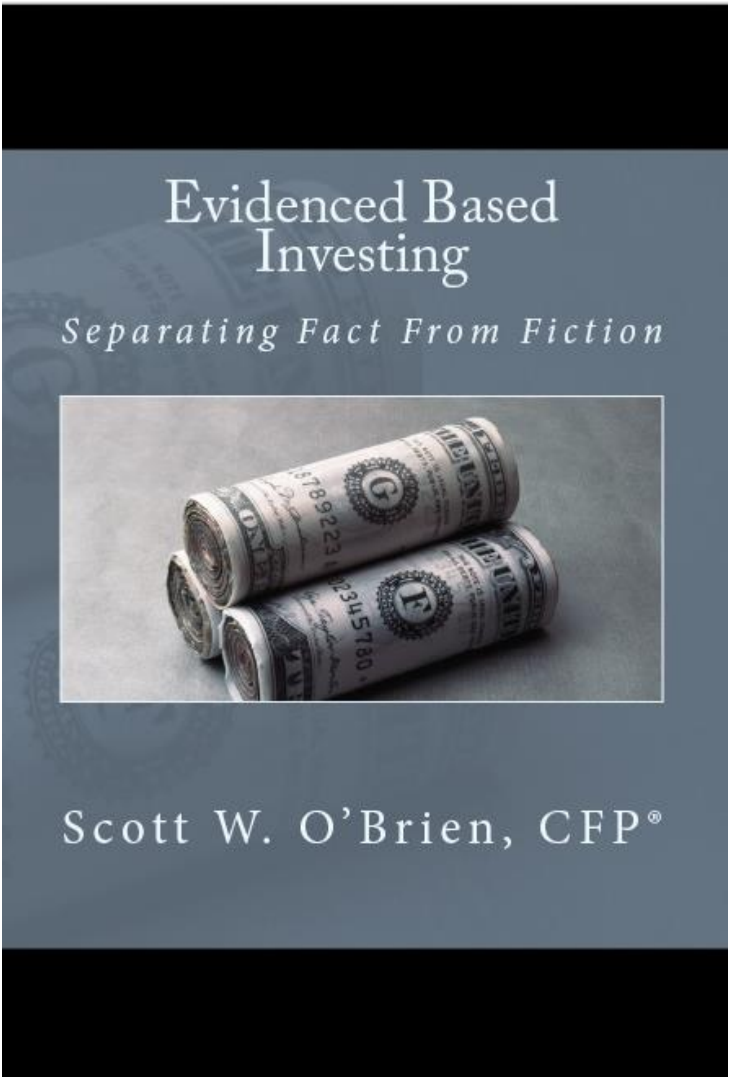
Evidenced Based Investing
Separating Fact From Fiction
Scott W. O'Brien, CFP®

Evidence-Based Investing
Separating Fact from Fiction

by Scott W. O'Brien, CFP®

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Dedication

"I am a success today because I had a friend who believed in me, and I didn't have the heart to let him down."
~ Abraham Lincoln

When I first started writing this book I looked back at all of my past teachers.

Pete Washburn introduced me to the stock market when I had an investments class in the 6th grade. Phil Michaud was my high school business teacher and he continued to pique my interest in the world of business, finance, and economics. All of my business teachers at the University of Maine extended and deepened my knowledge.

And recently, I had the distinct honor of being in a class with 70 colleagues listening to one of the winners of the 2013 Nobel Prize in Economics, Dr. Eugene Fama.

When it comes to learning, it's been quite a ride for this kid from a small town in Maine.
But most of all, I'd like to dedicate this book to my parents, Curtis and Maralie O'Brien, who were both teachers and taught my brothers and me by word and example how to be good human beings. Their unwavering support throughout my life has served

me well, and I am forever grateful.

Introduction

As I started writing this book, I got the feeling that much of the information in it would be new and unsettling to most readers. As humans, we seek out information that confirms rather than discounts our beliefs.

To a degree, this book is an attempt to "debias" you. Not with folklore but with academic research. I promise it will be interesting and eye-opening.

I have a healthcare background and I find the work of doctors and comprehensive financial advisors to be quite similar. I say comprehensive financial advisors because some, if not most, people in the financial services industry have a singular focus — be it investments, insurance products, real estate partnerships, or hedge funds.

