GLOBAL
WEALTH ADVISORS LLC
Registered Investment Advisor

INSIGHTS

Michael J. Krencicki, MSF, CFP ® Winter 2017 James M. Knaus, MSM, CFP ®

Prediction Season

December 2016

The close of each calendar year brings with it the holidays as well as a chance to look forward to the year ahead. In the coming weeks, investors are likely to be bombarded with predictions about what the future, and specifically the next year, may hold for their portfolios. These outlooks are typically accompanied by recommended investment strategies and actions that are aimed at trying to avoid the next crisis or missing out on the next "great" opportunity. When faced with recommendations of this sort, it would be wise to remember that investors are better served by sticking with a long-term plan rather than changing course in reaction to predictions and short-term calls.

Predictions and Portfolios

One doesn't typically see a forecast that says: "Capital markets are expected to continue to function normally," or "It's unclear how unknown future events will impact prices." Predictions about future price movements come in all shapes and sizes, but most of them tempt the investor into playing a game of outguessing the market. Examples of predictions like this might include: "We don't like energy stocks in 2017," or "We expect the interest rate environment to remain challenging in the coming year." Bold predictions may pique interest, but their usefulness in application to an investment plan is less clear. Steve Forbes, the publisher of *Forbes Magazine*, once remarked, "You make more money selling advice than following it. It's one of the things we count on in the magazine business—along with the short memory of our readers."[1] Definitive recommendations attempting to identify value not currently reflected in market prices may provide investors with a sense of confidence about the future, but how accurate do these predictions have to be in order to be useful?

Consider a simple example where an investor hears a prediction that equities are currently priced "too high," and now is a better time to hold cash. If we say that the prediction has a 50% chance of being accurate (equities underperform cash over some period of time), does that mean the investor has a 50% chance of being better off? What is crucial to remember is that any market-timing decision is actually two decisions. If the investor decides to change their allocation, selling equities in this case, they have decided to get out of the market, but they also must determine when to get back in. If we assign a 50% probability of the investor getting each decision right, that would give them a one-in-four chance of being better off overall. We can increase the chances of the investor being right to 70% for each decision, and the odds of them being better off are still shy of 50%. Still no better than a coin flip. You can apply this same logic to decisions

A Personal Note From Global Wealth Advisors

Last month, the Federal Reserve's Open Market Committee raised the Federal Funds rate .25%, something they had done only once before in the last ten years. This move signaled the end of the government's seven year run of suppressing short-term interest rates through three Quantitative Easing programs.

Federal Reserve Chairwoman Janet Yellen said in a briefing that unemployment is down to acceptable levels (4.6% in November), inflation is still low (1.7% in November), and overall growth in the US economy was moderate (third quarter 2016 GDP was 3.2%). In other words, it was time.

Bond prices were down in November in anticipation of that increase but the US equity markets reacted positively to the November election results. The talk of reducing taxes, increasing infrastructure spending and bringing jobs back to America resonated well with investors.

As we look forward to 2017, we must remember that we never know what the future will bring, and that is especially true in investing. Therefore, we accept short-term volatility as part of the long-term process of global investing. As investor Robert Arnott once said, "In investing, what is comfortable is rarely profitable." Have a Happy and Healthy New Year.

Jim Knaus Mike Krencicki

within asset classes, such as whether to currently be invested in stocks only in your home market vs. those abroad. The lesson here is that the only guarantee for investors making market-timing decisions is that they will incur additional transactions costs due to frequent buying and selling.

The track record of professional money managers attempting to profit from mispricing also suggests that making frequent investment changes based on market calls may be more harmful than helpful. Exhibit 1, which shows S&P's SPIVA Scorecard from midyear 2016, highlights how managers have fared against a comparative S&P benchmark. The results illustrate that the majority of managers have underperformed over both short and longer horizons.

Rather than relying on forecasts that attempt to outguess market prices, investors can instead rely on the power of the market as an effective information processing machine to help structure their investment portfolios. Financial markets involve the interaction of millions of willing buyers and sellers. The prices they set provide positive expected returns every day. While realized returns may end up being different than expected returns, any such difference is unknown and unpredictable in advance.

