

# FINANCIAL PLANNING NOTES

## CLIENT NEWSLETTER

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#### 4 FINANCIAL NEW YEAR'S RESOLUTIONS FOR 2021

Have you made your New Year's resolutions yet? After a year like 2020, you may find it helpful to focus on your financial health. Here are four financial New Year's resolutions that can help improve your financial life in 2021.

##### 1. Build Your Emergency Savings

If last year taught us anything, it's to expect the unexpected. Emergencies can creep up anytime, anywhere. A car accident where you end up needing a new car, a burst pipe that floods your home, a company downsizing that puts you out of work—all these can throw your finances into a tailspin if you aren't ready.

If you don't have a budget, now's a good time to create one. Online budgeting tools like Mint or YNAB (You Need a Budget) can help simplify the process, or you can work with a [fiduciary financial advisor](#) who provides cash flow planning as part of your comprehensive financial plan.

In setting up your budget, make sure to earmark a portion of your paycheck to build an emergency fund. We generally recommend that people have six months' worth of expenses for their emergency fund in their savings account.

##### 2. Pay Off Your Credit Cards

Credit card debt—or too much debt in general—can

derail your savings goals. The interest you're paying for purchases that you no longer remember represents an opportunity cost. It is money that could have gone toward your savings, your retirement, or your dreams.

Make a plan to pay down your debt in 2021. The first step is to take inventory. Order your free credit reports at [annualcreditreport.com](#) and assess your credit picture.

What are your highest-interest-rate credit cards? Call your credit card companies to try to [negotiate a lower interest rate](#). This can work if you have a good credit score and a track record of on-time payments. Credit card companies want to get paid, and if you are a good customer, they don't want to lose you.

Make the minimum payments on your lower-interest-rate loans while you focus on paying off the credit card with the highest interest rate. Once that's paid off, you can then tackle the debt with the next highest rate.

You might also try shopping around for a new credit card with an introductory period of low or no APR. You can transfer your existing balances to that credit card, then pay off your new card's balance within the initial period.

Debt can be suffocating—don't let it keep you up at night. If your credit score is lower than you like, reducing the balances on your credit cards will help.

##### 3. Focus on Your Retirement Savings

Every working American should be saving for retirement. It may be cliché, but life moves fast.

Retirement will be here in a blink of an eye. The more you can save for that day, the better your chances of enjoying the lifestyle you want in retirement.

If you have a company retirement plan like a 401(k), start there. Save enough to get the company match if they have one. And continue to increase your retirement contributions by at least 1 percent each year. If you are able, contribute the maximum, which is \$19,500 in 2021. If you are 50 or older, you can make an additional \$6,500 “catch-up” contribution.

You can also open a traditional IRA or Roth IRA and contribute up to \$6,000 in 2021, plus a \$1,000 catch-up contribution. Just make sure you understand the [deduction and income limitations](#). If income limitations prevent you from contributing to a Roth IRA, you might consider a Roth conversion.

Also consider opening a taxable account, such as a brokerage account, to contribute even more money to your retirement. Unlike 401(k)s or IRAs, you can withdraw money from your brokerage account at any time without penalty—try to avoid that temptation. Remember that this money is for your retirement. And if you need the cash? That’s what your emergency fund is for.

#### 4. Assess Your Investment Accounts

While you are opening your brokerage account, take a look at your entire investment portfolio. What fees are you paying, and are you getting enough value and service for the cost? Is your investment account diversified appropriately? Are you taking on [too much risk](#) or too little risk? Is your portfolio putting you on track to achieve your long-term goals?

If you are unsure how to answer these questions, consider working with a fiduciary, fee-only financial advisor. The right advisor can help you construct an investment strategy and portfolio in line with your financial situation and goals. Our Plantation, FL financial planning firm provides this service as part of the ongoing wealth management we offer to clients.

#### Make 2021 the Year of Financial Well-Being

It seems like most New Year’s resolutions revolve around physical fitness. We would argue that financial fitness is essential too.

As with any change in habits, reaching your financial goals starts with baby steps. Keep track of your

spending and cut any expense that isn’t serving you. Build a fund for life’s emergencies, and reduce your debt burden. Then incrementally increase your retirement savings, and make sure your investments are aligned with your long-term goals.

Finances can be complicated, especially as your wealth increases. If you want a professional’s help to reduce your worries and [achieve your goals](#), consider talking with a financial planner. A fiduciary, fee-only financial advisor will help you get on track while always putting your best interests first.

