KEATING
WEALTH MANAGEMENT

NEWSLETTER

4th Quarter 2018

This Too Shall Pass

This is a condensed version of a blog published in August 2018.
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If you've ever flown into Denver, you likely experienced turbulence—perhaps even extreme turbulence—because the airspace in and around Denver is some of the roughest in the nation. Even though frequent fliers know what to expect, the experience can still be distressing. It's rather like being an equity investor.

Although investors may worry about how any number of current events may affect the market, let's briefly address two that tend to be top of mind:

1. The current Trump-initiated tariff/trade wars
2. The length of the current economic expansion.

Tariffs and Trade Wars

Mr. Trump is not the first president, nor will he be the last—of either party—to fail to grasp the basic economics of international trade and/or choose to ignore them in favor of some political purpose. So be it.

And while it is undeniable that tariffs are effectively a tax, and therefore a drag on both earnings and productivity, over the last century, equities have still generated annual total returns of about 10%—regardless of the nation's prevailing tax and tariff policies. Frightening though the idea of a trade war may be, it's just one form of economic turbulence. Six months from today, the impending apocalypse du jour will be something else.

Economic Expansion Enters Tenth Year

According to data tracked since 1854 by the National Bureau of Economic Research, we are now in the second longest economic expansion in U.S. history. At 108 months, the current expansion just surpassed the 1961-1970 expansion of 106 months. The next milestone is 120 months, which was the length of the 1991-2001 expansion. Not only that, but the current bull market turned 9 years old back in March. At its current level of about 2,800, the S&P 500 is more than four times higher than its March 2009 bear market low of 677.

So we've got an early-stage trade war combined with the second longest economic expansion/bull market in U.S. history. Nevertheless, the only rational action for an investor to take is …*nothing*. That's right, do nothing. Here's why.

What It Means to Be an Equity Investor

The average annual drawdown for equities is 14%. Based on historical frequency, we're statistically overdue for a bear market—a stock market decline of at least 20%. Between 1947 and 2017, the S&P 500 had 11 such declines, about one every 6.4 years, with an average peak-to-trough decline of 34%. After each of these temporary declines, though, the equity market then resumed its permanent advance of both values and dividends.

Statistically, the average person will experience eight bear markets in a 40-year working career and six more in a 30-year retirement, but rational equity investors should be willing to ride out those declines. Why? Because over the long term—and which should be the relevant time horizon for most investors, equities

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International Equities Allocation: How Much and Why?

Once you have determined the appropriate allocation to equities in your portfolio, the next question is which securities you should own and why. There are countless ways to slice and dice the asset class: by size, by style (value or growth), by sector, by fundamental factors such as dividends and volatility, and so on.

All of that will likely amount to only tiny differences over a multidecade time horizon, so it's really just noise. Worse, emphasizing security selection reinforces some detrimental behaviors. The most insidious of these, for individual investors, is judging "investment success" by the relative performance of different types of equities, rather than overall progress toward the achievement of financial goals.

Your investment portfolio is a medium to fund your financial plan. And you own equities because, over long periods of time, they have been the best way to preserve and grow purchasing power. Since 1926, equities have a delivered an inflation-adjusted real return of 7% for large-company stocks and 9% for small-company stocks—double and triple the real return for bonds.

There's one more feature that distinguishes equities from all other asset classes: It's the only one that monetizes human ingenuity. Think about that for a moment.

You can own 3,654 individual U.S. equities and have exposure to stocks of all sizes through a fund such as the Vanguard Total Stock Market index mutual fund (ticker symbol VTSAX) or exchange-traded fund (VTI). With large-cap stocks comprising about 80% of the portfolio, mid-caps about 14%, and small- and micro-caps accounting for the balance, you can enjoy complete sector diversification at an annual cost of just 4 basis points (0.04%). Not to be outdone, in August 2018, Fidelity completed the race to zero by launching similar index funds that charge no fees at all.

But how do international equities fit into the equation?

We live in a global economy, and human ingenuity is not limited to the United States. There are dominant companies in developed markets such as Japan, the U.K., France and Germany, as well as in "emerging" markets such as China, South Korea and India. Given a world population of about 7.6 billion people, only about 4% of whom live in the United States, international equities offer you the opportunity to share in the profits of companies that serve the remaining 96% of the world. Diversification is a secondary but helpful benefit.

