NORTHSTAR
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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

"Even before Christmas has said Hello, it's saying 'Buy Buy.'"

—Robert Paul

IN THIS ISSUE:

BEATING THE SPREAD

It's easy to pick sports winners. Without even looking at next weekend's NFL schedule, I'm going to pick New England, the 49ers, Green Bay, and the Saints. Will all four of those picks be winners? Maybe not, but if I follow a strategy of picking big favorites every week, I'm highly confident I will pick a lot more winners than losers.

Stock pickers do the same. They look at all the "teams" and select the ones they think will win. And often, the difference in teams is as stark as the contrast between the World Champion Patriots and the currently winless Cincinnati Bengals. Apple or Motorola? Easy. Netflix or Vudu? No contest.

So why is it so hard to turn "winner picking" into financial success? Simple: the spread. You can pick the 49ers to win this weekend, but you can't bet on it. If you try to place a bet, you'll see a number after the team name. Something like this: "San Francisco -8." The -8 is really important! It means if you place a bet on the Niners, you won't make any money unless they *win by more than eight points*. That means you could pick a team to win, they could win, but you could still lose your bet if the team wins by less than eight.

That's the spread. It's the adjustment that is made in recognition of the fact that more people will bet on the favorite than the underdog. While you get a "penalty" you must overcome if you bet on the favorite, you get an incentive to bet on a bad team. The same week, the Bengals' bet line might read: "Cincinnati +9." That means if you bet on the Bengals (currently ranked the worst team), they could lose and you could still win your bet, if they lose by less than nine points.

The bookmakers (or "bookies") who take bets on sporting events create the spread with one main objective: equilibrium. Specifically, they want the same amount of money bet on both teams in the matchup, no matter how evenly or unevenly matched the teams are. So if more money is being bet on the favorite, the spread will increase, while more bets placed on the underdog will shrink the spread. If the teams are evenly matched, the spread might be just a point or two, or it may be zero.

So the bookies set the spread and collect money from people making bets. If they set the spread right, they will have enough money to pay the winners. For example, they get $1 million in bets on the Ravens and $1 million for the Steelers. The Ravens are favored by 5, and they end up winning by 10. The bookies keep the money that was bet on the Steelers and use all of the $2 million collected to pay out to those who bet on the Ravens.

Except that isn't the exact math. If you lose your bet, you lose 100% of the money you put up, but if you win, you don't double up. The bookies keep a cut, which they call the "vig." Instead of paying out the whole $2 million to

the winning bettors, they may pay out only $1.9 million. The vig, the remaining $100,000, is the bookie's profit.

At its simplest level, the vig is why it is so difficult to make money on the sportsbook. The game is set up so you will guess right half the time. When you guess wrong you lose 100%, but when you win, you get something short of 200%. Keep repeating that long enough and you will eventually transfer all of your money to your bookie. Any other outcome would be driven purely by luck—or cheating. I don't recommend relying on either strategy, particularly the latter unless you know a doctor who is very good at bone setting.

Stock picking in the financial markets is similar, but presumably with less bone breaking. Picking Apple over Motorola is easy. But in this case, the bookies are the market makers who decide what the proper price is for a share of stock in every publicly traded company. In recognition of Apple's status of "favorite," they set the price higher than the price of Motorola, which has had disappointing results for many years. The goal is to get money flowing to both companies and, in a manner of speaking, to make half of your picks winners and half losers.

Thankfully, stock picking isn't usually a double-or-nothing game. Who would play if you expected half of your investments to fall to $0? But your winners and losers add up to your overall return, with winners giving you a boost and losers being a drag on your portfolio value. And whether you win or lose, the bookie takes a cut. The same math comes into play: Repeat that strategy long enough and watch your money move from you to your broker.

The less vig you pay, the better you can preserve, even grow your money. The obvious way to pay less vig is to play less. Make fewer bets, make fewer trades.

Investing offers a solution not available in sports betting: the option to *bet on every team*! If you bet on all 16 NFL games each weekend (not accounting for bye weeks), you'll have 16 winners and 16 losers, so you'll break even and pay 16 vigs. Zero percent chance of making money.

But if you "bet" on every publicly traded company by buying low-cost, diversified mutual funds, even after counting up all your winners and losers, and paying the vig, you could still end up making money, because the overall value of all stocks tends to rise over time[1]. Over some periods, it falls, but the historical trend over long periods has been upward, a trend we have no reason to suspect won't continue.

Many people think of investing in stocks as another form of gambling. If you do it wrong, by trying to pick winners, it is. But with a disciplined approach to diversification and lowering costs, it is reasonable to expect a positive return.

—Steve Tepper

[1] Past performance is no guarantee of future results.

