NORTHSTAR
FINANCIAL PLANNERS INC.

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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

"If you don't know what is going to happen, don't structure your portfolio as though you do."

—James Montier

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MUTUAL FUND REPORT CARD

Last month, Dimensional Fund Advisors shared its annual review of mutual funds, which provides some fascinating insights into the $9 trillion mutual fund industry.

I've seen quite a few of these annual reports and the one thing that is amazing is how little changes from year to year. Oh, sure, there are strong performance years and poor ones, but the bottom-line conclusions we can draw are startlingly consistent.

Over the past 15 years, investment in mutual funds has nearly tripled, ending 2017 at $8.953 trillion in total value. For most investors, mutual funds are a key component, or the **only** component of their portfolio, so there's a lot at stake for an investor who chooses poorly.

Morningstar looks at those funds and matches them to a "benchmark," an index that most closely reflects the type of assets held by the fund. A simple example is an S&P 500 index fund, which holds shares of the 500 companies in the Standard and Poor's index of large U.S. corporations. The appropriate index for that fund would, of course, be the S&P 500 index itself.

A fund that invests predominantly in small U.S. corporations might be benchmarked to the Russell 200 index of small cap stocks.

Why are benchmarks important? Because with nearly 5,000 mutual funds out there, it isn't enough to simply look at each fund's return and rank them from #1 to #5,000. Not all mutual funds are created for the same purpose. Some are meant to expose the investor to more risk than others, and those funds are expected to provide a higher return than less risky funds. If a very risky fund performs only slightly better than a much safer fund, the added return may not be worth the risk.

So we look at benchmarks to see if the fund is doing what it intends to do, which is to reward its investors for the risk they take.

The Dimensional report looks at 5-year, 10-year and 15-year performance of all equity (stock) and fixed income (bond) funds, and determines two very easy-to-determine factors: (1) Do they still exist? And (2) did they outperform their benchmarks? Here are the results for equity funds:

Equity Mutual Fund Performance Through 2017

After	Still Exist	Outperformed
5 years	82%	26%
10 years	58%	20%
15 years	51%	14%

These results are attention getting, to say the least. After five years, three out of four funds trail their benchmarks, and the numbers only get worse as time spans grow. The survival rate is not healthy either. About half of funds shut down within 15 years.

Now, to be fair, if your fund shuts down, it probably doesn't mean you've lost all of your money. But very few funds close because they did so darn well. It is a pretty good indication that you didn't do nearly as well as you should have for making the investment and exposing your hard-earned assets to market risk. Now let's take a look at bond funds:

Fixed Income Mutual Fund Performance Through 2017

After	Still Exist	Outperformed
5 years	86%	28%
10 years	67%	20%
15 years	57%	13%

Déjà vu on the performance side—almost the same results as equity funds. So in selecting a bond fund, you have an equally poor chance of picking a winner. A little bit better on survivorship with 57% still around after 15 years, but still no great shakes.

The next area of the Dimensional study is persistence. Simply put, that's determining if a fund's past performance is an indicator of future results. If you believe that fine print at the end of every financial article (including this one) and the fast talk at the end of every E-trade and Charles Schwab commercial, you know it doesn't.

But here's a little secret between you and me and everyone else on Earth: Most investors (and a whole lot of advisors) believe it does. Or at least they want to believe it, and that desire can drive them to ignore what they know to be true and make some bad investing decisions. Every investor who picks a fund because of its Morningstar "5-Star" rating is doing just that—picking what he thinks will be a winner based on its past performance.

Dimensional looks at fund persistence in a simple way. Over a three-year period, which funds performed in the top 25% of all funds, and how many of them were able to repeat that performance over the next three years?

If fund performance is not persistent, if it is just random chance, then the percentage of funds that show up in the top 25% two periods in a row would be 25%.

