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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

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PUNDIT SEASON

Election season is also pundit season—when every self-proclaimed expert who maybe made one correct market call years ago emerges from their lair under the steps. You'll find them making the rounds on the financial news shows to cast predictions on how capital markets will respond depending on who wins the upcoming election. Based on track record, you might be better off getting your weather predictions from Punxsutawney Phil.

It isn't just elections the pundits get wrong. It's pretty much everything—predictions that seem laughable in historical context. Here are a few of my favorites culled from the highly reliable internet:

The Strong 2005 Real Estate Market: Ben Bernanke is a modern rock star economist, former head of the Federal Reserve, and advisor to George W. Bush. In July 2005, he rejected the idea that the housing boom was a dangerous bubble, saying, like pretty much every real estate agent, that housing prices never fall (at least not nationally), and seeing no possibility of a collapse rippling through the credit and job markets.

The Post-WWII Great Depression: Few economists amassed the resume of Paul Samuelson: Harvard PhD, MIT professor, Nobel Prize winner, best-selling author, advisor to multiple presidents. Yet he came up with a beauty of a prediction in 1945 after the war ended, when he advised President Truman that grinding the government's enormous war machine spending to a halt would bring a return of the Great Depression, or worse.

Truman ignored that warning and cut spending by a massive 61%. The recession that followed lasted just eight months, and even with millions of GIs returning home and looking for work, the unemployment rate topped out at 5.2%. By 1947, economic prosperity returned to pre-Depression levels.

The End of Market Crashes: Arguably, no economist had as great an impact on government macroeconomic policy than John Maynard Keynes. His 1936 book *The General Theory* posited that during a recession or depression, government can stimulate consumer demand through deficit spending, a theory that has been put to practice many times since, including right now as Congress negotiates a massive spending bill.

Yet the man who invented one of the most-used recession remedies failed just a few years earlier to see one coming. In 1927, Keynes believed economic crashes were a thing of the past, stating: "We will not have any more crashes in our time."

Bernanke, Samuelson, and Keynes are hardly under-the-steps-dwelling crackpots with one lucky prediction to their credit, parlaying that one-time luck into unending TV appearances. In fact, after their horrible predictions, they went on to their greatest acclaim. Bernanke, for example, was *Time* magazine's 2009 Man of the Year. This highlights the problem with listening to *anyone's* predictions on the economy and the markets, let alone taking action on your investments based on their predictions.

We have seen that the downside of taking action and making a big mistake can be far greater than the downside of taking no action, getting caught fully invested during a tumbling market, but patiently riding it out. In the absence of a truly reliable voice to guide us in that decision, the choice is obvious.

—Steve Tepper

Source: *Worst Economic Predictions* by Devin Roundtree, American Institute for Economic Research, July 15, 2014.

AN EXCEPTIONAL VALUE PREMIUM

It's probably not news to most value investors that the value premium has struggled over the past decade. What might be news is just how extreme an outlier recent value stock underperformance represents.

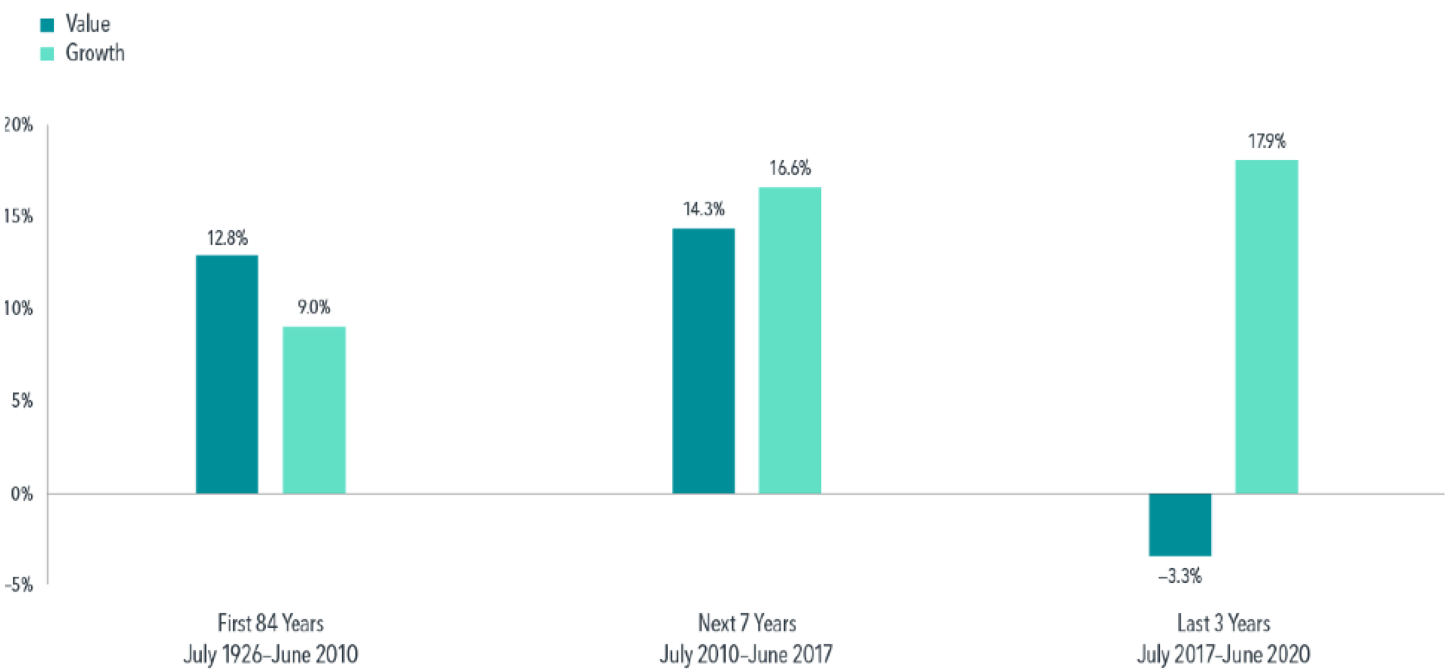
The periodic returns for value versus growth in **Exhibit 1** convey a stark contrast between recent years and the longer run of evidence, suggesting the past decade's disappointing premium was disproportionally impacted by the last three years.