However, an advisor who provides compre-hensive wealth management will look at your finances from a broad perspective, much like your family doctor.

When you go to see your doctor, he will do an assessment of your current condition by asking you about any symptoms you might have and about your health history. If he unearths an issue, he will order some tests — such as blood work or x-rays. After reviewing the results he will determine a diagnosis, develop a plan of treatment, implement the plan, and then monitor for changes.

Your wealth management planning is quite similar. Your advisor will ask many questions about your goals, income, assets, etc. Then he may run some tests (Monte Carlo simulations, retirement projections), go over the results, determine a plan of action for your finances, make any needed changes to your investments, estate plan, insurance coverages and then review on a regular basis for any needed updates.

Much like the healthcare field, the financial planning field is part art and part science with the practitioner and client responding to unexpected developments. As Helmuth Von Moltke said, "No battle plan survives contact with the enemy."

Many people procrastinate about the most important areas of their lives. We plan things we enjoy instead of thinking long-term, and that’s why estate planning is a difficult task to get individuals to complete. We like planning vacations and parties instead of our future.

However, if you never go to the doctor, a silent disease can progress to a point where recovery is beyond reach. In much the same way, you need to periodically review your portfolio and financial plan.

If you never check your portfolio it can become misaligned from your target allocation and financial goals. If you never have a financial plan, how do you know if you are on track to meet your important goals? Minor financial issues become major retirement issues.

You don’t want to be the guy climbing the ladder only to found out at the top that it was leaning against the wrong wall.

The idea of having a yearly physical is to get a status update. During the year you will experience numerous illnesses or pains — most aren’t serious like headaches, colds, or a sprained ankle.

Taking care of your health and taking care of your wealth have similar attributes. Minor symptoms can become major illnesses. Similarly, minor financial issues can become major financial issues.

Unless you are a member of the Lucky Sperm Club (a child of Bill Gates for example) and have no financial worries, this book should give you some interesting insights into your investments and proper investment strategy and tactics. You need to know the facts about investing that are backed up by academic and scientific research.

Almost everything we use, know about, and do for productive purposes is probably based on some type of research. High mileage motors, good nutrition habits, or even how to hit a golf ball are subjects that have been researched and the results have been validated.

Despite the incredible amount of academic research on many of the investment subjects I will touch on in this book — we are, after all, only human. Many times the lure of riches articulated by smooth talking salespeople overcomes all that we intuitively know is true. How else could the Bernie Madoff scandal have ever happened?

How could thousands of sophisticated well-educated people believe Madoff could produce consistent returns in the midst of the volatility that we all know accompanies the stock market?

Greed would be one answer and naivety could be another.

Surely, most of these folks knew some of what academic research has demonstrated about investments.
One aspect of being a good investor is knowing how markets work — knowing the rules and putting them to use in your favor.

This reminds me of a story of a lawyer who bought a box of very rare and expensive cigars and then had them insured against fire, among other things. Within a month of having smoked the entire stockpile of these great cigars, the lawyer filed a claim with the insurance company. In his claim, the lawyer stated that the cigars were "lost" in a series of small fires. The insurance company refused to pay, citing obvious reasons — the man had smoked the cigars.

The lawyer sued...and won.

In delivering his ruling, the judge agreed with the insurance company that the claim was frivolous. Nevertheless, the judge stated that the lawyer had a policy from the company that had warranted the cigars were insurable and guaranteed that it would insure them against fire. However, since the insurance company did not define what is considered to be an unacceptable fire — they were obligated to pay them.

Rather than endure a lengthy and costly appeal process, the insurance company accepted the ruling and paid $15,000 to the lawyer for his loss of the rare cigars that were lost in a series of small fires.

After the lawyer cashed the check, the insurance company had him arrested for 24 counts of arson.

With his own insurance claim and testimony from the previous case being used against him, the lawyer was convicted of intentionally burning his insured property and was sentenced to 24 months in jail and a $24,000 fine.

Actually, the above story is just an urban legend. The point is this; **you need to know the rules**.

Pay attention to what academic research reveals and pay no attention to marketing gimmicks.

