



Strength in Numbers: A Golden First Half for Global Stocks

by Jim Bell, CFP®, President and Founder, Chief Investment Officer

By no means am I an authentic basketball fan. For example, I do not understand a *pick and roll*. But our Oakland office at 11th and Broadway is directly across the street from the Golden State Warriors' headquarters and practice court atop the Oakland Convention Center. Occasionally we see Warriors in restaurants and crossing the street, and when the Warriors won the NBA Championships in 2015 and 2017, the victory parades started right at the corner of our building. I have enjoyed getting swept away in Warrior fever, even though I cannot explain *pick and roll*.

Taking Stock of Basketball

As I was reading the July 1 *Wall Street Journal* headline article, "Global Stocks Cap Strong First Half," I thought of the Warriors and their team motto, *Strength in Numbers*. 26 out of the 30 indices that measure the world's highest value stock markets gained ground in the first half of



The US economy is a good example of weathering rate increases and continuing to grow.

— Jim Bell, CFP®



2017. Such synchronized results have not occurred since 2009. I will just observe that 26 out of 30 is not as good statistically as the Warriors in the 2017 playoffs winning 16 of the 17 games played.

Compounding Growth

For me, teamwork and competition in basketball share similar dynamics with global stock markets. When one economy and market does better, or a group of economies and markets do better, it can help all economies and markets do better. I think of it as a super-compounding effect. In the 2016 NBA Finals, Golden State was ahead of the Cleveland Cavaliers by three games to one. The Warriors needed only one more win to clinch the championship. It did not seem possible, but the Cavaliers came roaring back winning the final three games in a row and the championship. My nine-year old granddaughter, Sofia, was devastated.

Compounding Performance

The Warriors needed to play better in the playoffs, so in the off-season they signed

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super star Kevin Durant (KD) from the Oklahoma City Thunder; KD has had a compounding effect on the positive performance of the whole Warriors team. Even Draymond Green, the Warriors' self-control-challenged power forward played in all five games against the Cavaliers without being suspended as he was last year. In the playoffs this year, the Warriors won 12 games in a row against three different teams to get to the finals, and the competition that the Cavaliers brought made the Warriors play even better.

Growing Demand

This performance-compounding effect is going on in the world economies and markets as well. In the first half of 2017, foreign markets from South Korea to India to Spain produced double-digit gains. With demand growing in these markets, it spreads to other markets including the US, which grew in the single-digits. Strong corporate earnings are fueling the synchronized rally around the world. First quarter earnings in the US from the S&P 500 grew by 14% compared to Q1 last year; Asia and Europe on average also grew by double-digits.

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How the Dow Led to Modern Index Investing

by Forrest Bell, CFP®, Sr. Investment Advisor, Financial Planner

If you listen to the news of the day on your way to work in the morning, chances are you will hear a report about the status of the Dow Jones Industrial Average. Mentions of the Dow are even more frequent when it approaches a new high as it did in the beginning of 2017, surpassing 20,000. Charles Dow, the American journalist who created the index, would probably be proud of where it sits today, but it wasn't always so well-known, and it wasn't always setting new highs that made it famous.



Dow Jones Industrial Average Origins

The Dow Jones Industrial Average came into existence on May 26, 1896, but it wasn't until 1907 that the index started to become widely talked about. A severe recession began that year. Banks were collapsing and the New York Stock Exchange fell by almost 50%. It was during that tumultuous period that people became desperate for something to help measure and explain what was actually happening to the country economically. The statistics we rely on now to assess the health of the economy were not yet established. Statistics such as the unemployment rate and the gross domestic product were immature and unreliable measures then. In the absence of other polished statistics, people turned to the Dow to help them understand how bad things were and whether or not they were getting better.

Price-Weighted Indices

The Dow's incredible history has a lot to do with why it is still prevalent today,

but as a meaningful measure of the stock market, it has its limitations. The Dow is

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— Forrest Bell, CFP®



a price-weighted index, which means that it focuses on the share price of the stocks within the index. In order to determine the Dow Industrial Average, you add up the share price of the 30 stocks included in the index and divide by a number called the *Dow Divisor*, which is a proxy for the number of stocks in the index.

Price-Weighted Index:

Sum of Share Prices ÷ Number of Stocks

Price-weighting methodology gives extra weight to companies with high share prices. However, it is possible for a company to have a high share price but not actually contribute much to the economy. It is also possible for a company to have a low share price, but be economically significant. By focusing simply on share price, indices like the Dow exclude companies such as Alphabet (Google) and Facebook despite their importance.

