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# Urban Legends

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Storytelling has always been an important part of our culture. There are many different genres of storytelling; fables, nursery rhymes, and urban legends are a few. Fables are stories that convey a moral. Nursery rhymes are short stories designed to entertain children, although they are often dark and disturbing. The fiction in fables and nursery rhymes is transparent. Animals speak to one another and geese lay golden eggs. Urban legends are also fictional but are conveyed to be true. The goal of an urban legend is to convince the listener that something is true even though it isn't. Often the storyteller themselves is unaware an urban legend isn't true. Since urban legends aren't true, storytellers don't tell the story from a first-person perspective. They use the friend of a friend technique when telling the story. This allows for the story to appear to be true even though it isn't.

Most everyone reading this commentary has heard about cow tipping. Cow tipping is an urban legend (not just in my home state of Wisconsin). There are many variations of this urban legend, but most versions start with a late night of beer drinking and end with the partygoers sneaking up on an unsuspecting cow and pushing the bovine over. Simple research would prove this story to be an urban legend, yet many believe it to be true. For starters, cows don't sleep standing up. Cows are also very aware of their surroundings, sneaking up on them is almost impossible. If somehow you overcame these obstacles and did find a dim-witted standing-up sleeping cow, you would then need 4,000 newtons of force (about 14 people) to push the massive beast over. Nevertheless, this urban legend lives on.

Another urban legend is the average historical returns on investment portfolios. Investors enjoy telling stories about how well their investments have performed. More specifically, they enjoy letting others know how expert their investment skills are. We acknowledge that some investors have made outsized gains, but on average investors inflate their returns when telling these tales. There are many different reasons investors exaggerate their returns. Two of the biggest reasons are ego (they want to be viewed as a skilled investor) and selective memory (they remember the good investments and forget the bad).

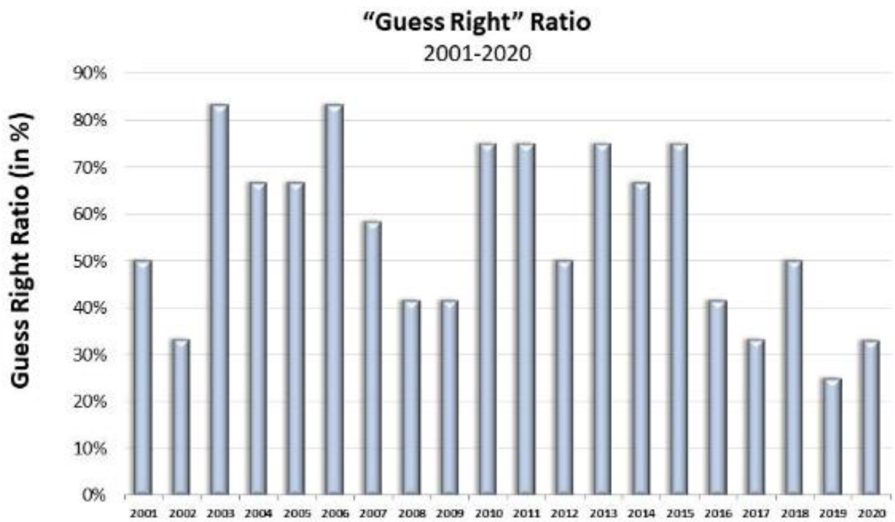
Importantly, this urban legend creates an unrealistic expectation for all investors. Investors systematically overestimate what is a realistic long-term expectation for their investment portfolios. Research on average long-term stock and bond market returns, along with numerous academic studies, sets a more realistic expectation of future returns.

The Dalbar Company is widely considered the investment industry's leading independent expert on industry-wide investor returns. They created our industry's seminal study on investor returns, the *Quantitative Analysis of Investor Behavior (QAIB)*. The study compares how the average investor performed relative to the stock and bond market. The study has been conducted annually for many years. QAIB data shows the average stock and bond investor has consistently underperformed the broad markets over every time frame (study is through 12/31/2020).