It is my hope that by the end of this book, some of the myths and misconceptions of investment management will be clearer to you so when you will always be in the position of the educated investor.

By the way, this book uses "him", "his", "himself" when referring to an individual to make reading an easier task. It is no way meant to infer anything about the ability or intelligence of females. In fact, most studies conclude that female investors are better investors. As you read the book, you will see that all investors make mistakes, be comforted that if you are a female, you likely make fewer of them.

I have read over 100 books on investments, economics, and behavioral finance over the past 10 years and have taken notes on items I thought would be interesting to my clients. This reading has given me great deal of knowledge which I use daily in my job as a wealth manager and some of which I will pass on to you in this short book.

While researching this book, I came across a saying attributed to an unknown author, “To steal ideas from one person is plagiarism. To steal from many is research.”

I have diligently tried to give attribution to the works of others that I have included in this book — be it a research paper or a quote from an article. While perfection was the goal, I am sure I have come up short because my note taking over years was never done with the intention of writing a book.

Scott W. O'Brien, CFP®

Chapter 1

“Since you can't predict the future, you can prepare for it by putting yourself in the best position to succeed.”

~ Aristotle

Why Planning Is Important

Successful Planning Simplified

Most people have good intentions when it comes to their finances.

- You plan on sitting down and figuring out how much you need to save to reach your retirement goals.

- You plan to get together with an estate planning attorney to have the necessary paperwork in place should you die or become unable to make your own financial or health care decisions.

- You know that you should make an appointment with your insurance agent to make sure you have adequate coverage.

We all have the best intentions, but more often than not, we fail to follow through.

In the book Alice in Wonderland, Lewis Carroll tells how Alice came to a fork in the road and spoke to the Cheshire cat in a tree.

“Which road do I take?" she asked.

"Where do you want to go?” was his response.
“I don't know," Alice answered.

“Then,” said the cat, "it doesn't matter. If you don’t know where you are going, any road will get you there.”

Few disagree with the idea of planning. The problem is typically one of procrastination.

Most families spend more time planning their vacations than their financial lives. With financial planning, it’s not just your finances at stake; it’s the quality of the rest of your life.

Why *Do* You Procrastinate?

The biggest reason has to do with urgency. You falsely believe that because retirement is in the far off future, you don’t need to do anything about it now. But nothing in this life is free. If you want “paid” time off when you retire, you need to save, invest and plan for it now.

People who put off financial planning remind me of a joke from Mark Victor Hansen, co-author of the Chicken Soup series of books: “My banker asked me for a statement. I said I was optimistic.”

Scott Wenger, Editor In Chief of Financial Planning Magazine, states, “People don’t want to plan — they want the effects of planning or the benefits of planning. People don’t go to the doctor for a colonoscopy. You go to make sure nothing is wrong with you, and they might do a colonoscopy."

Aim For A Target

If you don't have a target, how do you know if you're on track?

At the 2004 Summer Olympics, Matthew Emmons was in the lead and expected to win a gold medal as he prepared to fire his last shot in the rifle competition. All he needed to win was a score of 7.2 on his last shot. He hadn't scored lower than 9.3 that day.

Emmons took aim, fired, and hit the bull's eye. The only problem was that he hit the bull's eye on the wrong target. Instead of hitting the target in his lane, he hit the target in the lane next to him. China's Jia Zhanbo took the gold medal and Emmons ended up in eighth place. Ouch.

So the overall lesson is this:

You have to have a target and then you have to aim for the right target if you want to succeed with your financial future.

And Then...

So, you have a target and it's the right target for you. Next you have to make sure that you have the right plan in place to get from where you are today to where you want to be in the future.

Financial planning should be the foundation of your quest to be financially independent. It’s crucial to perform a financial gap analysis — a safety check looking for holes in your specific financial situation that need filled. By ignoring the plugging of these holes you can cause your financial ship to sink, and you don’t want that.

26 centuries ago, Sun Tzu said:

“Strategy without tactics is the slowest route to victory. Tactics without strategy is the "noise" of defeat.”

Financial planning has to do with the Effective and the Efficient.

- Effective means doing the Right Things.

- Efficient means doing Things Right.