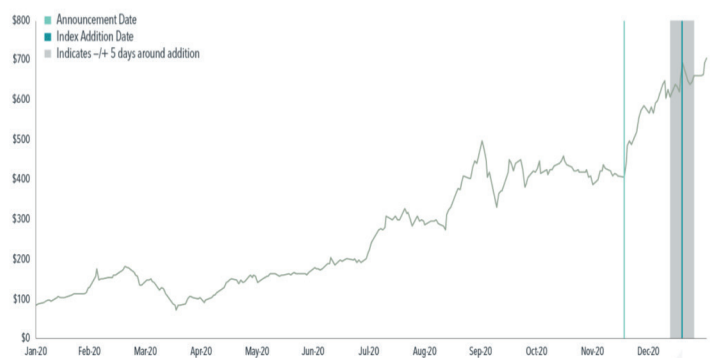
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## ELON MUSK DESTROYS THE S&P 500! (AND OTHER PROBLEMS WITH INDEXING)

Index additions and deletions are typically a routine affair, but the recent announcement by S&P that Tesla would be added to the widely tracked S&P 500 Index stirred up quite a lot of attention. No surprise, given that Tesla is the largest company to ever join the index and, at the time of its addition on December 18, 2020, became the sixth-largest company in the S&P 500.

On news of the announcement on November 16, Tesla’s stock price jumped 8.2% from \$408.09 to \$441.61. As shown in [Exhibit 1](#), Tesla then continued to post strong returns, closing December 18 up 70.3% since the announcement. That made the 2.3% return to the S&P 500 Index<sup>1</sup> over that period look meager by comparison.

**EXHIBIT 1 - TESLA DAILY STOCK PRICE:**  
JANUARY 1, 2020 THROUGH DECEMBER 31, 2020



While Tesla’s stock price wowed investors ahead of the company’s addition to the S&P 500, the pattern quickly reversed: The stock climbed 13.9% over the five days



ending with its index addition on December 18 yet slumped 4.8% over the subsequent week.<sup>2</sup>

What does this mean for investors? The answer, unsurprisingly, is that it depends.

Indices generally undergo regular reconstitution events during which securities are added or deleted. Index funds, constrained by the objective of maintaining low tracking error versus the index, generally have to mirror these changes by purchasing and selling securities based on the revised index weights.

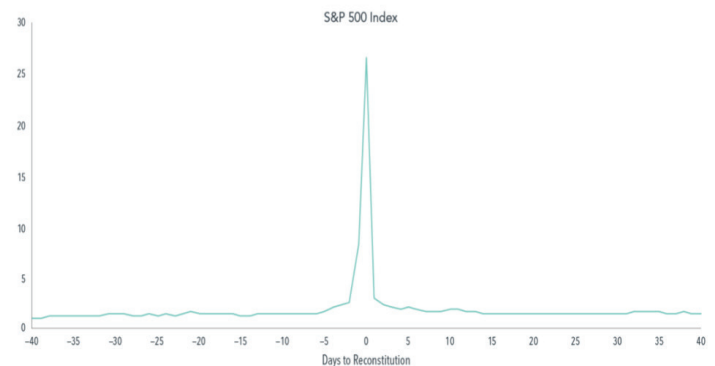
With over \$4.6 trillion in assets tracking the S&P 500 as of year-end 2019, that implies many index funds sought to buy Tesla stock on the day it was officially added to the index.<sup>3</sup>

For passively managed index funds, this lack of flexibility can come at a cost. One way to assess this potential cost is to examine the extent to which index reconstitution events are associated with unusually high trading volume. Abnormally high trading volume is a potential indication that demanding immediacy to trade in such stocks in the same direction may be costly.

We illustrate such abnormal trading volume in **Exhibit 2**, which compares trading volume in stocks added to or deleted from the S&P 500 on reconstitution day with trading volume in the same stock on days before and after the reconstitution day across reconstitution events over the 2015–2019 period. For the 40 days before and after reconstitution day, we present the average volume for rebalanced stocks as a multiple of the stocks' volume on the day 40 days prior to reconstitution.