The much trickier question is what percentage of an equity portfolio should be allocated to international equities. Using market capitalization as a starting point, some academics recommend as high as 50%. But we suggest a mere 20%. To be sure, this is not a mathematically derived number. Instead, here are five factors supporting the reasoning:

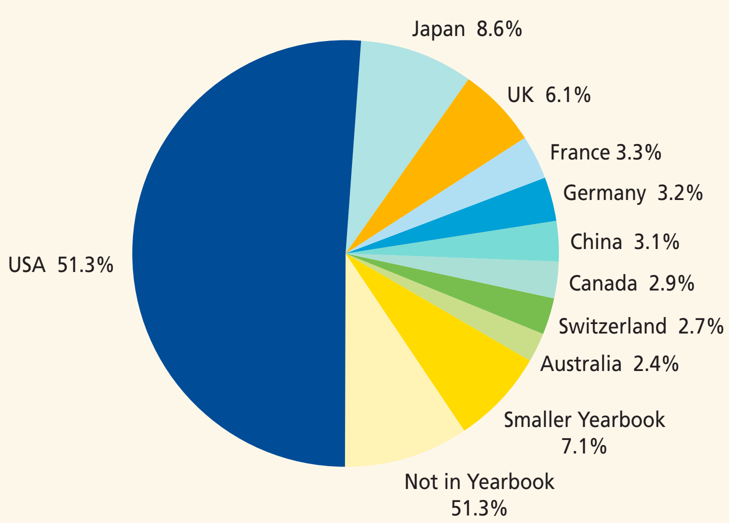
1. ***Market capitalization is a more relevant weighting consideration than gross domestic product.*** At about $19.4 trillion in nominal GDP as of 2017, the United States represents about 24% of the $79.9 trillion global total, according to the International Monetary Fund. At the same time, U.S. public companies accounted for about 51% of 2017 global equity market capitalization, according to Credit Suisse. (See image on the next page.)
2. ***Large American companies derive a significant share of their revenue from outside the United States.*** In 2017, about 43% of S&P 500 companies' sales came from abroad, according to Standard & Poor's. Since these large companies implicitly provide exposure to the global economy, an American investor can adjust the allocation percentage downward.

3. ***The long-term correlation of returns between U.S. and foreign equities is extremely high.*** For the 10 years ending in 2017, the correlation between the S&P 500 ETF and the MSCI EAFE ETF, covering Europe, Australia and the Far East, was about 88%, while the correlation between the S&P 500 ETF and the MSCI Emerging Markets ETF was about 80%, according to iShares. When you couple this high correlation with currency, economic and societal risks, Vanguard founder John Bogle argues that an American investor doesn't need to own any international stocks.

4. ***Most investors have a home country bias.*** The tendency to want to invest in one's own backyard is neither unusual nor surprising, and it's a worldwide phenomenon. Understandably, most people want to own companies whose products and brands they know and trust.

5. ***It's simple.*** This might be the most important reason of all. Round numbers are easy to understand and remember, and picking one avoids the fool's errand of trying to calculate a mathematically precise "optimal" allocation amidst widely diverging viewpoints.

Relative Share of World Stock Markets
(December 31, 2017)



Source: FTSE Analytics FTSE All-World Index Series, December 2017

As with your domestic equity allocation, ideally you should spend almost no time thinking about specific security selections. In addition to the endless ways of looking at U.S. exposure, geography and currency risk join the mix of factors to analyze when working within the relative performance mindset. It's an analysis that is not worth the effort when you can just buy the whole asset class very cheaply through an index fund.

As with our example for the U.S. market, there is a simple way to own the leading businesses of the rest of the world. Through either a Vanguard Total International Stock index mutual fund (VTIAX) or ETF (VXUS), at an annual cost of 11 basis points (0.11%), you can own 6,354 individual non-U.S. equities with exposure to Europe (about 43%), Asia (about 29%), emerging markets (about 21%) and Canada (about 7%). Fidelity recently launched a similar international equity index fund with no fees.

