KEATING
WEALTH MANAGEMENT

NEWSLETTER

3rd Quarter 2017

Finding the Next Amazon

Which of the two stocks described below would you rather have owned?

Stock #1

- This company went public 20 years ago.
- For most of its public life, the company has been "investing for growth," otherwise known as generating losses.
- On 199 occasions, the shares have had daily declines of 6% or more.
- Over three-day spans, the stock has fallen 15% or more 107 times.
- Over longer time horizons, the damage has been worse. In 16 out of its 20 years on the public markets, it has suffered 20% declines. On half of those occasions, the drawdown was greater than 40%.
- When the tech bubble burst, the stock plummeted, losing 95% of its value between December 1999 and October 2001.
- Just seven years later, during the depth of the financial crisis, the stock plunged a further 64%.
- The volatility has been gut-wrenching. Set forth below is a chart that shows the steepest drawdown by year, for each of the last 20 calendar years.

Stock #2

- This company also went public 20 years ago.
- At the time of its IPO, the company was three years old and had a market capitalization of $660 million.
- On a split-adjusted basis, the share price has since increased from under $2 to $1,000—a compounded annual gain of 36%.
- A $10,000 investment in the company at the time of its IPO would be worth $4.9 million today, a 49,000% return—and 155 times greater than a comparable investment in the S&P 500, including dividends.
- With a $480 billion market capitalization, it's now the fourth largest company in the S&P 500.

These two profiled stocks are one and the same:

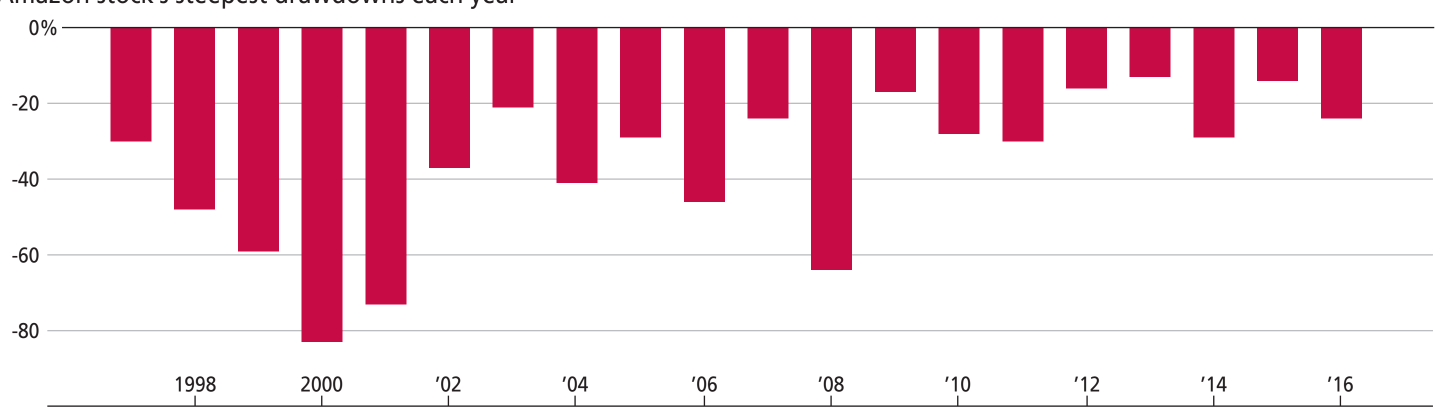
amazon.com

But there's much more to this story, with important implications for individual investors.

Please see AMAZON page 2

Wild Ride

Amazon stock's steepest drawdowns each year



Source: Irrelevant Investor, The Wall Street Journal

AMAZON *Continued from Page 1*

Superstocks

According to research from Arizona State University finance professor Hendrik Bessembinder, and as reported in *The Wall Street Journal*, "From 1926 through 2015, only 30 stocks accounted for one-third of the cumulative wealth generated by the entire U.S. stock market." Amazon was one of those 30.

To put that 30-stock number in perspective, there were 25,782 publicly traded companies over that period.

So before you endeavor to find the next Amazon, consider the long odds against you. The same *Journal* article notes, "Even though the stock market generates positive average returns over time, more than half of all stocks lose money over their lives as public companies, and the number of stocks that make big money is astonishingly small."

