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THE END OF VALUE?

From the day Northstar was founded nearly 20 years ago, we have had a consistent investment approach rooted in the world of academic study. What do the Nobel Prize-winning economists doing intense research into market behaviors tell us about investing?

The most reliable research, in our opinion, tends to come to the same conclusion: Investing is an exercise in risk and reward, and the most successful investing is done when you maximize your reward for the risk you take.

One of the most important factors in getting reward for risk is through value investing. The work of Eugene Fama of the University of Chicago and Kenneth French of Dartmouth tells us that over time, there is a premium (fancy way of saying "better return") for investing in companies that have a low value when comparing their stock price with the value of their assets (aka "book value"). We don't invest only in value, but it's one area that we look to for premium.

The opposite of value companies are growth companies, which have a very high stock price relative to book value. Think of a company like Uber that earned valuations of billions of dollars while having little or no hard assets—maybe just an app and a few people working in a small office space.

Growth companies are "sexy." They get the press coverage. They get investor attention, particularly those investors, and fund managers, looking for the home run, the stock that will rocket up in price and make you a fortune.

And to be sure, the home-run growth companies have provided extraordinary returns. In six months in 2018, Netflix stock doubled in price. In one of Apple's many growth spurts, from 2009 to 2012, the stock price went from $12 to $95. And perhaps the No. 1 growth stock of them all, Google, has gone from $50 in 2004 to over $1,400 as of late May 2020.

If there are value stocks with that kind of performance, I don't know of them.

But like a lot of Major League Baseball sluggers who hit a lot of home runs, growth stocks also have a whole lot of strikeouts. Remember Pets.com? The online pet supply seller fell from $11 per share to $0.19, taking $300 million of investor money with it.

So while the home runs usually come from growth stocks, so do an app-load of the failures, to the point that when you look at growth stocks as a group, they are more likely to underperform value stocks over time. And that makes sense too. If you looked at the world of internet search engines 20 years ago and said,

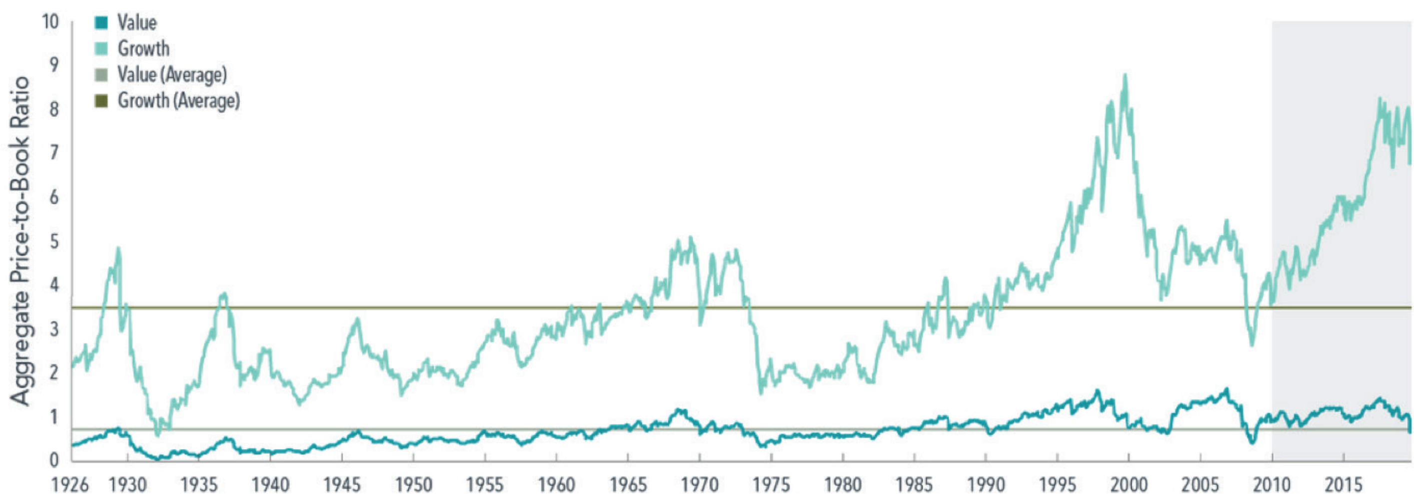
"I'll invest in Google," well, home run. But did you have any reason to think Google would end up being the only player left in a crowded field just a few years later?

Just as likely you might have picked Lycos, Alta Vista, Go, Infoseek, Wikia, Excite, or Ask Jeeves. Remember them? All competitors in the search engine space a couple decades ago. And as investments, all strikeouts. The only way to be sure you picked the search engine winner would have been to **invest in all of the above**. That's at least seven strikeouts to one home run, an average of .125. Do you know what you call a baseball player with a .125 batting average? Minor leaguer (if he's lucky).

So now that you are fully onboard with value investing, here's the bad news: Value stocks as a group have been underperforming growth for quite some time.

