Q3 2017 Market Commentary

The S&P 500 index is made up of 500 of the largest US companies and is estimated to cover roughly 80% of the market's available capitalization. As such it is the default benchmark used to gauge the economy, the health of the equity markets and in many cases the performance of one's own portfolio.

But using a nearly universal representation of the equity market to measure something as specific as how well you will be able to maintain your personal standard of living throughout retirement is misleading at best and at worst can lead investors to make strategic allocation decisions based upon inaccurate comparisons because the index is nothing like your actual invested savings for a variety of reasons.

First and foremost is the actual construction of the index. These 500 companies are chosen because of their market capitalization where capitalization is defined as the number of outstanding shares of a company's stock multiplied by its stock price. To be a part of the index a company must have a market value of at least $6.1 billion or more. Likewise, Standard & Poor's will only include US domiciled companies with at least 50 % of their assets and revenues from the US.

Most broadly diversified portfolios include at least a portion (10-20%) of foreign stocks, as well as firms that range from large to mid-sized and small. So right away there are discrepancies between what prudent planners would consider a well-diversified portfolio for their clients and the favored benchmark.

Digging even deeper, consider that market capitalization is not the same as book value in that it is entirely dependent on the price of a company's stock – disregarding long-term debt and even earnings. This can lead to interesting decision making by company management (which is another market commentary topic in and of itself) but more to the point it can create a situation where the best performing stocks take on an outsized role in the performance of the index.

You see, not only are companies chosen for inclusion based on their market capitalization but their "weighting" in the index is based on it as well. The largest companies, by market cap, enjoy the largest representation within the index. So while Standard & Poor's does try to maintain a balance of all industry sectors (healthcare, energy, consumer staples, etc.) this weighting by market cap can skew toward one industry sector if those stocks are doing well (like, say , technology stocks).

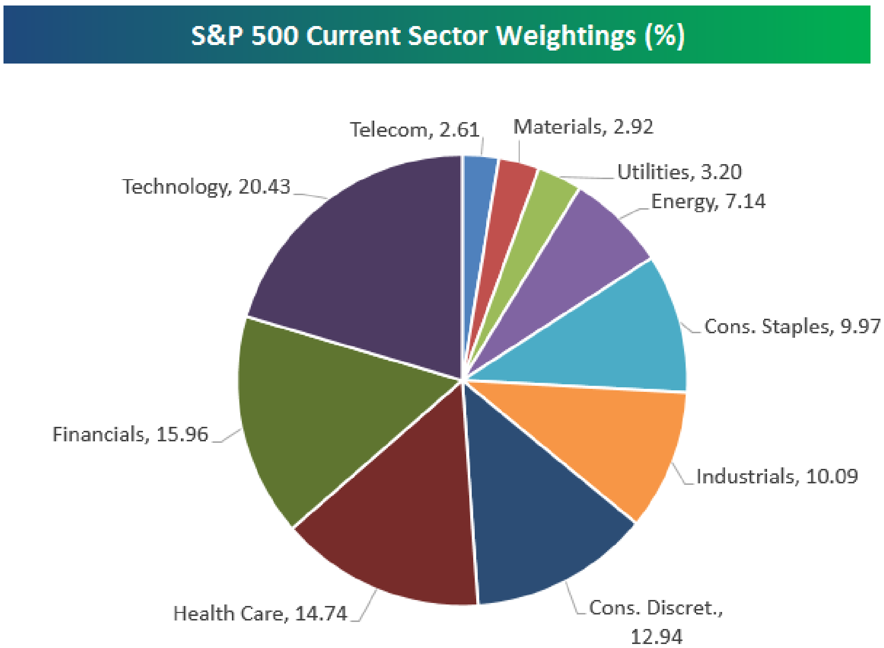
This effect can become so pronounced that the index no longer becomes a reasonable bellwether for the health of the economy as a whole. A particularly popular sector that suddenly falls out of favor can suggest an economy that is slowing when in fact the problems are really rather isolated.

This happened during 2015 when oil prices dropped quickly and precipitously. Up to that point, energy stocks were all the rage based on presumptions of growth (strategic drilling methods and new technologies) and high yields (pipeline and exploratory MLPs). This inflated the impact that companies like Exxon and Transocean had on the index as a whole, as their share prices soared.

Once the size of the ensuing oversupply in oil was realized, those stock prices fell back quickly, and kept falling. This led to softening prices in the related sectors of materials (commodity companies) and industrials (excavating equipment) and lackluster performance in the index as a whole, despite the fact that consumer, technology and healthcare stocks actually continued to perform well.

The reverse is possible as well as witnessed by recent sector performance. The technology sector has been singled out as the reason for the meteoric rise in the index over the last several months. In fact, it has been noted that the sector concentration in the index is even more pronounced now than it has ever been. An analysis of the index's performance over the first few months of the year by Barclay's Research revealed that nearly half of the appreciation in the S&P 500 (46.8%) was attributable to just 10 stocks.