Consider the data:

- Only 0.33% of all public companies over the last nine decades accounted for half of the return generated for investors.
- Fewer than 1.1% of all stocks that existed during this time frame were responsible for three-quarters of the stock market's cumulative dollar gains (as measured relative to returns on cash).
- The top 1,000 performing stocks—fewer than 4% of the 25,000+ total during this period—accounted for ***all*** the market's gains.
- Putting your money in one-month U.S. Treasury bills would have matched the combined returns of the other 96% of stocks.
- As the chart below illustrates, just five stocks accounted for 10% of the total dollar wealth creation in the stock market from 1926 through 2015.

Based on this data, we can clearly see that the average return of the stock market and the return of the average stock are two totally different concepts.

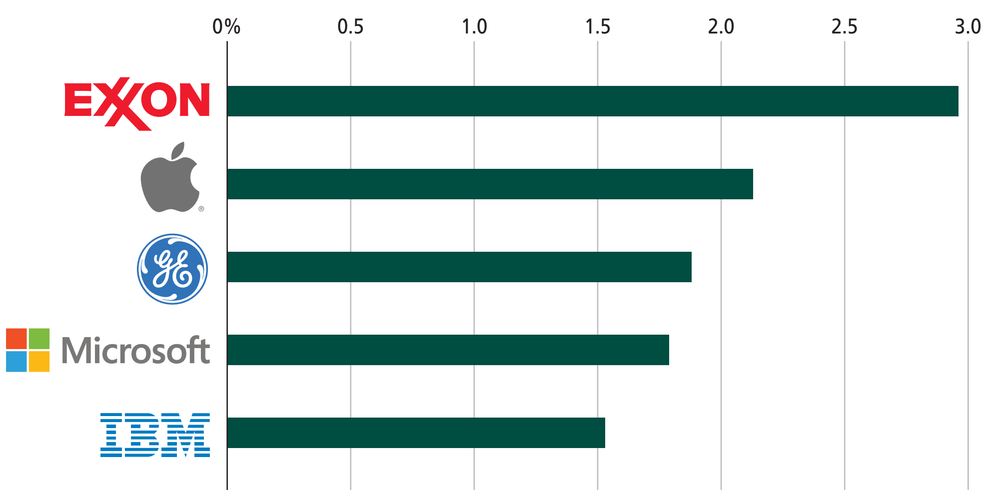
We can also conclude that the odds of finding the next superstock—another Amazon—are exceedingly slim. And even if one had the investing acumen at the time of Amazon's IPO to identify it as the investment monster it would become, what's the chance that same investor would have had the intestinal fortitude to ride out the stomach-churning declines of the ensuing two decades?

Therein lies the great challenge of stock picking: First, one has to identify a potential winner. Then, one ***also*** must have the behavioral discipline to follow one's convictions. Out of 100 people, how many would have stayed on the Amazon roller coaster for its entire 20-year ride to enjoy that 49,000% return? Besides founder Jeff Bezos, there are probably few others.

Please see EQUITIES page 4

Heavy Hitters

Five stocks accounted for 10% of the total dollar wealth creation* in the stock market from 1926 through 2015.



*`Wealth creation is measured based on capital investment and rates of return in excess of the yield on one-month U.S. Treasury bills.

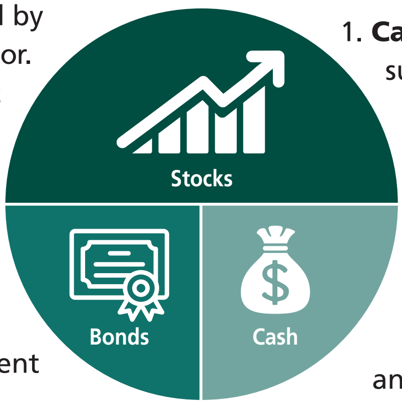
Source: Prof. Hendrik Bessembinder, Arizona State University, The Wall Street Journal

The two articles that follow form a linked pair. The first contains an extract from an essay that outlines a simple and highly effective asset allocation model. The full essay explains why equities need to be the core holding in any portfolio, special considerations for retirees, and stress tests how an investor employing this methodology would have fared in the Armageddon of the 2007-2009 financial crisis. The second article makes the case for owning only two equity index funds as the stock portion of a portfolio.

Asset Allocation Made Easy

The full article is available upon request.