The results for 12 different rolling three-year periods? On average, 26% of top funds were able to repeat their performance in the next period. Given that random chance would have produced a result of 25%, there's not very much evidence to convince us that we'd succeed in picking a top performer based on the last period's results. In the very best period, just 33% of top 25% funds were able to repeat, and in the worst period, it was down to 17%.

Results for bond funds were better, but still not enough to bank on. Overall, 32% of top-performing bond funds stayed in the top quartile the next period, and as high as 53% in 2015–2017. Hey, a little better than a coin flip! Unfortunately, there was another time period (2009–2011) when the result was 3%. Yes, 3%! That's almost none of them! What was going on with those fund managers that did so well in 2006-2008 but almost none of them could land in the top quartile the next period? Yes, 2009–2011 was a very difficult time for the bond market, but all the other bond funds had to deal with same environment. It's baffling!

In the end, this year's Dimensional report tells us the same story as last year's, and the year before that, etc. The majority of mutual funds fail to reward investors fully for the risks they take, and we would be really lucky to have even coin flip odds of picking a winner based on past results.

So what is an investor to do? Stay away from mutual funds? That would be great, if we had a better investment vehicle to help the average investor outpace inflation and maintain a well-diversified portfolio. So we recommend mutual funds, but we point investors toward funds with specific characteristics to increase the chances they will be rewarded for the risk they are taking:

- Stay away from active funds. Active funds are, as a group, worse performers than passive funds because their costs are higher, and given no evidence that they do a good job of beating their benchmark (net of costs) or that we can pick a good one, funds that don't try to beat the market through stock selection or market timing are better as a group over time. Unfortunately, it isn't always easy for a non-professional to identify active vs. passive funds, but the next few couple of items in the list can help.

- The lower the cost, the better. It's easy to look up a fund's fees at morningstar.com. If it has high fees, it is going to be that much harder for the fund to match or beat the benchmark index (which has no fees, trading costs, and pays no taxes). If you're not sure if a fund is actively or passively managed, fees are often a proxy to determine the investing style of the fund. If you see very high fees, with front-end or back-end loads and/or 12b-1 marketing fees, there's a good chance it's actively managed.
- Go for diversification. Like fees, you can look up the number of holdings at morningstar.com. Generally, more is better. Additionally, the number of holdings is another good proxy to determine the fund's investment style. A well-diversified, passive fund will usually have hundreds, or even thousands, of different holdings, while an active fund may have just a handful or a couple dozen.
- Diversify across many asset classes, and pick funds that stick to their class. A well-diversified portfolio will have large and small company stocks, domestic and international companies, and maybe a real estate fund on the equity side. On the fixed income side, look for a mix of short-term (1 to 3 years) and medium-term (3 to 7 years) bonds, corporate and government bonds, and once again, domestic and international. Morningstar can help determine how well a fund sticks to an asset class, with a variety of charts and graphs breaking down its holdings.

If all that sounds like a lot, or maybe too much, good time to give a financial advisor a holler. That's what I'm here for!

—Steve

Based on Dimensional Fund Advisors' 2018 Mutual Fund Landscape report. We'd be happy to provide the full report to you. Just call or email.

Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Investing risks include loss of principal and fluctuating value. There is no guarantee an investing strategy will be successful.

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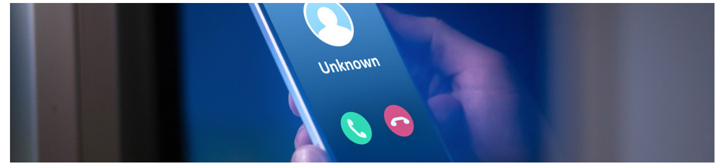

FRAUD ALERT

Wow, did I get a call last week. The robocall was a deep, booming voice telling me a warrant had been issued for my arrest by the IRS for unpaid taxes and the police would be arriving within 45 minutes.

That is, unless I immediately called the phone number provided in the message. Spoiler alert: I didn't. But if I had, an "IRS Case Worker" would have answered and would have requested my Social Security number to "match it to the case file," and of course a credit card number.

