October 15, 2023

Dear Client,

It didn't seem possible for the world to become more uncertain but with the attack on Israel, it has. And there is still the war in Ukraine. A now Speaker-less House of Representatives is paralyzing government. Economic headlines are all over the place; recently released data show low unemployment (good or bad depending on who you read) and persistent inflation (also good or bad depending on who you read). The United Auto Workers Union is on strike potentially crippling the auto industry. Is the economy headed for a soft landing? Will interest rates be "higher for longer"? Is recession around the corner? Is AI going to take over the world? After a big surge at the beginning of the year, Bitcoin is trailing the S&P 500 by about 16% over the past six months so is crypto good or bad?

Not surprisingly, opinions on what the future will bring are also all over the place. Which of course means nobody knows! The future is, by definition, unknowable. An opinion piece we read reminded us of the classic Samuel Beckett play *Waiting for Godot* in which the two main characters spend the entire play waiting for the off-stage character, Godot, to appear while they ponder life. But Godot never arrives leaving the audience bewildered. Sound familiar? There have been an awful lot of predictions about recession around the corner, but it never gets here leaving many pundits bewildered. It may happen tomorrow, or it may not. We just don't know.

This reminds us of the John Lennon lyric, "life is what happens to you while you're busy making other plans," and in that spirit, since we can't control macro-economic and political events and we can't wait around for Godot to maybe show up, we move forward and focus on what we can control – your financial plan, the investments within your portfolio, keeping costs low and managing taxes. As Jack Bogle, the founder of Vanguard, is quoted as saying, "Don't look for the needle in the haystack. Just buy the haystack." It's not sexy nor "get rich quick" but we believe in the underlying philosophy and have implemented it in a way we think enhances results to provide an efficient and steady path for our clients to achieve their financial goals. We're going to get technical now to address two aspects of this, first is a question that we're encountering more and more and second is what we mean by "enhances results."

The question is this: if everyone "buys the haystack" then who is determining the prices? Indexing and passive investing started over 50 years ago when the first index fund was created in 1971 and since then there has been steady growth with particularly explosive growth over the last two decades. Last year marked the first time there was more money invested in index funds than actively managed funds. Does that mean our approach is going to break down if no one is buying and selling individual securities to set prices? You know we like to go under the hood so let's take a look and see what's really happening.

Even though there are more and more dollars flowing into index funds, that does not mean there are more and more passive investors. This year there are three index fund ETF's – an S&P 500, Invesco's QQQ, and a Russell 2000 – in the top 10 for the highest trade volume for US-listed stock positions. This trading activity suggests investors are trading based on what they think will do well. In other words, they are market timers and are actively trading using index funds rather than individual companies. However, they are picked up in the statistics as "money invested in index funds" so while there is an underlying trend toward indexing, the

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stats that show its' rise make the market seem more passive than it is. This is corroborated by data showing individual security trading volume has not meaningfully declined.

The underlying flow from actively managed funds to index funds is not surprising. When you look over a 20-year period, only 19% of the actively managed funds that stay in business for the full 20 years end up outperforming the markets. Unfortunately, you do not know in the beginning which fund will first, stay in business and then second, be part of that 19%. With active management you are taking a lot of risk in hoping the manager you select will be the winner and the odds of being right are against you. And even if they are successful, will they be so tomorrow? Consider a recent example of a star manager falling back to earth, Cathie Wood of Ark Invest. She came to fame when her flagship fund, ARK Innovation ETF (ticker ARKK) skyrocketed during the pandemic. From April 1, 2020 to February 12, 2021, ARKK had a 289% return. Phenomenal! And then the money started pouring in. What happened next? Since then, through the third quarter of 2023, ARKK is down 74%. In terms of price, that's a rise from $40.24 on 4/01/2020 to $156.58 on 2/12/2021 and then back down to $39.67 on 9/29/2023. We don't mean to single out Cathie Wood, there are numerous similar examples over the years, she writes some insightful and worthwhile things. The point is markets are fickle and unpredictable. Have we mentioned that before?

A safer bet is to simply invest in an index and get market returns but even here you need to be careful because pure indexing has some pitfalls. One is they must invest in a certain number of companies. For instance, the S&P 500 lists the 500 largest US companies but there are thousands of US large stock companies so why should your investment be limited to the 500? A second and bigger one is reconstitution which is the process by which companies in the index are removed and added. Large indexes like the S&P publish ahead of time which companies will be added or removed and the date on which the change will be made is public knowledge. This means the prices on the trading dates are skewed by the artificial volume of all the funds tracking that index having to buy and sell to reconstitute. This makes purchases more expensive and sales cheaper, which are a drag on the fund.

It is for these and other reasons that we don't actually use index funds, this is what we mean by our approach "enhances results" over simply buying the haystack. We prefer the passive techniques of Dimensional Fund Advisors (DFA) because they avoid many of the pitfalls of pure indexing. They have discretion over which companies to own and are not constrained to trading on the reconstitution date. They can add or remove companies on any day. This flexibility reduces their trading costs, which enhances their return. Our portfolios are designed to target specific asset class performance primarily using the passive funds of DFA to capture returns without the drags of pure indexing. We then employ a disciplined rebalancing process to maintain your risk exposure. This is a great improvement over pure indexing which is itself a great improvement over active stock selection.

We are going to end this letter a little differently this quarter. As difficult as the stories and images from around the world are to digest, during our working hours we have to remain focused on our clients' well-being. Usually that's with numbers and financial advice, for instance reviewing the math of trade-offs for various options or how tax or estate law can impact a situation. But often non-financial matters enter the discussion, and it is here where clients need to assess the importance of the financial versus non-financial. One of our mantras is "whatever helps you sleep best at night" and sometimes that's different than the "numerical" answer. If there's anything we can do to assist you in making these judgements and decisions or quantifying options you are considering, please don't hesitate to reach out.

John, Richard, Mary, and Ryan