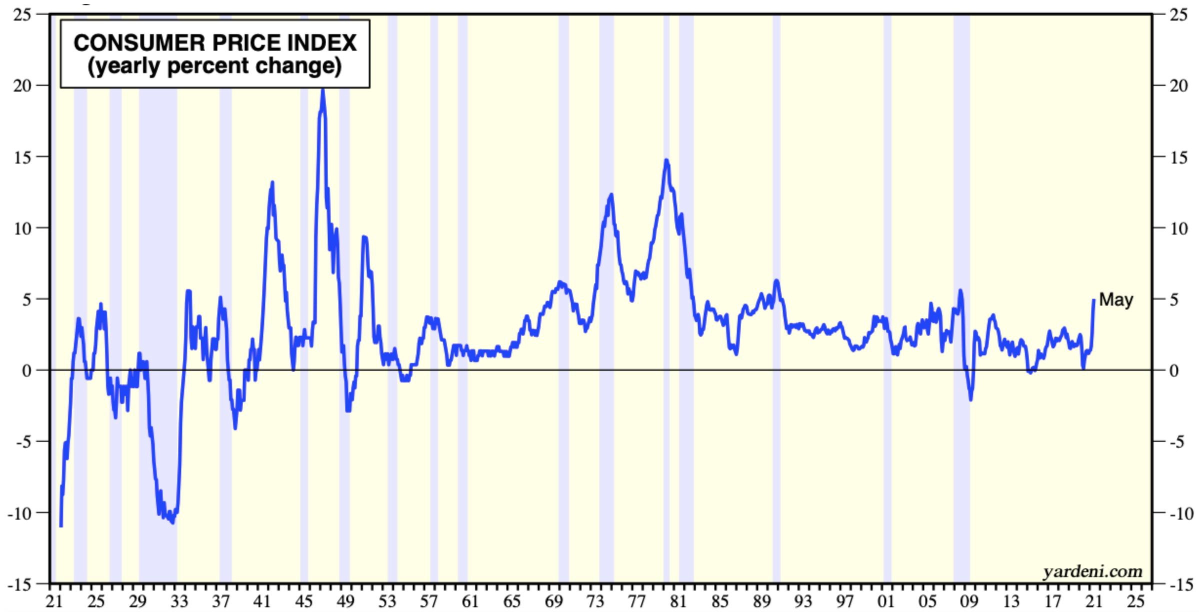
| | Average Equity Fund Investor | Average Fixed Income Fund Investor | Average Asset Allocation Fund Investor | S&P 500 | Bloomberg-Barclays Aggregate Bond Index | Inflation |
|---|---|---|---|---|---|---|
| | (%) | (%) | (%) | (%) | (%) | (%) |
| 20 Year | 5.96 | 0.57 | 2.89 | 7.47 | 4.83 | 2.05 |
| 10 Year | 10.23 | 0.73 | 4.90 | 13.88 | 3.84 | 1.77 |
| 5 Year | 12.31 | 1.40 | 6.12 | 15.22 | 4.44 | 1.95 |
| 3 Year | 10.37 | 1.61 | 4.48 | 14.18 | 5.34 | 1.86 |
| 12 Month | 17.09 | 3.09 | 6.13 | 18.40 | 7.51 | 1.36 |

This underperformance was attributed to behavioral issues. Most notably, investors bought stocks and bonds when markets went up and sold stocks and bonds when markets went down. The average investor tends to be a lousy market timer. The buy high and sell low strategy is not one we recommend. Dalbar created a G*uess Right Ratio* that measures investors' market timing successes and failures. This ratio examines investors' net purchases and sales relative to subsequent market returns. The *Guess Right Ratio* shows that investors guess right less than

50% of the time over the long term, including each of the last 5 years. More importantly, the negative impact of guessing wrong is far greater than the positive impact of guessing right. This is due to the dollar amount of bad guesses exceeding the dollar amount of right guesses. A great example was 2020. Many investors pulled most of their money out of stock markets after the pandemic selloff (bad guess). Then they only gradually reinvested as markets recovered (right guess). It took many months for the money that was pulled out to be fully reinvested, so much of that money missed out on the recovery.

