

WHEN IS 5 GREATER THAN 6?

By: Henry Pizzutello, Chief Investment Officer

Conventional wisdom states that investors will always choose higher returns over lower. This is not a controversial statement – but is it a correct one? Many clients compare their portfolio returns to arbitrary benchmarks like the S&P or worse, to the returns of their friends or neighbors. Invariably, “cocktail party talk” always leads to that great investment your friend made and how their portfolio is outperforming.

But when it comes to retirement planning is maximizing return always the best strategy?

Let’s take a look at two hypothetical retirees: Both Jason and Robert retired in 2000 with a portfolio of \$1,000,000. Jason invested his money conservatively – split equally between T-bills and Treasuries and his return over the next 16 years averaged 4.8% annually. Robert sought to maximize his return and invested exclusively in the S&P 500. Robert’s return over the next 16 years was 6.1%. Clearly Robert’s portfolio was the winner, having grown to \$2,578,869 versus Jason’s portfolio at \$2,117,290. However, if we assume there will be withdrawals during retirement, a different picture emerges. With a distribution of 5% per year and inflation adjustment of 3%, Robert actually runs out of money in 16 years! In Jason’s case he still has \$428,000 left in his portfolio.

How can the portfolio with the higher rate of return run out of money before the lower performing portfolio? The answer is found in the variability of the return stream. Robert’s return had significant gains and losses during the period, and the distributions that were taken every year meant that there was less to invest during the loss periods. This underlies the distinction between investment planning and investment performance. When it comes to retirement planning, the long-term linear relationship of growth over time no longer applies. What becomes critical is the sequence of returns and, more importantly, the ability to mitigate losses early in the retirement years. Unfortunately, there is no way to control what market returns will be in the year you retire, but you can control the amount of risk taken during that period.

Another example makes this point more clearly. In this scenario, Robert retires in 1966 and Jason in 1967. They both have the exact same returns except for the first year. Using the same distribution rate as our earlier example and no inflation adjustment, Robert’s

portfolio is worth \$188,749 in year 25 and Jason’s is \$1,128,287. This illustrates what is known as the “Butterfly Effect” and the premise that an unintended small changes may lead to very large unforeseen differences over an extended period of time. Randomness, in this case retirement year choice, cost Robert more than \$930,000.

However, now let us assume that Robert was able to exercise some measure of risk control over his portfolio, and conservatively invest to mitigate some of that first year loss. The portfolio in year 25 would have been worth \$661,205. That difference of \$473,000 is the value of risk control versus randomness and is one of the main reasons why investors who rely on “the market” often fail to reach their retirement goals.

Thus, as we approach retirement and in our retirement years, the focus should be only on the return needed for a successful retirement and not on absolute performance or benchmarks. The goal of the planning process is to determine the return needed to sustain retirement and the role of investment management is to find the solution with the least possible risk. This is why at HFG Wealth Management our investment focus includes all areas of wealth management from retirement, estate planning, tax-planning to investment management.

No one has crystal ball or can accurately predict the market over short periods of time. Nobel Prize winning economist Harry Markowitz coined the phrase “diversification is the only free lunch.” This idea of risk-based diversification is critical as we approach our retirement years. We cannot rely on a single stock or an improperly allocated portfolio to protect us. But, we can focus our efforts on creating strategies that are in alignment with your goals while constantly evaluating the underlying risk.



WILL THERE BE ANO

By: Henry Pizzutello, C

As we enter a new decade, most investors are wondering what we can expect from the equity markets in the 20's. The 2010's were a historically good decade. It begs the question: can we repeat that performance, or should we temper our expectations? Unfortunately, we cannot predict the future, but we can look at history as a potential guide. As Mark Twain famously said, "History does not repeat itself, but it often rhymes." Our inability to forecast short-term market fluctuations will not stop the media, economists, and market watchers from publishing their annual predictions.

Before we discuss potential returns in the equity markets, it's important to understand what components make up stock returns. Stock market returns can be broken down into 3 categories: dividends, earnings growth, and multiple expansion. As we will see, each component can have a pronounced impact on returns over a longer period of time.

If you look at the chart below, you will see that the primary driver of S&P 500 returns in the 2010's was not multiple expansion or even the dividend yield—it was actually earnings growth! This is very surprising to most investors since the media has bombarded us with headlines about how slow the US and world economy have grown. What, then, contributed to the best decade of earnings growth in history? There were three main factors. First, we started from very low levels of earnings growth coming out of the great recession. Second, and probably most important, we saw record share buybacks. Instead of paying shareholders a higher dividend payment or re-investing in capital projects, companies chose to purchase their own shares. These buybacks reduced the number of shares in the market and in turn inflated the earnings growth per share. Lastly, we saw a shift in index weights toward higher growth sectors like technology and away from traditional value.