The purpose of financial planning is to determine the Right Things to be doing with your money and how to do Things Right to meet your goals.

Your financial plan gives you a baseline framework that is solid enough to start from and flexible to go back to and adjust based on life events.

Wait! I'm Going To Make A Financial Plan Now And Will Have To Change It Later?

Author of The Behavior Gap, Carl Richards, said it best when he said, "Planning is the difference between a flight plan and a flight. The plan consists of the pilot's best guesses about weather, terrain and speed. No matter how long the pilot spends making assumptions, he will be wrong. After all the guessing is over and the plane is in the air, it is the pilot who will have to make the necessary course corrections to arrive safely at the destination. It's about the course corrections, not the plan."

During any flight you've ever taken, the flight pilot constantly monitored for potential problems and took action to get you safely to your destination. You didn't have to know any of it was going on; you could simply let the pilot do his job.

When it comes to your life, you're the pilot. You'll make a basic plan, a good plan, to reach your financial goals. But let's face it. Life happens and unexpected events come your way. When they do, you'll get out your financial plan and make any needed changes.

We like to think that unexpected events only happen to other people — divorce, death, disability, births, bankruptcy, sale of real estate, loss of a business, or a business sale. But things happen, and sometimes they happen to you. Even if you didn’t expect a sudden change, and typically change happens at unexpected times, you’ll be prepared for most contingencies if your initial plan was thorough.

The consequences from lack of planning can be seen in all areas of life. London's Millennium Bridge over the Thames River was designed by engineers to hold the weight of numerous pedestrians, so no problems were expected with a large crowd on the bridge on dedication day in 2000.

Once the crowd gathered, however, the bridge was hit by strong gusts of wind and began to wobble. The wobbling persisted as people on the bridge adjusted to the gusts by changing their stances at the same time. The engineers hadn't planned for a situation in which everyone behaved the same way at the same time; they assumed whoever was on the bridge at any given time would be moving randomly relative to one another.

Thankfully, no one was seriously hurt. The bridge was closed for two years as modifications were made to stabilize it. Circumstances caused a change in plans — it will probably happen to you, too.

Change is inevitable so I’m not talking about trying to predict the future. No one can do that.

Unknowable and unpredictable events happen all the time. Worry about the things you can control not the things you can't. If your initial plan is solid, you can handle the unpredictable as it happens.

“You have to pick what you’re going to be worried about. Markets are volatile, but retirement is certain.”

~author and speaker, Nick Murray

Handling Uncertainty

Instead of buying an entirely new investment wardrobe every time the forecast changes, I suggest creating an all-season portfolio that offers you some level of comfort and protection no matter what happens next week or next month.

You should either have or hire knowledge and experience (there’s a difference) to deal with the changing environment and course changes.

Remember "The Miracle on the Hudson" when Captain Chesley Sullenberger landed his disabled plane in the Hudson River with no fatalities and only minor injuries?

Even if you don’t remember the story, if you have traveled much over the last 20 years, you have no doubt heard the speech, "In case of a water landing..."

What you’d probably never heard is that it had never been done successfully in the history of commercial aviation, at least not until Captain Sullenberger. Lack of prior experience didn't prevent the crew from preparing a plan of action.

And that plan of action saved many lives.
After developing a plan, you need to stick to it like a stamp to an envelope. Along the way, recess-ions, tax changes, personal issues, political wrangling, and other unknown issues will test your plan.
Don’t confuse strategy with outcome. In the end, your correct course of action is to place the law of probabilities on your side.

I once went to a casino and had $100 to bet. I was playing with a couple of other novices like myself and a couple of other players who I could tell knew how to play. At the end of a few hours play, almost despite myself, I was up $150. I was the proverbial lucky blackjack player because I had no real process. I was lucky, but if I’d tried to continue with that approach day after day, I’d have lost and lost big to the skilled players with a plan.

When dealing with your finances, you should proceed like a “skilled” blackjack player and put the odds in your favor. A strategy is either right or wrong, regardless of outcome.

When Do You Really Need To Make A Plan?

Today! Seriously. If you don’t have a financial plan then ASAP is your answer.