If trading volume on reconstitution day is abnormally high for a rebalanced stock, it would lead to an increase in its multiple of volume traded on reconstitution day relative to non-reconstitution days. Indeed, averaging the volume ratios across all events over the five-year period, we find that trading volume for rebalanced stocks spikes more than 25 times relative to volume over the prior 40 days.<sup>4</sup>

**EXHIBIT 2 - ORDER OF THE DAY**  
ABNORMAL TRADING VOLUME IN S&P 500 INDEX, 2015–2019



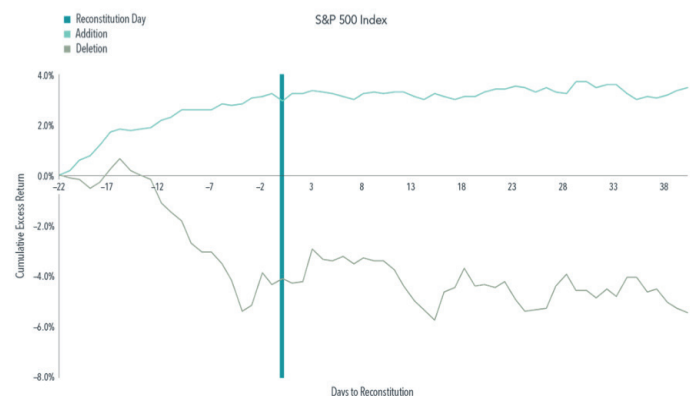
Demanding such unusually large trade volume can result in price pressure. But this price pressure does not have to manifest itself all on the day of reconstitution. We believe market prices are forward-looking.

Thus, because index rebalances are announced before the reconstitution date and often anticipated before the announcement date, an approach that is constrained to rebalance on the same day as an index may suffer from price pressure well ahead of the reconstitution date. Indeed, our research shows that stocks added to an index tend to outperform their respective indices prior to rebalancing, while stocks deleted from an index tend to underperform.

The remarkable upward march of Tesla's stock price ahead of its addition to the S&P 500 is consistent with that pattern.

More broadly, we see in **Exhibit 3** that the prices of additions (deletions) start to move higher (lower) than those of their index peers one month before the reconstitution day for the S&P 500.<sup>5</sup> This behavior suggests pricing adjustments may be occurring well before the reconstitution day for those indices.

**EXHIBIT 3 - RUNNING START**  
AVERAGE CUMULATIVE EXCESS RETURN OF S&P 500 ADDITIONS AND DELETIONS, 2015–2019



## WHO WE ARE

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The reconstitution effect is one example showing the lack of flexibility of an index approach, which can leave returns on the table.

While some of these costs can be mitigated by trading on a different date or spreading trading over a few days, we believe an even better approach would be a daily process that maintains a consistent focus on stocks with higher expected returns and spreads turnover across the entire year, with flexibility at the point of trade execution across stocks and quantity. Such an approach allows investors to incorporate information about liquidity and trading costs and avoid the cost of demanding immediacy from the market.

A daily investment process also allows for the incorporation of short-term information about expected returns that is relevant over days or months, such as momentum and information from securities lending fees. Such short-term information cannot be incorporated efficiently if rebalancing happens only once or twice per year. In addition, daily portfolio management can further enhance investment outcomes by maintaining a consistent and accurate focus on the desired long-term drivers of expected returns and continuously balancing tradeoffs between premiums, costs, and diversification.

—From *Dimensional Fund Advisors*

#### Footnotes:

1. S&P data © 2021 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.
2. Stock return over the week prior to index addition is from Friday, December 14, 2020, to Friday, December 18, 2020. Stock return over the following week is from Friday, December 18, to Thursday, December 24. Data are from Bloomberg LP, compiled by Dimensional.
3. Total assets indexed to S&P indices is from Annual Survey of Assets published by S&P Dow Jones Indices, as of December 31, 2019.
4. Reconstitution events for S&P indices sometimes fall on triple-witching dates, or days on which stock index futures, stock index options, and stock options all expire simultaneously. We examine reconstitution events outside of normal rebalancing dates, and therefore on days that do not overlap with triple-witching dates, and find that stocks added to or deleted from the S&P 500 Index still experience, on average, trading volume 26 times greater on the date of rebalancing relative to the trading volume 40 days earlier.
5. The initial increase in the gray deletion line is primarily driven by ENSCO PLC, which was dropped from the S&P 500 Index on March 29, 2016, due to an international merger. See “Enscopl and Rowan Companies plc Merge to Form Enscorowan plc, Industry-Leading Offshore Driller,” Business Wire, April 11, 2019.

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