We believe that lifetime investment returns are primarily, if not entirely, governed by two variables: asset allocation and behavior. The conventional wisdom regarding asset allocation is to spread one's assets among stocks, bonds and cash, primarily to mitigate the volatility of the equity market. This can be costly advice, because the attempt to shield against the equity market's temporary volatility also deprives an investor of the permanent incremental returns offered by equities.



Historically, investors who've been willing to ride out the equity market's occasional sinking spells have been rewarded with significantly higher returns. Indeed, over the last three-quarters of a century, the equity investor has earned a real return—net of inflation—nearly three times that of the bondholder. But it would be both imprudent and impractical for a retiree, for example, to have 100% of his assets invested in equities.

Our simple asset allocation model is:

1. **Cash.** Retirees should set aside an amount sufficient to cover two years' worth of living expenses in a side fund, the purpose of which is to enable the suspension of equity withdrawals if a long and/or steep bear market strikes relatively early in retirement. (Those still accumulating should set aside one year's worth of expenses as an emergency reserve.)

2. **Bonds.** Funds to cover foreseeable capital needs (e.g., the purchase of a second home) over the next five years should be invested in Treasurys (or equivalent) with a corresponding maturity.

3. **Stocks.** The remainder of the portfolio should be invested in equities, preferably in a highly diversified, low-cost, tax-efficient vehicle such as an equity index fund.

Radical Simplicity

This is a highly condensed version of a blog published in May 2017. For the complete article, please visit the Blog section of our website: http://www.keatingwealth.com/blog/radical-simplicty/

To maximize investment returns over a multidecade time horizon, buy two equity index funds and hold them indefinitely. You need nothing else in your equity portfolio. Don't attempt to minimize volatility or diversify it away. Instead, embrace volatility as the source of the premium return available from equities. Then—and this is truly the hard part—resist the temptation to time the market. Market timing is a fool's errand, and a recent study showed that it left the average investor two-thirds worse off than the return of the S&P 500 over the last 30 years.

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EQUITIES

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Fortunately, it isn't necessary to find the next Amazon to make money by investing in equities. Instead, one just has to own a market capitalization weighted index fund, which will include a number of potentially loss-making, "grossly overvalued" stocks—like Amazon.

Since large company stocks have historically generated an average return before inflation of 10% annually, the goal of every equity investor should be to earn as close to the market return as possible. And the equity market return can be achieved, simply, by owning broadly diversified equity index funds, which lets an investor own a little bit of every one of the leading companies in the world. This is also a bet in favor of humility—of not trying to outperform the market—which history has shown to be a valuable trait.

Behavioral Takeaway

Hindsight bias is a term used in psychology to explain the tendency of people to overestimate their ability to have predicted an outcome that could not possibly have been predicted. Believing that one can predict future results can lead to overconfidence, and over-confidence can lead to fatal investment mistakes such as concentrated bets on individual stocks and trying to time the market.

SIMPLICITY

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Most equity investors own far more individual securities and funds than they need to achieve diversification. Many large banks and investment advisers have black-box software that generates "model" portfolios for given investor profiles. As a result, clients—and, too often, their financial advisers—don't fully understand what they own or why they own it. Often, such model portfolios regularly underperform passively managed index tracking funds—sometimes dramatically so.

While a small number of active managers have managed to outperform the market over the long term, it's totally unnecessary to beat the market to enjoy the premium returns of equities. When it comes to building a fully diversified equity portfolio, an investor merely needs to own two broad-based equity index funds. The table below illustrates the diversification and expense profile of such a portfolio.

The 2-Index Fund Equity Portfolio

As an illustration, consider the two Vanguard exchange-traded equity index funds shown in the table. Based on their holdings as of March 31, 2017, an investor in these funds would own shares in 9,773 of the leading companies in the world while benefiting from some of the lowest expense ratios in the industry—typically 90% less than comparable actively managed funds.

Asset Class	ETF	Ticker Symbol	Number of Stocks[1]	Expense Ratio[2]
Domestic Equities	Total Stock Market	VTI	3,601	0.05%
International Equities	Vanguard Total International Stock	VXUS	6,172	0.11%

[1] As of March 31, 2017. (Source of all information: Vanguard.)
[2] VTI expense ratio as of April 27, 2016; VXUS expense ratio as of February 23, *2017.*

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