Sandpiper Capital

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Gleanings

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Index Returns	2022	2023	2024	**2025**
S&P 500	-18.3	26.3	24.9	14.8%
ML 1-5 yr Gov't/Corp	-5.5	5.2	4.6	4.9%
EAFE (Dev Fgn Mkts)	-14.4	18.2	3.8	25.1%
Emerging Markets	-20.9	10.1	7.5	27.5%

Simplify

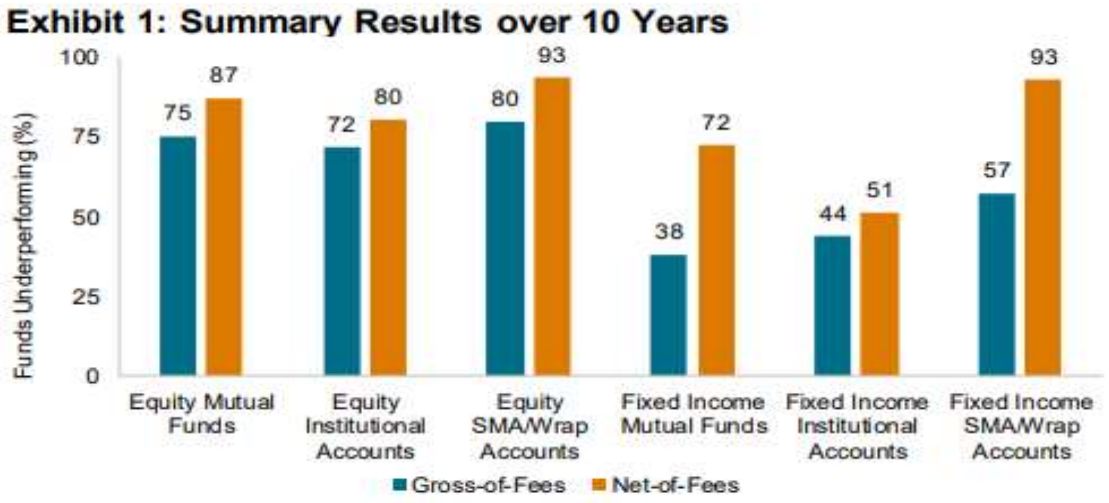
If "history is almost always written by the victors", then finance textbooks are almost always written by the financial services industry and one of the core tenets of finance is that investors should diversify across asset classes.

Bonds and stocks, both domestic and foreign; developed markets and emerging markets; private equity (businesses without public stock); venture capital; real assets like timber and farmland; some or all are to be included in a well-managed portfolio. Highly trained and specialized asset managers can allocate your portfolio across these markets and ensure that the proportions and rebalancing decisions are made in a way that maximizes your return and minimizes risk.

The Yale University endowment under David Swenson (who authored the textbook "Pioneering Portfolio Management") exemplifies this and serves as the benchmark for the institutional investment world. I think it's no coincidence that this is a strategy guaranteed to keep the maximum number of investment professionals employed per portfolio, (costing Yale about $80,000,000 per year). I'll bet you can guess how that has worked out. According to the numbers posted by the endowment (which is considered one of the top performers), the average five-year annual return for them over the last twenty years has been 10%, (the S&P was 12%). They did have lower volatility, however as their best five-year period was 15% (S&P was 19%) and worst was 2% (vs 0% for the S&P's worst five-year period since 2003). And considering an individual asking for that kind of investment management would be paying 1.5 to 2% per year for performance likely worse than Yale's $40 billion endowment, kind of seems like a big waste of time and money.

If you ignore the marketing and the pressure to follow the crowd, eventually everyone comes to the conclusion that S&P index funds predictably beat active professional management in the long run.

This is from S&P Global's annual review showing the percent of funds underperforming the index.