Cap-Weighted Indices

In the 1970s, indices like the Dow became available as investment vehicles in the form of index funds. Although the first index investment was based on the Dow Jones Industrial Average, the ones that followed used a different methodology. Instead of price-weighting, fund companies began to do cap-weighting. Capitalization-weighted indices consider both a company's share price and the number of its outstanding shares. By multiplying share price by outstanding shares, you have a better idea of a company's size and what the market thinks the company is worth.

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Changing Strategies

Worldwide support from central banks has also helped fuel this rally with low interest rates (easy money). But now, the US Fed has raised interest rates four times in this cycle, and American businesses have integrated these increases just fine. The Fed is moving at a slow and measured pace to normalize interest rates, always studying economic data for guidance. I believe that investors overreact to central banks when they talk about slowing and ultimately reversing easy money policies. The US economy is a good example of the capacity to weather rate increases and continue to grow. The European Central Bank is now signaling that it may synchronize with the US Fed in starting to normalize interest rates.

Keeping the Team Together (or Not)

Following the Warriors blowout victory over the Cavaliers, there has been much talk among players, managers, and fans about keeping the team together. The July 4 headline in the *San Francisco Chronicle* announced that Kevin Durant has put team above self by taking a pay cut to help keep the team stay together. This is truly *Strength in Numbers* by amplifying team above self. It also shows up in the way the Warriors play together; they are unselfish in the way they pass the ball, thus realizing the strength in their numbers. Often, grace and gratitude are palpable on the court, a rare experience in modern day sports. In Europe, Emmanuel Macron's election in France has gone a long way in keeping the European Union team together. But it is more often that a team roster changes. When the global markets lose the easy money policies of central banks, I believe it will be good economics and good business. Sometimes when a team roster changes, the team realizes it has the resources to move forward stronger. ■

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Learning to Fail

by Bonnie Bell, MA, MDiv., Principal, and Director of Career/Life Coaching

There's an odd new-ish problem besieging a certain segment of our population that deserves some attention: it appears that the most successful and most-likely-to-succeed young people among us have developed an inordinate fear of failure of any kind. In the June 25, 2017 edition of the New York Times (Sunday Styles Section), columnist Jessica Bennett lays out the issues in her article, *Learning to Fail*. They are a little hard to grasp, especially for someone like me who was raised at a time when every smart girl I knew was battling her own version of "inferiority complex" and countless real and imagined exterior barriers to her success were very real. I also clearly remember that our mothers frequently warned us "not to get too big for our britches", which meant we weren't supposed to think too much of ourselves or become too confident "or people wouldn't like us." Times have definitely changed for the better, but change is always harder than we think it will be. Now there seems to be more of a quest for perfection and a terrible fear of failure, not just for women and girls.

Everyone But You Is a Star

A young, attractive Smith College student, Jaycee Greeley, whose photo is featured in the Bennett article, explains, "It's pretty easy, by viewing social media, to convince



yourself that everyone but you is a star." This misperception is so widespread that several colleges, including Smith, have found it necessary to develop programs to help students learn to "fail well." Such programs aim to destigmatize failure through discussions on perfectionism and resilience and by making students aware of the increase in anxiety and in requests

... young people among us have developed an inordinate fear of failure of any kind"

— Bonnie Bell, MA, MDiv.



for counseling on campuses. Over ten years ago, faculty at Stanford and Harvard began to use the term "failure deprived" to describe what they were seeing: the idea that even though students were appearing more and more outstanding on paper, they seemed less and less able to cope with relatively simple struggles.

Perceived Failure a Growing Concern

"Many of our students just seemed stuck," Julie Lythcott-Haims, the former Dean of Freshmen at Stanford and author of *How to Raise an Adult* wrote. In 2010, after a wave of student suicides, a consortium of academics formed to share resources regarding the growing concern about students' perceived failure, and programs addressing this problem began to proliferate. There is the *Success-Failure Project* at Harvard; the *Princeton Perspective Project*, which encourages conversation about setbacks and struggles; *Penn Faces* at the University of Pennsylvania, a play on the term used by students to describe those who have mastered the art of appearing happy even when they are struggling; and others.

Succeeding at Every Level

"There is this kind of expectation of students at a lot of these schools to be succeeding at every level: academically, socially, romantically, in our family lives, and in our friendships," said Emily Hoeven, a recent graduate who helped start the *Penn Faces* project in her junior year. She continues, "And also sleep eight hours a night, look great, work out, and post about it all on social media. We wanted to show that life is not that perfect."