For 10 years back to March 2010, value stocks' annualized return has been 5.06%, vs. 13.04% for growth.[1] Not even close—it's a butt whoopin. And our client portfolios with a tilt toward value have reflected that underperformance.

The poor returns of value stocks have been so pronounced they've led to a widening gap between value and growth, as seen in this chart:



The chart shows stock price to book value taking off for growth stocks in 2009 (as they did in the late 1990s during the original dot-com bubble), while value has stayed pretty flat. As investors, it would be tempting to conclude that we are in another bubble and that a shift from growth to value would be wise. But then along comes research telling us that might not be the case.[2] The research says switching between growth and value based on the spread shows no better return historically than a buy-and-hold strategy.

On the other hand, it remains reasonable to expect that securities with lower prices relative to fundamentals should have higher expected returns. The value premium does not show up every day, year, or decade, and we have no way of predicting when it will. It's risky. And the only way to ensure you are rewarded for the risk is by maintaining consistent exposure to value, regardless of recent performance or current valuations.

—Steve Tepper

[1] Based on Fama/French US Value Research Index and Fama/French US Growth Research Index.

[2] Wei Dai, *Premium Timing with Valuation Ratios* (white paper, Dimensional Fund Advisors, 2016).

401(K) RETIREMENT INCOME PROJECTIONS: SHOULD YOU TRUST THEM?

Before too long, you should be seeing something new on your 401(k) statement: a retirement income number that tells you how much your balance would yield in lifetime income from an annuity. But where does this number come from, and should you trust it?

The SECURE Act and Annuities

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, passed in late 2019, included a number of provisions to help boost retirement savings. For example, it raised the age to begin taking required minimum distributions (RMDs) and made it easier for small businesses to set up retirement plans for employees.

The SECURE Act also made it easier for retirement plan sponsors to offer annuities in 401(k) plans. Although annuities can serve a purpose, they can also be overly complex and carry excessive fees. Though the lure of lifetime retirement income can be tempting, especially in down markets, annuities may not offer the same long-term returns that diversified investment portfolios will.

The new law requires that plan participants receive a projection on what their 401(k) balance would yield in monthly "retirement income" or "lifetime income" if converted to an annuity. This projection will have to be disclosed at least once per year, and the Department of Labor (DOL) has until December 2020 to finalize how the number is calculated.

While getting a sense of what your income might be can provide peace of mind about your retirement savings in general, there's the potential that this projection will be misleading, so take it with a grain of salt.

Eyeing Lifetime Income Projects with Caution

A lifetime income projection from an annuity may look appealing. However, its usefulness comes down to the inputs used to reach that very important number, which you would use in deciding between buying the annuity or drawing down your retirement portfolio.

The risk is that this lifetime income number could end up being a sales tactic for annuity offerings. For example, a recent Barron's article[3] cites criticism over how one insurer was arriving at its calculations.

From inflation projections to investment return assumptions, even small tweaks to such inputs can yield significant differences in projected lifetime income and how that compares with drawdowns from retirement accounts over time.

"While the devil will be in the details of what DOL requires in such disclosures, they will likely be telling participants the amount of lifetime income that they could achieve in a somewhat fictitious, perfect world," said John Lowell, an Atlanta-based actuary and advisor with October Three Consulting, in an article from the Society for Human Resource Management.

Putting Retirement Income Projections in Context

Rather than considering only the retirement income projections that plan sponsors must include as part of the SECURE Act, you should consider comparing this annuity-based projection against other retirement planning calculations.

For example, some 401(k) participants have access to calculators through their plan administrators. You can use such calculators to adjust variables like the retirement savings rate and annual investment return to get a sense of your projected portfolio income in retirement.

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At the least, you could estimate your overall balance at the time you retire based on current savings rates and determine how you would draw down the balance so that it sustains you over time. You can then compare this number against the annuity lifetime income projection.

Also make sure to read the annuity's terms carefully before purchasing one. Lifetime income can provide a sense of security that is especially attractive in volatile markets where portfolio values fall. But annuities can lock you in a lower rate of return than you would receive on a long-term, diversified investment portfolio. You should also make sure you understand the fees and any potential penalties associated with the annuity.

Consider Talking with a Financial Advisor

Retirement planning is complicated, and comparing an annuity against a portfolio adds another layer of nuance. You might consider discussing your options with a financial advisor to help determine the optimal solution for your situation. Our Plantation, FL financial planning firm considers our clients' options as part of our comprehensive retirement planning, and we recommend that you work with a fee-only, fiduciary advisor to make sure you get advice in your best interest.

This material was prepared by Kaleido Inc. from information derived from sources believed to be accurate. This information should not be construed as investment, tax or legal advice.

[3] Eleanor Laise, "Your 401(k) Will Soon Show Monthly Retirement Income. Beware the Math," Barron's, 28 Feb. 2020, https://www.barrons.com/articles/your-401-k-will-soon-show-monthly-retirement-income-beware-the-math-51582893001.

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