Steven Covey, author of The Seven Habits of Successful People writes, “Did you ever consider how ridiculous it would be to try to cram on a farm — to forget to plant in the spring, play all summer, and then cram in the fall to bring in the harvest? The farm is a natural system. The price must be paid and the process followed. You always reap what you sow: there is no shortcut.”

This country is full of doctors who ignore their health, attorneys without wills, architects who don't design homes for themselves, and insurance agents who are underinsured. They’ll all pay the price, and it’s a price they could easily avoid.

Fortunately, your financial plan doesn't have to become complicated to be successful. You just need to have a plan that considers the things that you can control.

What can you control?

- You can control your risk with proper asset allocation—the amount and types of risk you take.

- You can control your cost of investing by the types of investments that you use and the tax efficiency of those investments.

- You can control what happens to your assets after your death by having a proper estate plan in place.

- You can control for the unforeseeable by having a risk management strategy in place.

Your financial plan should help you develop your investment plan. Investment advice without financial planning is like a doctor prescribing surgery without performing an exam.

Summary

The Apollo moon shot was an engineering and technology breakthrough in its time. The NASA scientists and mathematicians plotted out the path that the rocket would need to take to get to the moon. They knew with great precision what path they had to follow. Interestingly, the rocket was only on its path 5% of the time. But they knew where they were and could steer themselves back on course. It wasn’t a perfect path but it was a critical path to reach the goal.

You now understand how important a plan is. Hopefully, you’ll take the time to figure out where you are and where you want to be. Now, it’s time to fill in a few details.

Chapter Takeaways:

- Develop a carefully designed plan.
- Implement strategies that give you the most likely possibility to meet your goals.
- Monitor your plan and adjust for the inevitable changes that will occur.

In the next chapter, I’ll talk about investments and particularly how to eliminate the mistakes that most people make when investing.

Chapter 2

“Don't buy a Rolex from someone who is out of breath, don't eat at a place named Mom's, and don’t put all your eggs in one basket.”

~ Anonymous

Allocating Your Investments
Asset Allocation * Correlation * Probabilities * Diversification

Begin With The End In Mind

Q: How should you allocate your investments — that's fancy speak for choosing where to invest your money — for the best returns?

A: The same way porcupines make love...very carefully.

Building a portfolio is like having a suit tailor made. You may use the same fabric as everyone else, but your suit is custom fit to you. Your goals should dictate your portfolio allocation. What's that mean?

Think about what you want to accomplish:

- Perhaps early retirement.
- College for the kids.
- A gift to a favorite charity after your death.
- A lifestyle during retirement that matches your current standards.
- Building a financial portfolio that will continue aiding your family long after you are gone.

It's a 4-Part Process.

The first part of this process is Objective Based Asset Allocation.

Objective Based Asset Allocation is a concept that says that your asset allocation should be based on what the ultimate objective is for your portfolio.

The process is similar to the process for buying a vehicle. The one you buy depends a lot on what you need it to do. Hauling a boat, transporting a family with 6 children, city or country driving, current budget, and cost all play a role in deciding the best vehicle for you. Investing is the same way. You have to define your long-term needs, and then you can figure out the best financial vehicles to get there.

That’s the logical part of investing.

The second part:

Once your goal is determined, choosing an allocation is a bit like a choir director putting together his choir. He needs to have many different performers working together for the greater good. You need the same strategy when allocating your investments. This is the “art” part of asset allocation.

The third part:

The science part is simply looking back historically and seeing how different asset classes work together. In other words, what investments have performed well in the past? Historical research reveals that adding increasing numbers of asset classes (diversifying) can increase your return while decreasing your risk. This is the proverbial having your cake and eating it too scenario.

You want to base your investment allocation on academic research instead of hunches, hope, and hype. With empirical data in hand, you can make precise decisions — the equivalent of operating with a scalpel instead of a meat cleaver. Use academic research, and you'll have the right tool (asset class) for the job.

The fourth part:

Once you have the logistics, art, and science parts established, it then becomes a matter of risk tolerance. Or as I like to call it, "loss tolerance." Most people don't mind risk if they get good returns — it's the losses they don't like.

Legendary investor, Benjamin Graham, put it best when he said, **"Do you want to eat well or sleep well? That will determine what I recommend."**

Base your loss tolerance on your willingness and need to take risk.