I just have to say, I knew from the first instant it was a scam, I've heard of the scam, it is my job to know it is a scam, but in that moment, listening to that message, it was a little bit, well, terrifying. It really was.

It's easy to understand how so many people can be duped by this and similar scams, particularly seniors, which is whom these grifters most often target.

So I offer this reminder to you, even though you have probably heard it before: When you get a threatening call regarding a matter that you have no knowledge about (like an IRS lien, any other debt, or a legal action), remain calm. If someone were really coming to arrest you in 45 minutes, they probably wouldn't "call ahead." You're not the Olive Garden—you don't take reservations.

And the IRS will never call you to demand immediate payment. That's not how they conduct business. They also won't email you with a similar threatening message to contact them right away over a debt.

If you don't owe taxes and have no reason to think you do, ignore any such communications. If you think you might owe money (or know you do), don't respond directly to the call or email, but go to this site: https://www.irs.gov/payments/view-your-tax-account.

There you can verify if you owe money and, if you do, review payment options.

—Steve

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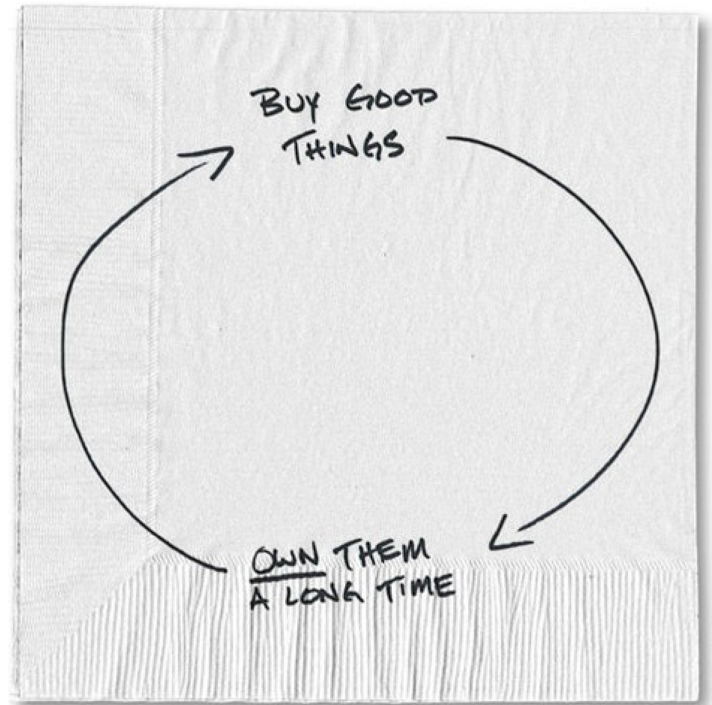
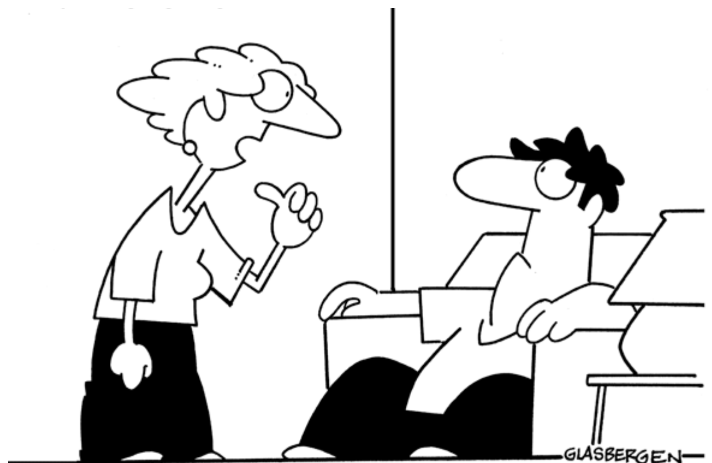
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT



"Remember the other day when you paid for a candy bar with a credit card? Dave Ramsey and Susie Orman are here to slap you silly!"

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