Over the first seven years of the last decade (July 2010–June 2017), value stocks actually outperformed their prior long-run average return, 14.3% versus 12.8%. However, a substantially stronger-than-average performance from growth stocks (16.6% versus 9.0%) resulted in a negative value premium for this period.

The last three years were a different story. While growth continued to its historically high return, value stocks produced a return of –3.30%, resulting in an annualized value premium of –21.22% over this period.

EXHIBIT 1 - GROWTH SPURT

ANNUALIZED COMPOUND RETURNS FOR VALUE VS. GROWTH, U.S. MARKET

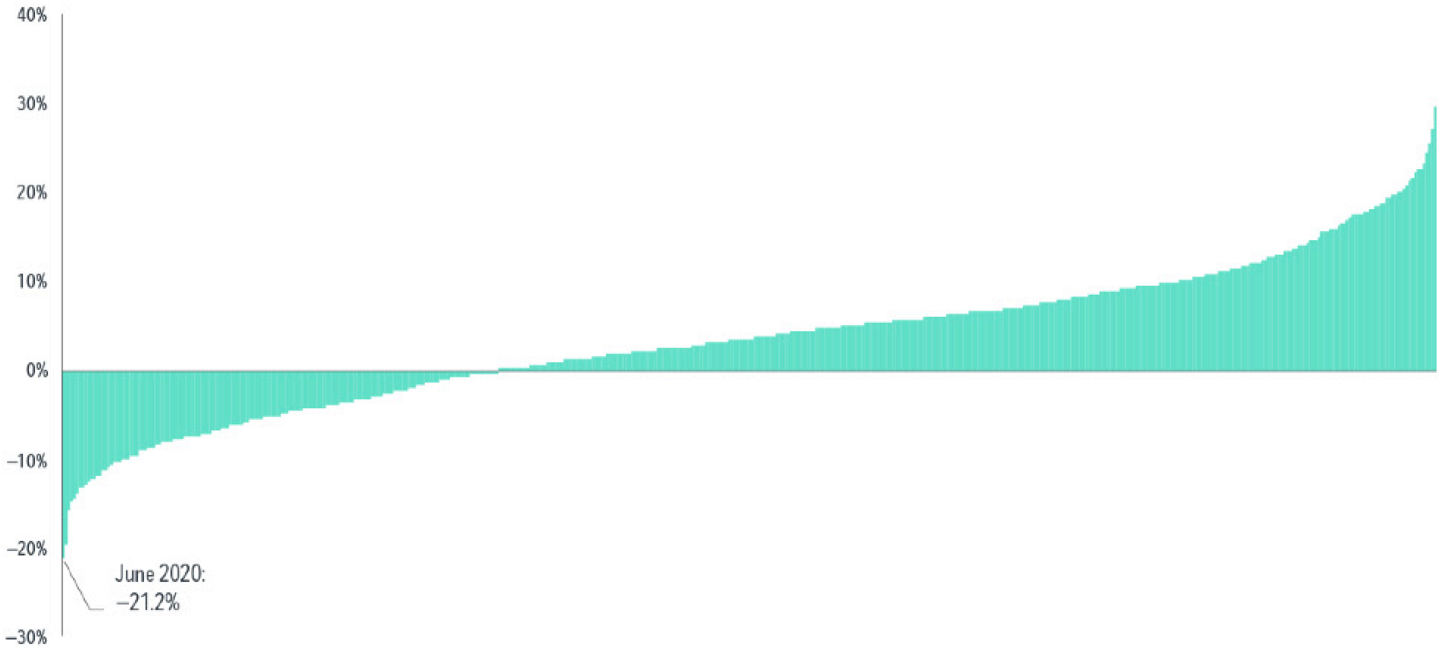


Value and growth stocks represented by the Fama/French Value Research Index and the Fama/French Growth Research Index, respectively. Returns provided by Ken French, available at *http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.*