More Tools Available

Not so many years ago, investors that lived in the States held portfolios primarily made up of US stocks and bonds. Fortunately, things have changed over the last 20 years. Access to asset classes such as commodities, real estate, and emerging markets have added to an investor's ability to find less correlated assets to reduce volatility and risk.

That means that you have more choices with the possibility of more returns with less risk of loss.

Research Box

Let's look at some data. From 1978 through 2007, US stocks provided an annualized return of 12.9% with a standard deviation of 15.3% (standard deviation is a measurement of risk with a lower number being better). By adding real estate to the stocks at a 10% allocation, the returns increased to 13.2% while decreasing the standard deviation to 14.4%.

One of the secrets to great asset allocation is to create an anchor within the portfolio that combats the emotional reaction to the panic and greed of the markets. A popular anchor is short term, high quality corporate and government bonds.

Because these types of bonds present little credit, inflation, or interest rate risk, their inclusion in a portfolio allows more risk to be taken in the potentially higher performing segments of the market — stocks and real estate. This combination is comparable to the need for having both a heating and a cooling system in your house.

Like shingles on a roof that shelters your house from the rain and snow, the bonds provide comfort during troubled times in the market. Fixed income investments dampen volatility, generate income, and enhance returns.

Bonds are your anchor to reduce risk.

How Important is Asset Allocation?

In the late 1980’s Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower published a study based on study of 82 large pension funds. Their conclusion was that asset allocation accounted for over 94% of the returns among the pension funds. Less than 6% of the returns were due to market timing or investment selection.

In other words, asset allocation was 15 times as important as the choice of individual stocks or attempts at market timing.

Research Box
In another study of 31 pension fund representing over $70 billion, Professor Eugene Fama found that allocation determined over 97% of the returns.
Roger Ibbotson and Paul D. Kaplan analyzed the 10 year performance of 94 balanced funds and the 5 year performance of 58 pension plans and concluded that approximately 100% of the portfolio's absolute returns is explained by asset allocation.

So instead of trying to figure out who the best investment manager is, spend your time figuring out an allocation that is compatible with your loss tolerance.

You see it's quite easy to figure out who the top performing managers are at any point in time. The tricky part is figure out who the top performing managers are ahead of time.

Top performers in one year, seldom if ever, repeat their performance in subsequent years. Many years ago a well-known Wall Street advisor, Robert Stovall, when asked about the persistently poor performance of active mutual fund managers responded, **"One-third of the money managers tend to beat the market every year, unfortunately it's different ones each time."**

History is also filled with evidence that annual lists of top managers were only the top performing managers due to being in the “hot sector” at that particular time. So when the hot sector eventually turned cool — or as academicians label it, "reverted to the mean" — these managers invariably suffer in their performance rankings.

Since asset allocation has been documented academically to determine up to 90% of your returns, it only makes sense that this is the area in where you should spend the bulk of your time.

The risk and return of each individual asset class by itself isn’t important. What is important is how the inclusion of each individual asset class adds to return and reduces risk in the entire portfolio.

Let’s move on to other areas to consider.

Probabilities

Investing is all about probabilities. About 70% of the time the stock market has a positive return on a year to year basis. That's 7 out of 10 times. To put this in perspective, look at the next page and consider the statistics from the Forum for Investor Advice.

Statistical Odds
Odds that you will win the lottery: 1 in 4,000,000
Odds that you will be dealt a Royal Flush: 1 in 650,000
Odds that a meteor will strike the Earth in your lifetime: 1 in 9,000
Odds that you will be robbed this year: 1 in 500
Odds that the airlines will lose your luggage: 1 in 186
Odds that you will be audited by the IRS: 1 in 100
Odds that you'll get snake eyes when rolling dice: 1 in 38
Odds that you will go to Disney World this year: 1 in 10

Odds that the next bottle of water you buy will be nothing more than tap water: 2 in 10
Odds that you will eat out today: 5 in 10
Odds that an investment in stocks will make money in any given year: 7 in 10

Part of your investment strategy should be "probability-based" investing. As Aristotle once said, "The probable is usually what happens."
Ed Thorp is the author of the best-selling book, Beat the Dealer. He noted that in blackjack, the payoffs are set, and the player's task is to assess the probability of drawing a favorable hand. Thorp showed how to count cards to identify when the probabilities of a winning hand tilt in a player's favor.

