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F.I.T. Focus – July 2019

The Stock Market: Many Losers, A Few Big Winners

The broad U.S. stock market is made up of a bunch of losers. We don't mean that disparagingly. It just appears that way, based upon two fascinating recent studies. According to "Do Stocks Outperform Treasury Bills?" by Hendrik Bessembinder of Arizona State University[1], among approximately 25,300 companies in the *Center for Research in Security Prices*[2] monthly return database, examined from 1926-2016, the study concluded:

- Only 42.6% had a buy-and-hold return (dividends reinvested) that beat the return of the one-month T-Bill.
- Only five stocks accounted for a full 10% of the lifetime dollar wealth creation (above T-bill) over that period. Microsoft, Apple, Exxon Mobil, IBM and GE.
- And the kicker, *only 4%* or so accounted for *all* of the lifetime dollar wealth creation, explaining the entire net gain above the T-bill since 1926. In aggregate, *the other 96%* generated lifetime dollar gains that matched investing in a one-month T-bill.

Vanguard[3] recently performed a similar study, "How to increase the odds of owning the few stocks that drive returns", over a more current time frame, from 1987 to 2017. Using the cumulative returns of the stocks within the Russell 3000 Index[4], they reached similar conclusions:

- Approximately 47% of the stocks were unprofitable.
- Almost 30% lost more than half of their value.
- On the flip side, *roughly 7% of the stocks had a cumulative return of over 1000%*.

In contrast to the return of the stock index itself, the majority of stocks have been relative losers over time. But, like Bessembinder's study above, Vanguard demonstrates that the majority of the positive long-term return of the Russell 3000 Index is a function of the returns of relatively few big winners. So what's the key takeaway here?

You have to hold the few big winners to achieve the benefit of the broad U.S. stock market's returns over time. To do that, you have two choices.

Choice #1: Pick the Winners, Avoid the Losers, Attempt to Beat the Market

Your first option is to try and pick the few big winners ahead of their gains while attempting to avoid the losers, an approach better known as "active" investing. While it's tempting to think that you, or some brilliant stock picker can consistently pick the winners, think again. The following table, from Standard and Poor's *SPIVA® US Scorecard*[5], shows the percentage of "professionally" active-managed U.S. stock funds that *do not exceed* the performance of their respective index over various time frames, ending in December 2018. Take a look at Large Cap Funds, the most standard of investment styles.

Report 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks

FUND CATEGORY	COMPARISON INDEX	1-YEAR (%)	3-YEAR (%)	5-YEAR (%)	10-YEAR (%)	15-YEAR (%)
All Domestic Funds	S&P Composite 1500	68.83	81.49	88.13	84.49	88.97
All Large-Cap Funds	S&P 500	64.49	78.98	82.14	85.14	91.62
All Mid-Cap Funds	S&P MidCap 400	45.64	74.29	79.88	88.03	92.71
All Small-Cap Funds	S&P SmallCap 600	68.45	84.35	89.40	85.67	96.73
All Multi-Cap Funds	S&P Composite 1500	66.79	82.44	88.58	86.36	90.70

Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2018. Returns shown are annualized. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

Last year, nearly 65% of funds did not beat the S&P 500 Index. Maybe they needed more time? Think again. The longer the timeframe, the worse the relative performance gets. Over the last 5 & 15 Year annualized periods, 82% and 91% of funds underperformed the S&P 500 Index, respectively. So, it typically doesn't pay to try and beat the market.

Choice #2: Be the Market

In reality, we believe it's much more effective to *simply be the market.* Do you see those indices above that beat all of those professional fund managers over time? They generally hold all of the stocks in a particular market, including the big winners that drive the market's long-term returns. Index funds, which seek to mimic the performance of those indices, provide an extremely low-cost way to nearly ensure that you hold the small minority of stocks that provide the vast majority of the market's returns over time. It has rarely been easier or more cost-effective to buy and hold the market through an index mutual fund or exchange-traded funds (ETF). As a bonus, these funds are typically very tax efficient as well.

Like many things in life, simple solutions can often be more effective than complex ones. In our view, for stock investors, the simple solution suggests that simply "being the market" generally leads to better outcomes than attempting to "beat the market".

If you have any questions regarding this report, please contact us at info@today2b.com or 914.302.3233

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End Notes:

[1.] Hendrik Bessembinder Department of Finance, May 2018, W.P. Carey School of Business, Arizona State University, Forthcoming, *Journal of Financial Economics*

[2.] CRSP monthly stock return database, which contains all common stocks listed on the NYSE, Amex, and Nasdaq exchanges

[3.] Vanguard; February 2019, Chris Tidmore, CFA; Francis M. Kinniry Jr., CFA; Giulio Renzi-Ricci; Edoardo Cilla

[4] The Russell 3000 Index represents the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

[5.] The S&P Indices Versus Active (SPIVA®) Scorecard is a robust, widely-referenced research piece conducted and published by S&P DJI that compares actively managed funds against their appropriate benchmarks on a semiannual basis.

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