Now let's take a giant step back to put the entire issue into proper perspective. The percentage you have allocated to international equities is ultimately irrelevant to the long-term, real-life outcome you will experience as an investor. Here's what really matters, in order of importance:

1. Whether you have a date- and dollar-specific financial plan that is updated regularly.
2. Whether and to what extent you own equities rather than bonds.
3. Your ability to stick with your plan rather than succumb to panic and abandon it.

Collectively, we believe these three factors explain 95% of the benefits you will enjoy—or not, as the case may be. Choose wisely.

Behavioral Takeaway

Mental accounting occurs when a person views various sources of money as being different from others. Although compartmentalizing international equities may be convenient for analytical or segmentation purposes, the choice of *which* equities to own is substantially less important than the decision about *how much* of a portfolio should be allocated to equities, as well as the investor's ability to avoid costly behavioral mistakes.

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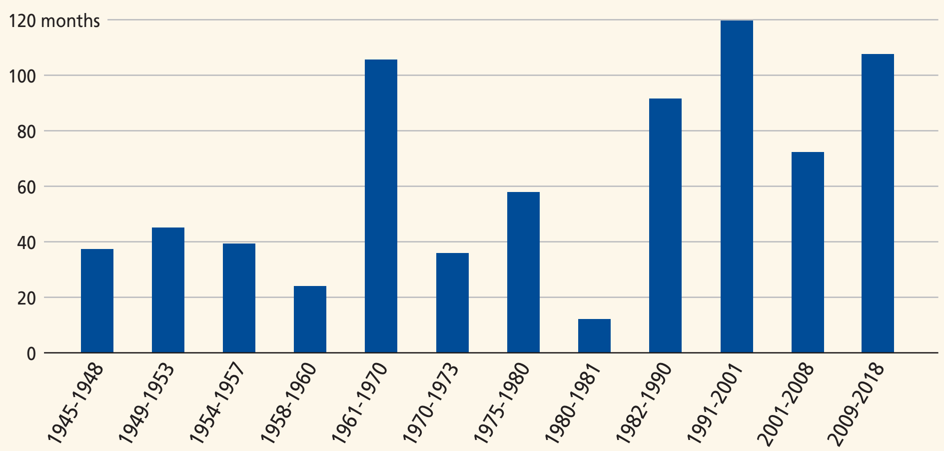
The current U.S. economic expansion is now the second longest in post-war history (108 months)



Source: FactSet

have compounded at a return 7 percentage points above inflation.

Thus, the biggest challenge that investors face is one of temperament. To be a successful equity investor, you have to be able to ride out both 14% average annual peak-to-trough declines and temporary bear market declines of about a third of your portfolio value every six years or so.

Most investors can't do it (i.e., sit tight and do nothing to their portfolios). Invariably, they sell low and buy high. And the consequences of such self-inflicted behavioral wounds are profound.

Consider this: For the 10 years ending June 30, 2018, the S&P 500 had a 10.2% annual total return, including reinvested dividends. But if you missed only the five best performance days in those 10 years (i.e., five days in total, not five days each year), your average annual total return would have been chopped by more than 4 percentage points to 5.8% per year. (Source: By The Numbers research)

A solid multidecade financial plan includes a cash reserve for emergencies and allocates funds for capital commitments occurring within five years to bonds. The remainder of the portfolio should be invested in equities, not in spite of volatility but because of it—which, after all, is the reason for the superior returns provided by equities.

If you receive a lump sum, whether through an inheritance or the sale of a business, for best results, statistically speaking, you should invest it in equities by nightfall, minimizing the chance that you will miss one of those peak performance days. If the fear of investing at what could be a temporary top is simply more than you can handle temperamentally, then average into the market systematically over some predetermined length of time. Although not mathematically ideal, it's better than the alternative of trying to time the market, which tends to provide the worst results overall.

Today it may be a trade war; tomorrow it could be rising interest rates or elections. But whatever happens, rest assured this too shall pass.

Behavioral Takeaway

Recency bias is the phenomenon in which a person most easily remembers things that have happened recently. It's easy to remember yesterday's news or the value of your portfolio from your latest monthly investment account statement, but it's harder to remember an important number from five or 10 years ago. Nevertheless, successful investing requires tuning out the short-term noise and adopting a long-term perspective at all times.

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