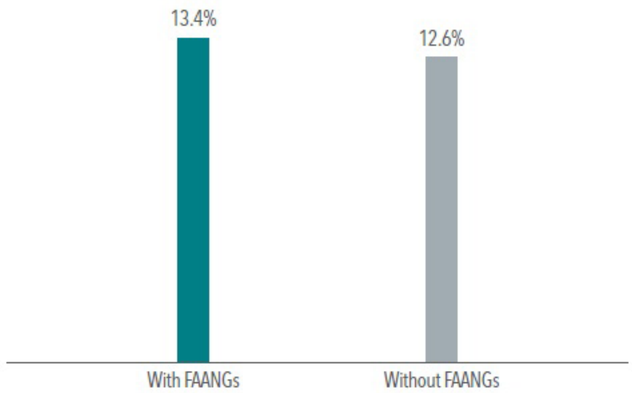
SOMETHING TO SINK YOUR FAANGs INTO

The stocks commonly referred to by the FAANG moniker—Facebook, Amazon, Apple, Netflix, and Google (now trading as Alphabet)—have posted impressive gains through the years, with all now worth many times their initial-public-offering prices. The notion of FAANG stocks as a powerful group holding sway over the markets has sunk its teeth into some investors. But how much of the market's recent returns are attributable to FAANG stocks? And does their performance point to a change in the markets?

Over the 10 years through December 31, 2018, the U.S. broad market[1] returned an annualized 13.4%, as shown in **Exhibit 1**. Excluding FAANG stocks, the market returned 12.6%. The 0.8-percentage-point bump resulted from the FAANGs collectively averaging a 30.4% yearly return over the decade.

Exhibit 1: A Little Help from the FAANGs

Annualized US market compound returns with and without Facebook, Amazon, Apple, Netflix, and Alphabet (Google), 2009–2018

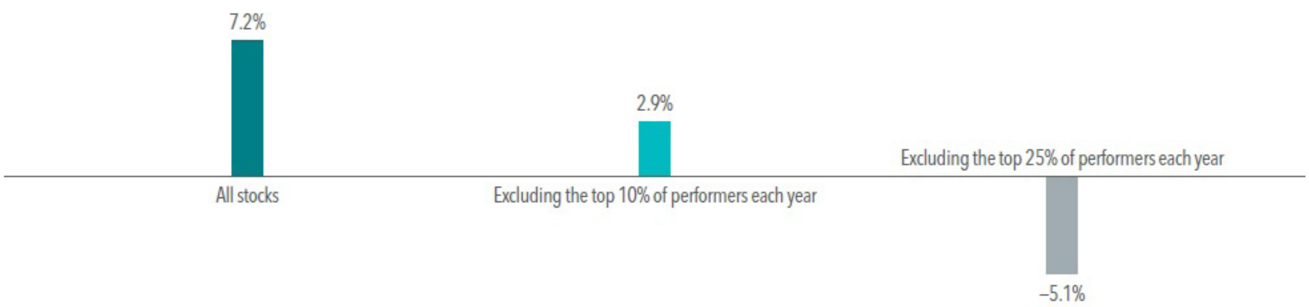


Source: Dimensional using data from the Center for Research in Security Prices (CRSP) covering the 10 calendar years since the financial crisis. With FAANGs portfolio formed each month including common stocks listed on NYSE, NYSE MKT, and NASDAQ. Stocks are weighted by market capitalization. Without FAANGs formed similarly but excluding Facebook, Apple, Amazon, Netflix, and Alphabet (Google). ***Past performance is no guarantee of future results.***

Investors may be surprised to learn that it is actually common for a subset of stocks to drive a sizable portion of the overall market return. **Exhibit 2** shows that excluding the top 10% of performers each year from 1994[2] to 2018[3] would have reduced global market performance from 7.2% to 2.9%. Further excluding the best 25% of performers would have turned a positive return into a relatively large negative return.

Exhibit 2: Weighing the Impact

Global stock market performance excluding top performers, 1994–2018



"All stocks" includes all eligible stocks in all eligible developed and emerging markets at their market cap weights. Eligible stocks are required to meet a minimum market capitalization requirement. REITs and investment companies are excluded. Compound average annual returns are computed as the compound returns of the value-weighted averages of the annual returns of the included securities. "Excluding the top 10%" and "Excluding the top 25%" are constructed similarly but exclude the respective percentages of stocks with the highest annual returns by security count each year. Individual security data are obtained from Bloomberg, London Share Price Database, and Centre for Research in Finance. The eligible countries are: Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Republic of Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, the UK, and US. ***Diversification does not eliminate the risk of market loss. Past performance is no guarantee of future results.***

This lesson also applies to capturing the premiums associated with a company's size and its price-to-book ratio. Research by Eugene Fama and Kenneth French ("Migration," 2006) provides evidence that these premiums are driven in large part by a subset of stocks migrating across the market.

Research has shown no reliable way to predict the top-performing stocks. Looking at the top 10% of stocks by performance each year since 1994, on average less than a fifth of that group has ranked in the top 10% the following year.

The tendency for strong market performance to be concentrated in a subset of stocks is therefore also a cautionary tale about the importance of diversification—investors with concentrated portfolios may actually miss out on the very stocks that deliver the best of what the market has to offer. An investment approach built around broad diversification can help achieve a more reliable outcome for investors over the long term—sharp acronym or not.