Exhibit 1: Percentage of US Equity Funds That Underperformed a Benchmark

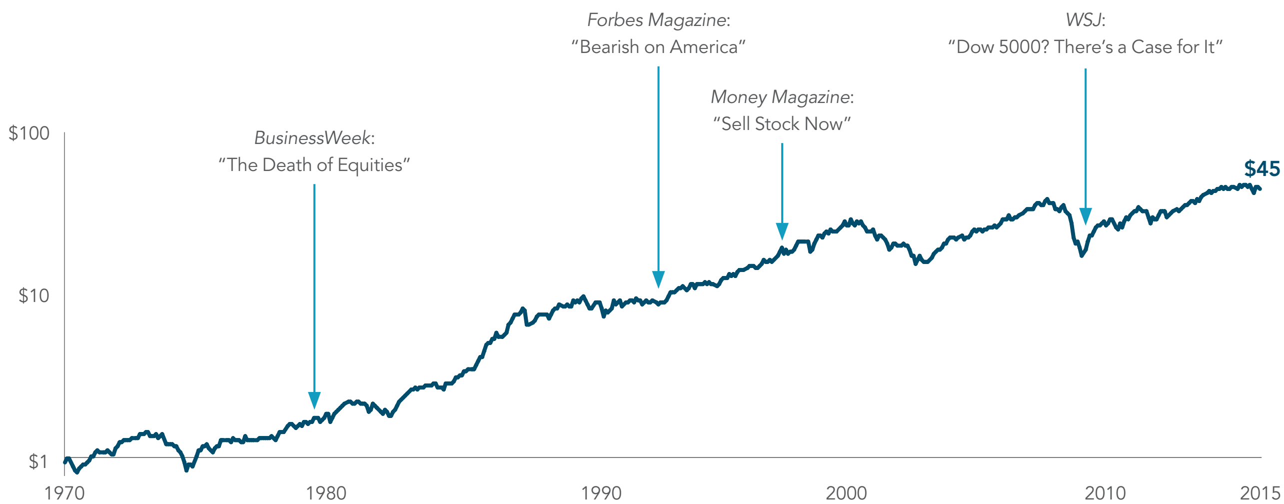
Fund Category	Comparison Index	One Year (%)	Five Year (%)	10 Year (%)
All Large Cap Funds	S&P 500	84.62	91.91	85.36
All Mid Cap Funds	S&P MidCap 400	87.89	87.87	91.27
All Small Cap Funds	S&P SmallCap 600	88.77	97.58	90.75

Source: SPIVA US Scorecard, "Percentage of US Equity Funds Outperformed by Benchmarks." Data as of June 30, 2016.

Past performance is no 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. The S&P data is provided by Standard & Poor's Index Services Group.

Exhibit 2: Markets Have Rewarded Discipline

Growth of a dollar—MSCI World Index (net dividends), 1970–2015



In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. MSCI data © MSCI 2016, all rights reserved.

Over a long-term horizon, the case for trusting in markets and for discipline in being able to stay invested is clear. Exhibit 2 shows the growth of a US dollar invested in the equity markets from 1970 through 2015 and highlights a sample of several bearish headlines over the same period. Had one reacted negatively to these headlines, they would have potentially missed out on substantial growth over the coming decades.

Conclusion

As the end of the year approaches, it is natural to reflect on what has gone well this year and what one may want to improve upon next year. Within the context of an investment plan, it is important to remember that investors are likely better served by trusting the plan they have put in place and focusing on what they can control, such as diversifying broadly, minimizing taxes, and reducing costs and turnover. Those who make changes to a longterm investment strategy based on short-term noise and predictions may be disappointed by the outcome. In the end, the only certain prediction about markets is that the future will remain full of uncertainty. History has shown us, however, that through this uncertainty, markets have rewarded long-term investors who are able to stay the course. ●

[1] Excerpt from presentation at the Anderson School of Management, University of California, Los Angeles, April 15, 2003.

The Power of the Markets

In 1958, economist Leonard Read published an essay entitled "I, Pencil: My Family Tree as Told to Leonard E. Read." The essay, narrated from the point of view of a pencil, describes the "complex combination of miracles" necessary to create and bring to market the commonplace writing tool that has been used for generations. The narrator argues that no single individual possesses enough ability or know-how to create a pencil on their own. Rather, the mundane pencil—and the ability to purchase it for a "trifling" sum—is the result of an extraordinary process driven by the knowledge of market participants and the power of market prices.

The Importance of Price

Upon observing a pencil, it is tempting to think a single individual could easily make one. After all, it is made up of common items such as wood, paint, graphite, metal, and a rubber eraser. By delving deeper into how these seemingly ordinary components are produced, however, we begin to understand the extraordinary backstory of their synthesis. Take the wood as an example: To produce wood requires a saw, to make the saw requires steel, to make steel requires iron. That iron must be mined, smelted, and shaped. A truck, train, or boat is needed to transport the wood from the forest to a factory where numerous machines convert it into lumber. The lumber is then transported to another factory where more machines assemble the pencil. Each of the components mentioned above and each step in the process have similarly complex backstories. All require materials that are sourced from far-flung locations, and countless processes are involved in refining them. While the multitude of inputs and processes necessary to create a pencil is impressive, even more impressive are the coordinated actions required by millions of people around the world to bring everything together. There is the direct involvement of farmers, loggers, miners, factory workers, and the providers of capital. There is also the indirect involvement of millions of others—the makers of rails, railroad cars, ships, and so on. Market prices are the unifying force that enables these millions of people to coordinate their actions efficiently.