Well, thank God! Because it doesn't usually take most people all that long to learn, from personal experience, that life has its ups and downs, that aiming for and working toward a good life is probably more doable and reasonable for most people

than desperately trying to create and maintain a perfect one, whatever that would be. The maxim, "The perfect is the enemy of the good," remains as true today as ever.

(For more reading on the subject of fear of failure, you might want to check out my blog of March 2012, called *Fail at Something Every Day*, advice from the mouth of Spanx entrepreneur and billionaire, Sara Blakely, who credits her own father for insisting that she and her brothers literally learn to fail at something every day — and grow from it. They did.) ■

UPCOMING EVENTS



WEBINAR (FOR CLIENTS ONLY)

Investment Committee Update

Thursday, August 24, 3 – 3:30 pm

WINE & CHEESE GATHERING

The Women's Roundtable

Wednesday, September 27, 6 – 8 pm
rsvp@bellinvest.com or 510.433.1066

LUNCH, NETWORKING, PRESENTATION

Making a Good Life Happen®

Wednesday, October 25, 12 – 1:30 pm
rsvp@bellinvest.com or 510.433.1066

WEBINAR (FOR CLIENTS ONLY)

Investment Committee Update

Wednesday, November 29, 2 – 2:30 pm

There may be additional webinars and live events during this second half of 2017.

REGISTER FOR THE WEBINARS:

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We appreciate your topic suggestions!

How the Dow Led to Modern Index Investing

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Market Capitalization:

Share Price x Shares Outstanding

An index that weights stocks by their capitalization will include the largest, most valuable companies and give more weight to them. By December 31, 1975, the Vanguard Group created what would later become the Vanguard 500 Index, a cap-weighted fund designed to track the Standard & Poor's 500 Composite Stock Price Index. Cap-weighted indices have grown in popularity ever since.

While a small number of financial institutions may have enjoyed a cozy, early

monopoly on cap-weighted index funds, the popularity of these funds has attracted some determined competition. The effort to create the most cost-effective cap-weighted index created a price war. Cap-weighted indices are not complicated investment vehicles, so it makes sense that their operating expenses would be low. But the idea they would be as low as they currently are was hard to foresee. The chart below demonstrates just how cost-effective cap-weighted funds have become:

Fund	Ticker	Expense Ratio
Vanguard 500 Index Fund	VFINX	0.14%
Fidelity 500 Index Investor	FUSEX	0.09%
Schwab S&P 500 Index	SWPPX	0.03%

And the cost savings don't stop there. Many institutions have even eliminated the transaction costs of buying and selling cap-weighted funds.

Risks of Investor Euphoria

This is all welcome news to investors, but the intense focus on cost has obscured another change in indexing. Today, not everyone believes that cap-weighting is the best design for an index. In the 2000 to 2002 market crash, for example, some analysts noticed that losses in cap-weighted indices were worsened by the euphoria for technology stocks. As investors bid up the price of technology stocks, the tech sector assumed a larger and larger presence in cap-weighted index funds. In less than



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two years, from 1998 to 2000, the weight of the technology sector in the S&P 500 Index more than doubled from a recent historical average of 15% to 35%. When the crash happened, the cap-weighted Vanguard 500 Index lost almost 50% because of its suddenly substantial exposure to the technology sector.

Fundamentally-Weighted Index Funds

To address some of the risks of euphoria in indices, analysts such as Research Affiliates founder Bob Arnott sought a different index methodology and created fundamentally-weighted index funds. Fundamentally-weighted index funds try to measure a company's economic footprint: what it ac-

tually contributes to the economy. Weighting companies by their fundamentals — things like revenue, retained cash flow, and dividends — provides some insulation from the risks of investor euphoria.

Other Weighting Methodologies

There are other weighting methodologies that try to mitigate investor euphoria. Some indices screen out stocks with exuberant prices. By eliminating stocks with prices that are too high relative to the company's balance sheets, an index can avoid being teased into overweighting stocks that might be more vulnerable to losses and instead give more weight to stocks with higher long-term expected returns.

Risk

Indexing has come a long way since the creation of the Dow in 1896. The universe of index funds continues to expand. For investors, this means better options to invest in low-cost cap-weighted index funds or their newer, thoughtfully constructed counterparts. Even fundamentally-weighted index funds and index funds that screen out overpriced stocks, however, require a high tolerance for risk. Whatever the preferred methodology, developing a strategic approach tailored to the individual, family, their accounts, and their financial plan is paramount. For a more personal, meaningful conversation, please call your investment advisor to discuss how he or she can be of help. ■