When the odds favor the player, the ideal strategy is to increase the bet (effectively increasing the payout.)
Thorp notes that even under ideal circumstances, favorable situations only arise 9.8% of the time; the house has the advantage the other 90.2% of the

time.

“That is the nature of the art of investing — it requires probabilistic decision-making using imperfect information about an inherently unknowable future.”
~ Barry Ritholtz

Because most investors don’t have a good grasp of the history of the financial markets, they tend to make emotional decisions regarding their investments based on the current news. According to Ned Davis Research, there have been 294 dips of 5% or more in the S&P 500 since 1928. This means these dips happen on average 3-4 times a year. This also translates into 3-4 times a year that the average investor can completely screw up and do something stupid.

The S&P 500 has dipped over 10% exactly 94 times since 1928. That’s just over one time per year. Historically, 15% dips happen every other year and a 20% dip every 3 years.

Correlation

Correlation is the interdependence of certain quantities. For our purposes, think of it as how different investment assets interact with each other.

Think of practicing the piano and how well you play

— there is a positive (or high) correlation between how much you practice and how well you play. The same is true for surgeons and golfers. The more you practice any task, the higher your skills become at it.

Negative, or low, correlation can be explained with the following example: The more you criticize someone, the less likely they are to be your friend and the higher the negative correlation between the two.

A zero correlation would be if two things are unrelated or random. If the correlation concept were applied to basketball players:

- A correlation of -1 is when two parts behave very differently — like a 6'1" left handed point guard and 7'4" right handed center.
- A correlation of +1 is when two parts behave exactly the same like twin right handed brothers who play point guard.
- A correlation of 0 means the items being studied move in a random matter — two random people from the audience running around on the court during a game.

You should look to invest in assets with a low correlation. This often seems counterintuitive. Wouldn't you want your investment assets to all go up at the same time? Well, in theory, yes.

But in the real world of your financial future, that would also mean your investments would all go down at the same time and that’s a problem. Everyone is happy when investments are going up, but despair surfaces when asset prices fall.

Most investors look at their portfolio and see the ones that have gone down or aren't doing as well as others and think, "I should sell that one and buy this other one that's doing well."

If you find yourself feeling that way, you’re falling into the trap of believing that what is going up will continue to go up and what is lagging will continue to lag. The evidence from tracking real life financial portfolios over a lifetime says the “principle of reversion to the mean” will surface at some point, and the opposite will happen.

Reversion to the mean is the theory that prices and returns eventually move back towards their mean or average. For example, the S&P 500 has a historical average of close to 10%.

If the S&P 500 Index were to have 5 very good years in a row and averaged over 10%, then the reversion to the mean theory would say that there is a high probability that the index will start to produce lower returns as the performance numbers return to their historical average.

When building a portfolio, you want to combine assets that have low correlations to each other. Some are going up and some are going down. The goal is for your portfolio to travel on a smoother ride with lower volatility and risk. That’s your goal, but it’s difficult to achieve.

Overall risk in a portfolio isn’t the average risk of each of your investments; risk can actually be less if your investments don’t move together.

Beyond correlation, there is diversification.

Diversification

Money manager, James Gipson wrote:

> **"Diversification for investors, like celibacy for teenagers, is a concept both easy to understand and hard to practice.”**

Diversification is simply spreading your investments between the numerous different asset sectors or classes to spread the risk of holding any one component.

To listen to some of the talking heads on TV you would think diversification is a bad word. You might hear some gunslinger investment manager proclaim that diversification is nothing but a guarantee of mediocrity.

In contrast, financial writer Nick Murray states:

“Diversification is the conscious decision not to try to make a killing, in return for the comforting knowledge that you'll never be killed.”

Diversification requires discipline.

Many investors can't seem to resist the temptation to gamble or speculate — hoping for the big return.

Proper diversification dampens down the "excitement" quotient of a portfolio, and it does it on purpose. It can lower the risk while simultaneously increasing your overall portfolio return.
For investment managers, the best chance to outperform is to concentrate the portfolio in a small amount of stocks betting on superior performance. The idea is that by just having the manager’s very best ideas, you’re more likely to have superior results.