—From Dimensional Fund Advisors

[1] With-FAANGs portfolio formed each month including common stocks listed on NYSE, NYSE MKT, and NASDAQ. Stocks are weighted by market capitalization. Without-FAANGs formed similarly but excluding Facebook, Apple, Amazon, Netflix, and Alphabet (Google). Source: Dimensional using data from CRSP.

[2] The onset of broad coverage of all-cap stock data across developed and emerging markets.

[3] All eligible common stocks in all eligible developed and emerging markets, ranked by total return. Source: Dimensional, using data from Bloomberg LP.

SCHWAB–TD AMERITRADE MERGER

As you may have heard in the news, Charles Schwab and TD Ameritrade have reached an agreement for Schwab to acquire TD Ameritrade. The combined company will retain the Schwab name. The transaction is expected to close in the second half of 2020. During that time, there should be no impact for any clients who have accounts with either custodian.

We are committed to keeping your money custodied with high-quality brokerage institutions that give us confidence your accounts are secure and your trades are executed at best price and low cost. We expect the new Schwab entity to continue to provide us with that confidence going forward.

If you have any questions, please feel free to reach out. If you would like to learn more about the transaction, visit www.amtd.com for details.

YOUR YEAR-END FINANCIAL CHECKLIST

Here's our 11th annual Year-End Financial Checklist:

Employer-sponsored retirement accounts: To take a deduction for contributions to an employer-sponsored plan such as a 401(k) or a SIMPLE IRA, you must make your contribution through payroll deduction by the end of the year.

Your primary goal should be to save at least enough to earn any company match offered. Contribution limits for 2019 if you are under 50 are $13,000 for a SIMPLE IRA and $19,000 for a 401(k), 403(b), or 457(b) plan. If you are over 50, the limits are $16,000 for the SIMPLE and $25,000 for the 401(k), 403(b) or 457(b).

Charitable giving: Make your contributions (either of cash or donated goods) by the end of the year, and get a receipt from the charity.

Gifting: You can contribute up to $15,000 per recipient per year ($30,000 if married and filing jointly). This includes contributing to your child's 529 college savings plan. Note: Gifting is not tax-deductible, but gifting in excess of limits could result in a very high gift tax.

Required minimum distribution: If you are older than 70½ years at the end of the year, you must take a distribution from your tax-deferred retirement savings. This is important because the penalty for not taking your RMD is very high—as much as 50% of the amount you should have taken!

RMD rules can also apply to inherited retirement assets even if you are younger than 70½. There is a small caveat to all of this, however. The year you turn 70½, you can delay your distribution until the following year. But that would mean you would have to take two distributions that year (one for the prior year and one for the current year).

See the doctor: Most medical and dental plans offer free annual or bi-annual wellness visits. Of course, nothing is free—you are paying for those appointments through those astronomical monthly insurance premiums. Or you may have already maxed out your out-of-pocket health care costs for the year. In either case, take advantage and go to see your doctor and dentist for a checkup.

Spend all your FSA dollars: Though they are not common these days, some people have flexible spending accounts to cover routine medical expenses such as prescriptions and doctor co-pays. So, if there's still money in that account, get all your prescriptions refilled or get an extra pair of glasses. Maybe that's why optometrists always walk around with a big smile in December.

Check your credit report: You can get a free credit report from each of the major credit agencies once a year. You can do this any time of the year, but if you haven't done so this year, now is a good time. **AnnualCreditReport.com** is a good place to start.

Talk to your financial advisor: If you haven't talked to us in a year, let's get together or just catch up on the phone. It is important that we touch base with you occasionally to check our strategy and plan, especially if you have had important life-changing events this past year or anticipate big changes in 2020.

On behalf of the Northstar staff, I wish you and your family a safe and happy holiday season and new year.

—Steve Tepper

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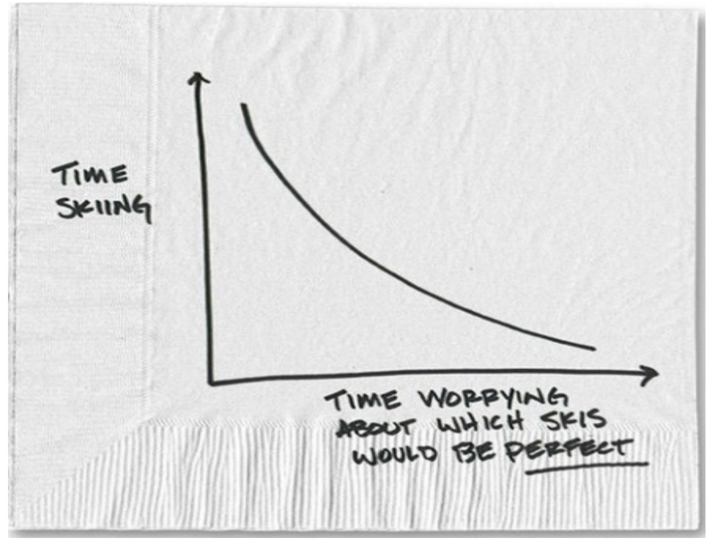
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

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