-day U.S. Treasury bill. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs. Returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds or cash. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss.

GFM
Garner Financial Management
3595 Mt Diablo Blvd
Suite 290
Lafayette, California 94549
info@garnerfm.com
http://www.garnerfm.com
Tel:925-282-5500