Cherry Tree Wealth Management

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CHERRY TREE WEALTH INSIGHTS: Published by Keith Tufte, President of Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.

INVESTING QUOTE OF THE MONTH:

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go." — Benjamin Graham

ANOTHER HORRIBLE YEAR FOR STOCK PICKERS

Trying to pick stocks that will beat the overall stock market index is extremely difficult and has gotten much more difficult over time. It is a loser's game. In 2021 86% of all actively managed U.S. stock funds underperformed their benchmark index. That was the 12th year in a row that they have underperformed the index. That is an impressively bad and consistent track record. The vast majority (80%) of investors and funds that try to pick stocks end up lagging behind the simple index significantly over a 10-year time period. Stock picking is so hard and the odds of success over time are so small that we don't even try. We prefer to invest in index-based exchange traded funds (ETFs) and index-based mutual funds so we will keep up with the index, and so that we will outperform the vast majority of actively managed funds and investors. Going with index funds is "settling for above-average" compared to most funds and investors.

ASSET CATEGORY	FUNDS THAT LAGGED THE INDEX OVER 10 YEARS (%)
All U.S. stock funds	86%
U.S. large stock funds	83%
All small company stock funds	79%
International stock funds	78%
Emerging Market stock funds	80%
Global stock funds	85%
Government Intermediate Bond funds	84%
High Yield Bond funds	94%

— Data from Standard & Poors SPIVA Research through 2021.

As you can see from the data in the chart to the left, the underperformance of active funds vs. their index is consistent across U.S. stock funds, small company stock funds, international stock funds, and bond funds. For investors in taxable accounts the case against actively managed mutual funds is even worse, since these active funds are less tax efficient than index-based funds due to their higher turnover and more short-term capital gains. On an after-tax basis an even higher percentage of actively managed funds would report worse performance than the index. If each actively managed fund only has a 20% chance of beating the market index, can you imagine how low the odds are for a typical investor's portfolio of 5-10 or more of these funds to all outperform?

Another important factor to understand is that the few funds that outperform in one time period are not any more likely to outperform in the next time period. There is no persistence in which funds are winners over time. You can't just buy the funds that have outperformed over the past three or five years and expect that they will continue to outperform. Thus, the funds advertising their great recent 5-year track record means nothing about future performance.

How can these active funds be so bad and the vast majority of them lag behind the market? The first reason is cost. Actively managed funds are typically MUCH more expensive than index-based funds. Many actively managed funds can be 10 times more expensive than the index-based funds we use. Most investors have no

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idea how much the funds they own cost. We focus on it. The other reason is that there are so many funds that they basically are the market, and by definition at least half of them must be in the bottom half. The stock market is smarter and more efficient at quickly processing information into stock/bond prices than nearly any individual could be.

With such overwhelming evidence that picking stocks and actively managed funds doesn't work why do so many people keep investing in them? It is the power of hope (and fund advertising) over experience and facts. The fund companies only advertise the funds they manage that have good recent performance, while keeping quiet about the majority of their funds that are losers. They also close down or merge their loser funds so their bad track records "go away" which creates some survivorship bias. This gives the illusion to the unsuspecting public that they are a good fund firm full of outperforming funds. And keep in mind an outperforming fund over the past 5 years has no higher odds of continuing to outperform over the next 5 years.

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Professional fund managers at firms like Fidelity and T. Rowe Price have many years of experience, often MBA degrees from great schools, work full-time on just this mission, have unlimited access to computer power and data, access to the CEO and CFO of the companies they follow, and have a huge team of industry analysts following all their stocks for them. And the vast majority of them can't beat the index. Keep this in mind when you hear a "hot stock tip" on CNBC or from a stockbroker or if you think you can pick a few winners doing some internet research in a couple hours on Saturday morning in your den.

On CNBC: The vast majority of funds (80%) lag behind the benchmark index over time.

Also On CNBC: Coming up next we have a fund manager who will tell you where to put your money!

We feel very confident that our investment strategy which focuses on asset allocation and uses low-cost, tax-efficient, diversified, liquid, simple, index-based funds is the best way to invest. This is backed by extensive empirical evidence. That is why we think of ourselves as "evidence-based" investors. We use what the majority of the evidence and research shows works best over time.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (President of CTW) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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