Workers with specific knowledge about their costs, constraints, and efforts use market prices to leverage the knowledge of others to decide how to direct their own resources and make a living. Consider the farmer, the logger, and the price of a tree. The farmer will have a deep understanding of the costs, constraints, and efforts required to grow trees. To increase profit, the farmer will seek out the highest price when selling trees to a logger. After purchasing the trees, the logger will convert them to wood and sell that wood to a factory. The logger understands the costs, constraints, and efforts required to do this, so to increase profit, the logger seeks to pay the lowest price possible when buying trees from the farmer. When the farmer and the logger agree to transact, the agreed upon price reflects their combined knowledge of the costs and constraints of both growing and harvesting trees. That knowledge allows them to decide how to efficiently allocate their resources in seeking a profit. Ultimately, it is price that enables this coordination. On a much larger scale, price formation is facilitated by competition between the many farmers that sell trees to loggers and between the many loggers that buy trees from farmers. This market price of trees is observable and can be used by others in the production chain (e.g., the lumber factory mentioned above) to inform how much they can expect to pay for wood and to plan how to allocate their resources accordingly.

The Power of Financial Market

There is a corollary that can be drawn between this narrative about the market for goods and the financial markets. Generally, markets do a remarkable job of allocating resources, and financial markets allocate a specific resource: financial capital. Financial markets are also made up of millions of participants, and these participants voluntarily agree to buy and sell securities all over the world based upon their own needs and desires. Each day, millions of trades take place, and the vast collective knowledge of all of these participants is pooled together to set security prices. Exhibit 1 shows the staggering magnitude of participation in the world equity markets on an average day in 2015.

Any individual trying to outguess the market is competing against the extraordinary collective wisdom of all of these buyers and sellers. Viewed through the lens of Read's allegory, attempting to outguess the market is like trying to create a pencil from scratch rather than going to the store and reaping the fruits of others' willingly supplied labor. In the end, trying to outguess the market is incredibly difficult and expensive, and over the long run, the result will almost assuredly be inferior when compared to a market-based approach. Professor Kenneth French has been quoted as saying, "The market is smarter than we are and no matter how smart we get, the market will always be smarter than we are." One doesn't have to look far for data that supports this. Exhibit 2 shows that only 17% of US equity mutual funds have survived and outperformed their benchmarks over the past 15 years. ●

Exhibit 1: Embrace Market Pricing

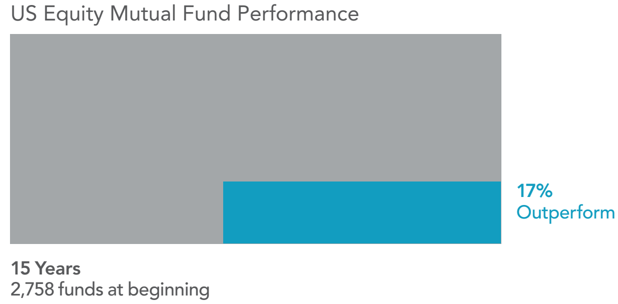
World Equity Trading in 2015

	Number of Trades	Dollar Volume
Daily Average	98.6 million	$447.3 billion

In US dollars. Global electronic order book (largest 60 exchanges).
Source: World Federation of Exchanges.

Exhibit 2: Don't Try to Outguess the Market

US Equity Mutual Fund Performance



Beginning sample includes funds as of the beginning of the 15-year period ending December 31, 2015. Past performance is no guarantee of future results. Source: Dimensional Fund Advisors, "The US Mutual Fund Landscape." See disclosures for more information.

There is no guarantee investment strategies will be successful.

US-domiciled mutual fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago. Certain types of equity funds were excluded from the performance study. Index funds, sector funds, and funds with a narrow investment focus, such as real estate and gold, were excluded.

Funds are identified using Lipper fund classification codes. Correlation coefficients are computed for each fund with respect to diversified benchmark indices using all return data available between January 1, 2001, and December 31, 2015. The index most highly correlated with a fund is assigned as its benchmark. Winner funds are those whose cumulative return over the period exceeded that of their respective benchmark. Loser funds are funds that did not survive the period or whose cumulative return did not exceed their respective benchmark.

All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services.

Ken French is a member of the Board of Directors for and provides consulting services to Dimensional Fund Advisors LP.

Dimensional Fund Advisors LP is an investment advisor registered with the Securities and Exchange Commission.

Global Wealth Advisors LLC
200 East Big Beaver Road • Troy, MI 48083 • Phone: 248-457-4555 • www.gwallc.com