This three-year run warrants further inspection—just how uncommon was this value premium magnitude? Literally unprecedented, as illustrated by the rolling three-year value premiums in **Exhibit 2**. Of the 1,093 rolling observations in U.S. history, the three years ending in June 2020 ranked dead last. This is the very definition of an outlier.

EXHIBIT 2 - BACK OF THE PACK

ROLLING 3-YEAR ANNUALIZED RETURN DIFFERENCES FOR VALUE VS. GROWTH, U.S. MARKET, JUNE 1929–JUNE 2020



Past performance is not a guarantee of future results.

Value and Growth represented by the Fama/French US Value Research Index and Fama/French US Growth Research Index, respectively. Fama/French index data available from the data library of Ken French.

Appreciating the extraordinary nature of an observation is important to assessing its implications going forward. A successful entrepreneur becoming a billionaire after dropping out of college does not marginalize higher education as a means to maximizing one's career earnings potential. Similarly, asset allocation decisions are more reliably informed by a long series of evidence rather than the exception.

An extremely disappointing run of results for value versus growth does not necessarily signal a "new normal" for value. The theoretical premise behind value investing—paying a lower price for expected future cash flows, indicating higher expected returns—is just as valid today as it was 10 years ago. And even strongly negative recent value premiums haven't offset a preponderance of evidence for positive value premiums spanning nearly a century in the U.S. and more than five decades in non-U.S. markets.

While exceptional observations of the value premium should not erode a belief in value investing, they do serve as a reminder of the variability of realized returns. As **Exhibit 3** illustrates, there has been a wide range of outcomes for the premium on a month-to-month basis.

In fact, the distribution tells us that when value shows up, it can show up in bunches. For example, about 1 in 20 months during this period saw a realized value premium of at least 6%, or 20 times the size of the average monthly premium (0.30%).

WHO WE ARE

ALLEN P. GIESE, ChFC®, CLU®, ChSNC®
President, Investment Advisor Representative

STEVE TEPPER, CFP®, MBA
Vice President, Chief Operations Officer, Investment Advisor Representative

GARY S. GLANZ
Director of Business Development, Investment Advisor Representative

GARY C. GONZALEZ
Investment Advisor Representative

STACY SAAVEDRA
Client Service Specialist

RICHARD LOTTIER III
Client Service Specialist

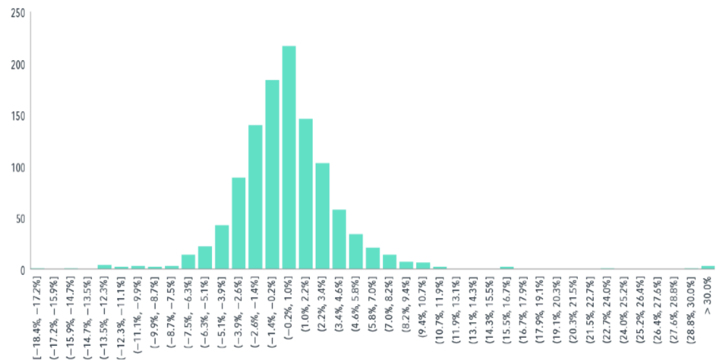
NORTHSTAR
FINANCIAL PLANNERS INC.

(954) 693-0030
1250 S. Pine Island Road, Suite 275
Plantation, FL 33324

northstarplanners.com
info@northstarplanners.com

EXHIBIT 3 - MONTHLY STATEMENT

DISTRIBUTION OF MONTHLY RETURN DIFFERENCES FOR VALUE VS. GROWTH, U.S. MARKET, JULY 31, 1926–JUNE 30, 2020



Past performance is not a guarantee of future results.

Value and Growth represented by the Fama/French US Value Research Index and Fama/French US Growth Research Index, respectively. Fama/French index data available from the data library of Ken French.

Why is this important for investors (and value strategy managers)? These outsize positive returns are an important component of the long-run positive average value premium. A disciplined focus on value is essential to capturing this source of higher expected returns.

—Dimensional Fund Advisors

Past performance is no guarantee of future results. International investing involves special risks such as currency fluctuation and political instability.

Growth stocks are stocks trading at a high price relative to a measure of fundamental value such as book equity. Value stocks are stocks trading at a low price relative to a measure of fundamental value such as book equity. Value premium is the return difference between stocks with low relative prices (value) and stocks with high relative prices (growth).