Technology has majority representation in that list (six out of the ten are tech stocks) and that makes sense as the prices of stocks in the tech sector have grown considerably. Right now, technology is the largest sector component of the index by a significant margin – the next largest sector is the financial industry, which has enjoyed a boost due to the promise of rising rates.



This kind of ebb and flow between sectors is natural in the market. The way the index is constructed, however, can sometimes amplify the impacts of this natural cycle, causing the index itself to become more volatile as an investment than the actual market it represents.

This brings us to the next issue – that, even if it were advisable to construct a portfolio that exactly mirrored the index, your actual return experience will be lower than the average return of the index – over any time period, but increasingly so the longer you are invested. There are a number of reasons for this.

First, the index will never hold cash or any cash-like securities (money market or short term bond funds) but you will, because you will inevitably need your savings to pay for things, big and small – planned or unplanned. And when you do, you may also need to pay taxes. Taxes are never a consideration in the index, but they are for you. You can defer taxation by holding the investment in an IRA or a tax deferred annuity but you (or your heirs) will need to pay them eventually. This isn't reflected in most comparisons between actual investors and the index.

Nor are the costs of rebalancing, which happens in the index naturally as part of the business cycle. An investor would need to trade often if their intention is to keep up with rotations that are common in the S&P 500, shifting weightings in and out of favored stocks. Even in an Exchange-Traded Fund set to follow the S&P 500 exactly, all of this rebalancing and reinvestment has a cost that, while possibly minimal, is non-existent in the actual index.

Inflation is also not an issue for the S&P 500, but the impact that it has on the ability of your savings to meet your spending needs cannot be overstated. The cost of your standard of living will increase over time – that is a given, with very few exceptions. Most return figures you see for the S&P 500, or any index really, are in Nominal terms. In other words, you need to actively adjust the results for the impact of inflation to see what would have really happened to your money because your money, invested or not, is always impacted by inflation.

And finally, and most importantly, the average return of the S&P 500 – or any other index, over any time period – belies the reality of how you would experience those returns. Dollars that you invest, into anything, are cumulatively impacted by the experience of that investment while the measure of that performance, by definition, is not.

A 10% drop in the first six months of the year will necessitate an 11% increase in the next six months in order to get back to your starting dollar amount by December. A deeper loss in a bear market, of 20% for instance, would require a recovery of 25%, again just to break even.

To put it differently, the effect of investment losses are compounded the same as gains, and this can be so disruptive that an investor suffering a significant loss must not only start over, but start over from a lower value. As an example, if your target return is 4% but the balance of your savings experiences a 20% decline in a downturn, then that 4% target suddenly becomes woefully inadequate. Your target will need to be higher, permanently. In this way, taking on too much market risk necessitates taking on potentially more market risk later, as you are starting from a lower balance – and have less time to grow your savings.

For an index, time is arbitrary. There are no deadlines, and performance can be expressed in calendar terms (Year to date) or in years (rolling 12 months) without much in the way of lasting differences. For our clients, time is anything but arbitrary – the time it takes to build up savings, and the time before those savings will be called upon to finance goals, are the most decisive factors in determining the feasibility of any plan. For the S&P 500, a full recovery from the financial crisis took about six years, which is a lot of lost time that investors can never recover.

With all of that said it should be noted that we at Northstar do use indexes, the S&P 500 in particular, as a tool for evaluating the health of the market over a particular period of time – or even to assess the mood of a particular day. But we would never judge a client's portfolio against the S&P or any other index because most clients hold too wide a variety of assets to really be captured by an index (especially if you consider your home an asset, as many do).

Of course that doesn't mean we don't measure performance or use benchmarks. For the purposes of building and maintaining an investment portfolio, we will create a benchmark that matches up with what our clients are actually holding, at that moment, so that we can determine if the particular securities that we are using are doing the job that we are asking of them, or if there might be an alternative that does better. If the benchmark does not agree with our expectations of how a client should be allocated, then we know that a rebalancing is probably in order.

Similarly, if a client's investment performance begins to lag their benchmark or is otherwise out of line with expectations, then we know we need to examine their holdings, or allocation, to see if any changes may be helpful. But the key is that our expectations are developed and informed by our clients themselves – their time line, their level of resources and capacity for saving, and their own personal responses to a variety of market environments – not by what a given index might or might not be doing.

The S&P 500, indeed an investment portfolio of any kind, on its own cannot speak to any of the reasons why we create an investment portfolio in the first place; to provide for future spending in a manner that accounts for inflation – keeping taxes as much in mind as the potential for emergency needs, to help finance an investment in a child's education, to maintain a comfortable lifestyle without working.

That is why, even as we take measure of our clients' portfolio performance, the only measure of success that we feel is appropriate is attaining, and sustaining, the financial goals that are developed and refined over their lifetime. If you have questions about your own goals and how your investment performance relates to their achievement, reach out at your convenience by email at Julia@nstarfinco.com and Steve@nstarfinco.com, or by phone at 800-220-2161.

Take Care,

Steven B. Girard
President

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