Components of Return

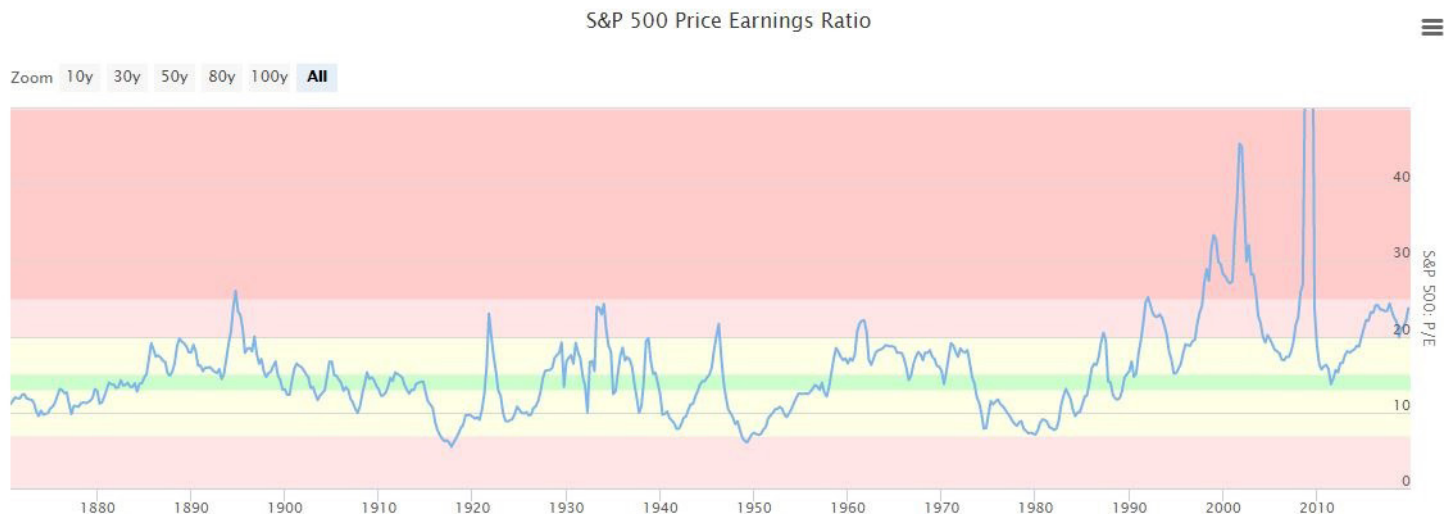
<u>Decade</u>	<u>Annual Return =</u>	<u>Dividend +</u>	<u>Earnings Growth +</u>	<u>Multiple Expansion</u>
2010's	13.6%	2.3%	10.1%	1.2%
2000's	-0.9%	1.8%	0.6%	-3.3%
1990's	18.2%	2.9%	7.7%	7.6%
1980's	17.5%	5.0%	4.4%	8.2%
1970's	5.9%	4.3%	9.9%	-8.3%
1960's	7.8%	3.4%	5.5%	-1.1%
1950's	19.3%	5.8%	3.9%	9.7%
1940's	9.5%	6.5%	9.9%	-6.9%
1930's	-3.4%	1.9%	-5.7%	0.4%
1920's	14.6%	5.4%	5.6%	3.5%
1910's	4.5%	5.9%	2.0%	-3.5%
1900's	9.9%	4.4%	4.7%	0.8%
1890's	5.5%	4.3%	4.8%	-3.6%
1880's	5.8%	5.0%	-2.3%	3.1%

Source: Robert Shiller, Bloomberg, Standard & Poors

OTHER ROARING 20'S?"

Chief Investment Officer

S&P 500 Price to Earnings Ratio



What does the data tell us we can expect going forward? If we look at periods of time when we saw close to double-digit earnings growth (1940's and 1970's), the following decades saw earnings growth fall to 3.9% and 4.4%, respectively. Most economists predict that the dividend yield of the S&P 500 will remain steady or fall slightly due in part to the aforementioned share buybacks.

Finally, let's take a look at our last component: multiple expansion. Current market multiples are running above the long-term trend. The price to earnings ratio of the S&P 500 stands at 23.72 versus a post WWII historical average of 17.3 (see chart 2). Low interest rates and very accommodative central banks have contributed to the higher multiple, but it is important to remember that mean reversion can be a powerful factor in the markets. Putting it all together, what can we reasonably expect

from the S&P 500 in the new decade? If we see the dividend yield hold steady at 2.3% and earnings growth moderate to around 4-6%, the big variable will be what happens to the earnings multiple. Historically, the earnings multiple has expanded following a decade of nearly flat growth; however, as we discussed earlier, multiples are higher than normal and we should expect some mean reversion. If we believe earnings will not grow as fast in the 20's, we might also assume some contraction in the earnings multiple. Utilizing our return formula of dividends + earnings growth + multiple expansion = total annual return, then we could possibly see returns in the 6-7% range. This would fall below the post WWII average of 10%, but is certainly more favorable than the negative return of the 2000's.