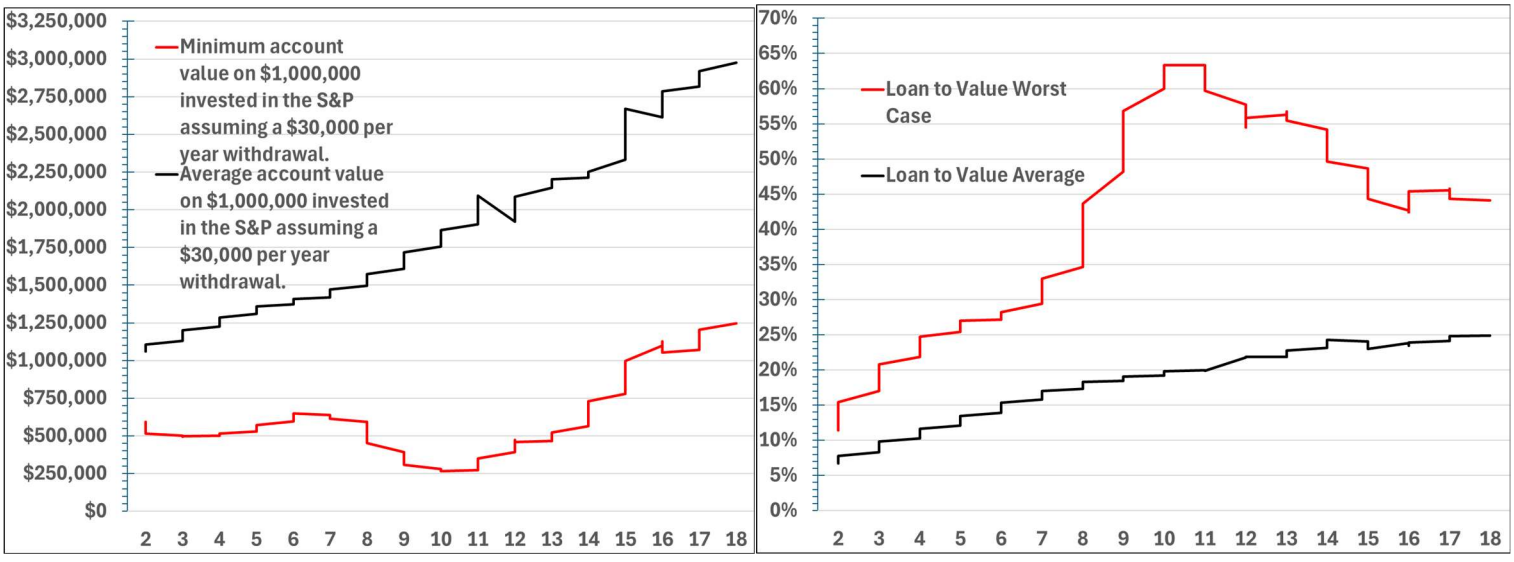
Source: S&P Dow Jones Indices LLC, eVestment Alliance, CRSP. Data as of Dec. 31, 2024. Based on fund aggregate total underperformance rates across all reported categories. SMA stands for separately managed account. As funds can be included in more than one category, underperformance rates for the most-narrow categories were used. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

As I've stated before, however, there are challenges associated with having all your money in an S&P index fund. Every investment manager has had very emotional calls from clients who think that the market decline they just experienced would continue and wipe out their savings. And, as you know, the emotional side of your brain does not listen to reason. That's one of the reasons that individual investors in the index make less than the index (see Morningstar's annual "Mind the Gap" research). They sell when scared and buy when excited. Plus, if you need money for an unexpected expense and the market is down, you end up selling "low". Money managers, like myself, then typically keep a portion of clients' account in bonds to offset the down years and to serve as a ready source of cash. So, in the long run bonds pay 4%, stocks earn 10% and clients get single digit returns.

Is there a better way? Here's one hypothetical answer (not investment advise): Invest 100% systematically over time in an S&P index fund, never sell, and use a margin account for expenses. That is, a bank will give you cash advances whenever called upon if you pledge your securities account as collateral. You pay a fixed rate of interest (currently 6.5%) on the oustanding balance and conceivably, your account grows at 10%. In theory. Here's a couple of graphs illustrating how that would likely work out, keeping in mind that the loan account cannot exceed 65% of the total account value. If it ever does, you get a "margin call" and you have to sell stocks and pay down the loan.

The left graph shows a history of the *worst* S&P returns as well as the *average* S&P returns for a $1,000,000 account for all of the two to eighteen year periods since 1999, assuming you invested gradually over ten quarters and net of a loan balance that's paying out $30,000 per year. The chart on the right shows a history of the growth of that account using the minimum total returns for all of those 3390 different holding periods as well as a line showing the average total return each year. We used a 3% withdrawal because, as you can see, the loan balance grows too fast with anything greater. If you happened to start investing in the wrong year, say 2000 or 2007, you could find yourself down almost $750,000 and perilously close to a forced liquidation. On average though, you would almost triple over eighteen years in addition to all of those $30,000 checks. So, that *is* a strategy. Invest systematically every quarter over ten quarters. Pledge to never sell. Limit your withdrawals to a maximum of 3% of your investment and cross your fingers. You'll probably make $300,000 to $500,000 over the 18 years along with the $30,000 annually and save yourself a lot of time and aggravation.

S&P 500 Index Portfolio Accumulated Over Ten Quarters



While you could probably get away with a withdrawal greater than 3%, it's reassuring to know that over the past twenty-five years at least, you would never have had a margin call and your account, if held for the long run and not disturbed, would still appreciate.