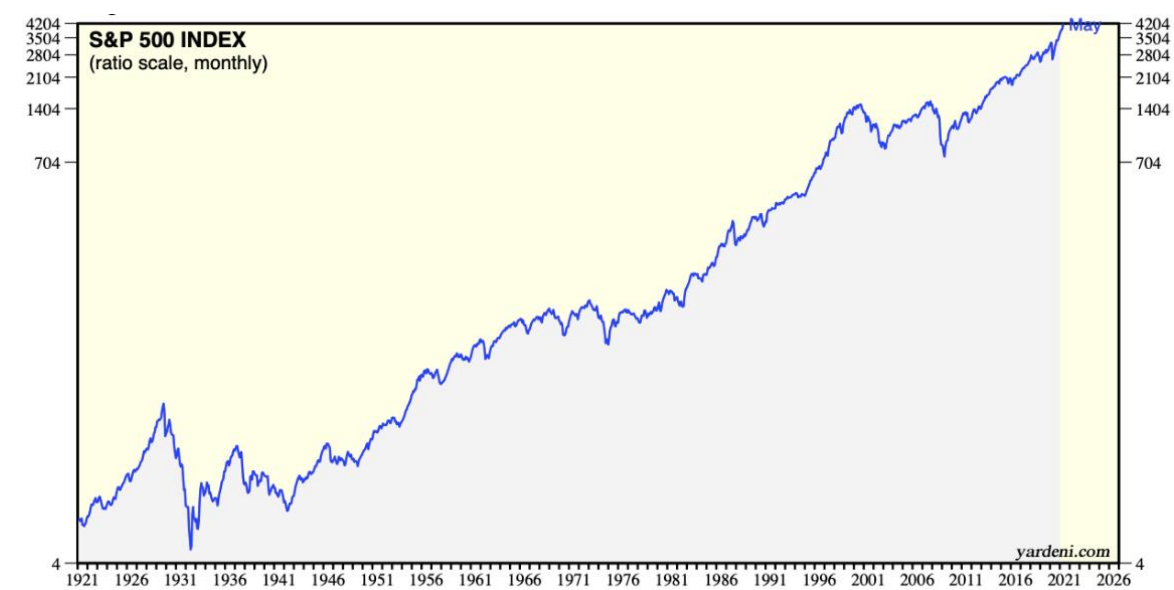



Academic studies also show us that investors incorrectly measure historical market returns. This also leads investors to overestimate future market returns. Specifically, investors use absolute returns (nominal) instead of real returns (inflation-adjusted). This is an enormous mistake. The Capital Asset Pricing Model (CAPM) shows us that the proper way to measure market returns is to look at the long-term real return of markets, and then add the current inflation rate back in. This makes sense. A 15% return in the 70s' (inflation rate was 15%) is less desirable than 10% return today.




Our investment process, and we believe any viable investment process, uses real returns when constructing portfolios. As financial advisors, our primary goal is to make sure we invest your money prudently so that you successfully obtain your financial goals. Often your goals are retirement or education. We construct and discuss your financial plan together.

We have all heard it said, “Stock markets return 10% a year on average”. We would argue this is urban legend. The S&P 500 has averaged a little below 10% (about 9.8%) over the last century.