GROWTH vs. VALUE IN THE 2000'S & THE NIFTY FIFTY OF THE 1970'S

By: Robert Borden, CFP®, EA, Chief Compliance Officer

Last year we examined the Growth vs. Value question and whether the paradigm is shifting. While value stocks experienced short periods of outperformance in 2019, growth continued to dominate for the full year – as it has over the last ten years. To understand why, it's important to remember the technological innovations we've experienced over the last 20 years. It's easy to forget but in January of 2000 CDs and DVDs were the media of choice, we could either choose from “brick” or “flip” style cell phones. Streaming wasn't in the lexicon. I recall as a native Houstonian how Houston's leaders breathlessly announced a deal with EarthLink in February 2007 to provide a citywide, wireless Internet network within the next two years. “Its terms put Houston in line to have the largest such network in North America, covering nearly all of the city's 600 square miles by spring of 2009, the mayor told the Chronicle.”¹ By August 2007 a financially distressed EarthLink paid the city of Houston \$5 million just to get out of the deal. Obviously today we have nearly nationwide access to 4G content. Remember, the original iPhone was launched in January 2007 and the iPad was introduced in 2010. With the rollout of 5G networks in coming years, a high definition movie can be downloaded in under 10 seconds with expected speeds up to 100 times faster than 4G.²

To add context to historical P/E ratios or stock valuations, the average ratio for the S&P 500 over the last 60 years is 16.8, but today we are at 23. However, during the two significant bear market events (2001-2002 & 2008-2009) over the last twenty years, P/E ratios briefly exploded higher – up to over 100 during the first half of 2009! The reason why? While stock prices were declining – earnings were declining exponentially faster with negative earnings and severe losses occurring during the fourth quarter of 2008. Of course, since the conventional P/E metric uses trailing 12-month earnings, we didn't realize quite how extended the ratio was at the time.

Is the NASDAQ 100 today comparable to the Nifty Fifty of 1972? What exactly was the Nifty Fifty? It was a group of approximately 50 stocks that were defined as strong US companies with high growth rates. At its peak in 1972 the P/E ratios of the most expensive stocks among the group were Polaroid, McDonald's, MGIC Investment, Walt Disney and Baxter Travenol.³ These companies had P/E ratios ranging between 80 and 90. Today Amazon enjoys a P/E ratio of 80 and Netflix's P/E ratio is well over 100. However, Apple, Alphabet (Google), and Facebook have much more reasonable valuations. Many analysts have even proclaimed Apple to be a “stealth” value stock, with tremendous cash on hand, steady

cash flow, as well as a recognized global brand. While the dividend yield was nearly 2% in early 2019 it has declined to just over 1% after the stock's explosive 89% return in 2019. On the other hand, we still have speculative companies such as Tesla which has no P/E ratio because there is no E, or earnings, to underpin it. The stock price is purely built around future earnings expectations and perhaps Elon Musk himself. Have the tremendous technological innovations over the past two decades changed the Growth vs. Value paradigm or will returns revert to the mean over time? Many brokerage firms back then listed Walmart among their own Nifty Fifty. \$1,600 invested in the company in 1970 would be worth \$4.3 million today – obviously, they are the reigning performance champ among the group. Oh and by the way, for the first time in over 30 years vinyl is poised to outsell CDs.

Nifty Fifty Companies with the Highest P/E Ratios in 1972²

Company	1972 P/E Ratio
Polaroid	90.7
McDonald's	85.7
MGIC Investment	83.3
Walt Disney	81.6
Baxter Travenol	78.5
Intl. Flavor & Fragrances	75.8
Avon Products	65.4
Emery Air Freight	62.1
Johnson & Johnson	61.9
Digital Equipment	60.0
Kresge (now Kmart)	54.3
Simplicity Pattern	53.1
AMP	51.8
Black & Decker	50.5
Schering	50.4
American Hospital Supply	50.0
Schlumberger	49.5
Burroughs	48.8
Xerox	48.8
Eastman Kodak	48.2
Coca-Cola	47.6
Texas Instruments	46.3
Eli Lilly	46.0
Merck	45.9

¹ Source: www.chron.com/business/technology/article/Houston-picks-EarthLink-to-be-its-WiFi-provider-1814853.php

² Source: www.digitaltrends.com/mobile/5g-vs-4g/

³ Source: <https://theirrelevantinvestor.com/2018/11/26/the-nifty-fifty/>