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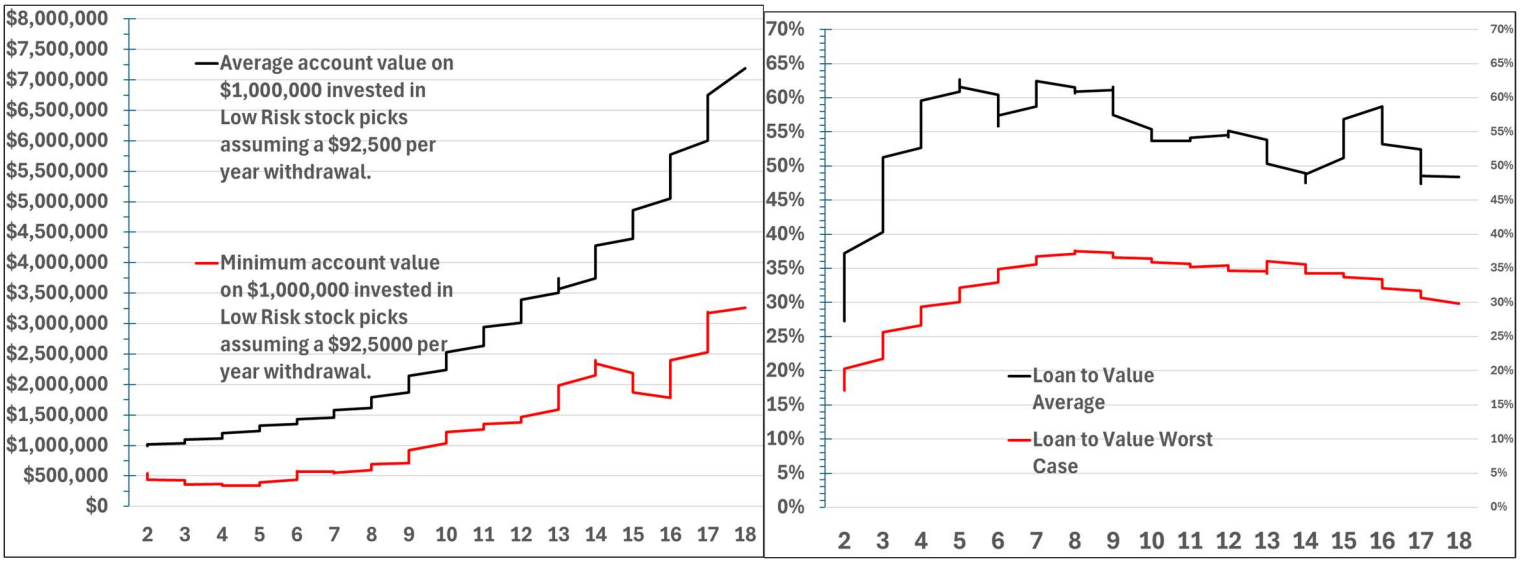
Alternatively, using the same strategy but with our low-risk model stocks, and tracking the results over the same 3390 different holding periods, you get the charts below. I bumped the withdrawal up to $92,250 per year or 9.25% as that is the maximum that you could take and not have the loan balance go over 65%. Obviously, that is too high a number, but for holdings accumulated anytime between 1999 and now, 9.25% would have been the *maximum* you could have safely withdrawn annually. The returns are generated from the 124 different portfolios generated by our low-risk model selected out of the universe of stocks in the S&P. That is, the stocks purchased are the lowest risk, most profitable companies in the index on the day that we run the model at the end of each quarter. We systematically buy ten different portfolios over ten quarters and then hold all of the companies for six years when we again update the names with new portfolios selling and buying over another ten quarters. This added wrinkle of rebalancing after six years keeps the stocks long enough to benefit from their superior attributes but refreshes the list as better names appear. Bad luck with timing could find you with your $1,000,000 invested worth only $340,000 after five years. You would have the $462,500 that you had withdrawn, however. That was the worst-case drawdown. At year eighteen, the *minimum* historic value was over $3,000,000 - the same as the *average* return of the S&P index with only a $30,000/year distribution. The *average* return was a seven to one after 18 years in addition to the $1,665,000 taken out. That's a whole lot better than a single digit return.

Low Risk Stock Portfolio Accumulated Over Ten Quarters



This seemingly impossible result happens because of consistently higher returns. For almost all holding periods of six years or more, the low-risk stocks beat the S&P by an average of about 4.8% per year. That doesn't quite match the 6% per year that research out of Columbia University this month cites (you can find it on Google Scholar if you search for "Exploiting Myopia: The Returns to Long-Term Investing") but it's an actual net of expense return to specific stocks and not a PHD dissertation. Basically, there are just not enough long-term investors, so the ones who do have that outlook have their pick of opportunities that short-term investors overlook. I know it shouldn't be this easy but the entire financial industry is focused on maximizing their employment prospects by over-complicating things and making you think more activity is better than less.

Your experience as an investor depends upon when you buy and when you sell. The person who buys in June of 2003 and sells in March of 2009 will have a very different result than one who buys in March of 2009 and sells in September of 2015. That's why I look at all of the possible investment periods from two to eighteen years for all of the possible quarterly buy dates. When I compare each of those almost 4,000 different period returns with the S&P, I find the low risk portfolio outperformed the index 96% of the time. Simplicity and low expenses for the win!.

Tom Lukic