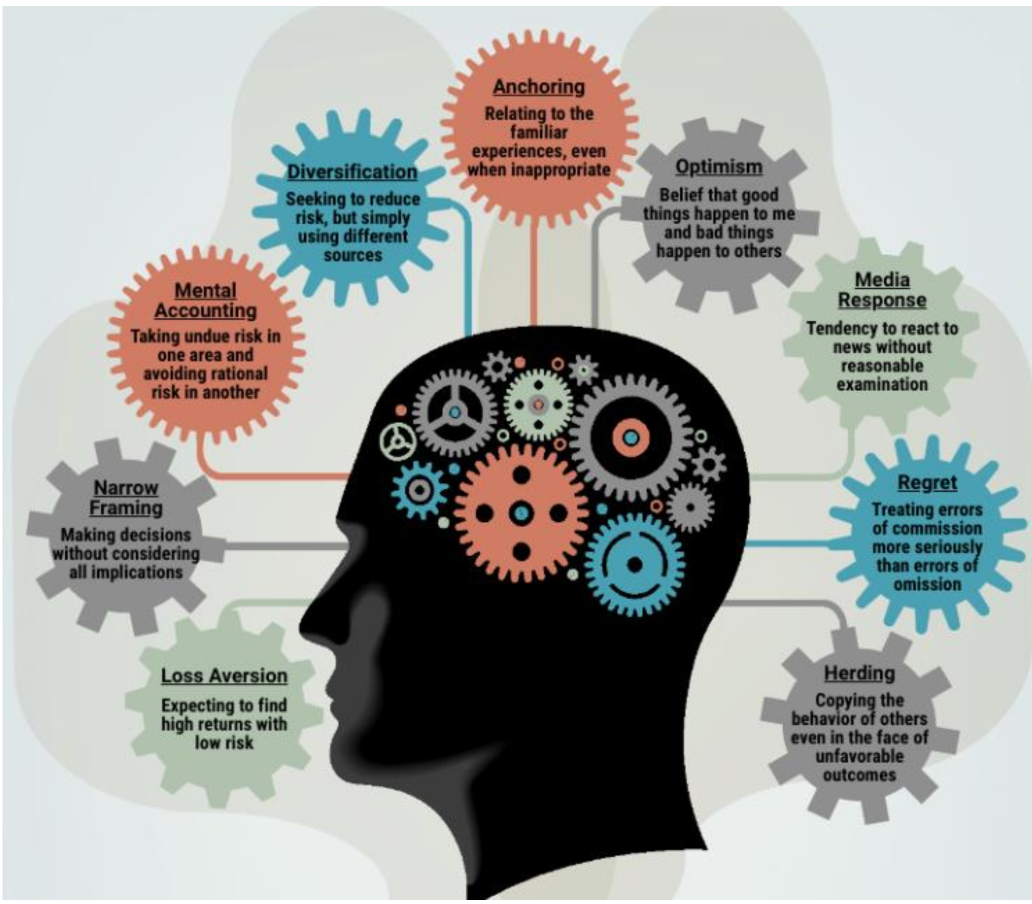



Admittedly, we are being a bit petty on that one. Okay, a lot petty. Here's the real catch, the inflation rate has averaged 4.5% over the last century. This means the real return of stocks over the last

100 years is about 5.3% (9.8% minus 4.5%). It's at this point we take on the accent and persona of Joe Pesci and Marisa Tomei during their closing arguments in *My Cousin Vinny.*

"Therefore, the inflation rate has been hovering right around 2% over the last 20 years and the S&P 500 has returned 7.47% during this period. (Reference our first table of returns). So, it goes to stand that the actual real rate of return of stocks has and continues to be 5.3%. Given the current 2.2% inflation rate, 7.5% is the expected rate of stock returns for the foreseeable longer-term, not 10%."

Portfolio returns have been quite robust over the last 15 months and we are certainly pleased about that. Our concern is that investors are developing unrealistic expectations about future returns. Being a successful investor is challenging. The human brain has natural biases built in that are counter-productive to creating wealth. One of these biases is *recency bias*. Investors give a disproportionate amount of weight to recent returns and overlook long-term returns when developing expectations. The Dalbar Report identifies another 9 distinct behaviors that cause investors to harm their own portfolio returns.



We continue to be constructive on markets. We believe investors will continue to experience modestly appreciating markets along with much more volatility. That has been the case over the last couple of months. We must all prepare ourselves for returns closer to long-term averages, not what recent returns have provided.

**My Cousin Vinny** - This movie is a classic that is often shown on late-night TV. We are hopeful a *My Cousin Vinny* sequel will feature MMFS's storyline about disproving the false allegations about long-term investor returns. Might we also suggest that Brad Pitt would be a great choice to most closely resemble our likeness?

Happy July 4th,
The Mommaerts Mahaney Financial Team

**Jon C Mommaerts, CFP®:** Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

**J. Matthew Tuccini, CFP®:** Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

**Robert Kea, CFA:** Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

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Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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