Unfortunately, having a concentrated portfolio is also the most likely way to have poor performance if the manager is wrong.

Diversification is an important strategy because the highly unlikely is still possible.

The strategy of diversification is simply based on the old adage: "Don't put all your eggs in one basket".

One clever quip says, "I put all my eggs in one basket and the handle broke.” Don't let it happen to you.

Putting all your eggs in one basket is the surest way to make a fortune; it’s also the surest way to lose one.

Diversification isn’t a complete failsafe. If you look back to 2008 when all asset classes except for US government bonds fell dramatically at the same time, diversification didn’t work as desired.

As many pundits have noted, in 2008, diversification failed at the exact time it was needed. Investors suffered losses in almost every asset class. The reason behind the failure is that in a panic, all asset classes become correlated and act alike.

Diversification mitigates losses but doesn’t eliminate them. Some people use the 2008-2009 timeframe as an argument that diversification doesn’t work. That argument is much the same as going to a doctor and being told to take a specific medicine in the hopes of preventing a particular ailment and then coming down with the ailment anyway. Was it wrong to take the medicine? Of course not! Don't confuse the strategy with the outcome.

Just because it didn't work one time, the strategy of diversification shouldn't be cast aside.

Study after study has proven the diversification is a critical component to your investments strategy. Just ask the former employees at Enron, World Com, Adelphia, and the hundreds of high-tech companies that have failed since the 2000-2002 tech bubble burst. These employees lost most, if not all, their money by failing to diversify their investments. They had most if not all of their money concentrated in one company.

There are a handful of periods in the last century where the stock market has made no money for 10 years or more. For example, an investment in stocks that made up the S&P 500 during the periods of 1929-1942 (13 years) 1996-1982 (16 years) and 1997-2009 (12 years) would have amounted to no more than a break-even investment.

However, at least in the decade of the 2000's, if you had been invested in bonds, real estate, commodities, and foreign stocks, your return would have been in the 5-6% range. Not great, but not zero. The S&P 500 suffered a cumulative loss of 9% for 2000-2009 decade while emerging markets were up 405%, small international stocks gained 199% and real estate increased 176%.

Diversification works.

Author Larry Swedroe makes a great point:

"Diversification is always working; sometimes you will like the results and sometimes you don't."

The importance of diversification is lies in the inability to predict which sector is the best investment. Stocks move in response to unpredictable, unknowable events — both good and bad — such as regulation, technology breakthroughs, management woes, fraud, and geopolitics to mention a few.

Nobel Prize winning economist Paul Samuelson proclaimed:

"Because we cannot predict, we diversify."

With all the attributes of diversification; decreasing the risk of underperformance, reducing volatility without reducing expected returns, why do some investors take the risk of owning individual stocks? It related to the behavioral aspects that will be covered later in the book — overconfidence, confusing the familiar with the safe, and confusing information with wisdom.

"Diversification is protection against ignorance."
~ Warren Buffett

Summary

Investing is part logic, art, science, probabilities and risk.

Chapter Takeaways:

Asset Allocation is much more important than trying to figure out who the latest “hot” fund manager is.

- Diversification reduces volatility.
- Reducing volatility maximizes the chances that you will stay invested during periods of market turmoil.
- Be strategic by placing the law of probabilities in your favor.
- Develop a portfolio that contains uncorrelated assets so that all your investments don’t move in the same direction at the same time.

In the next chapter, I’ll talk about how to take advantage of the volatility that is naturally in the markets.

Chapter 3

"You have to plant in the spring to sow in the fall."

~ Jim Rohn

Rebalancing

Why Do I Need To Rebalance?

Portfolio management parallels taking care of a garden. Weeding consists of selling the losers. Watering involves making consistent contributions. Pruning involves taking losses for the greater good.

Take care of your garden and you'll eat well; ignore it and you'll find that most of what's left doesn't taste very good.

It is extremely important that you occasionally rebalance your portfolio — sell some of your strong performers and buy some of the poor performers. This rebalancing process simply involves periodically moving your portfolio back to its original target allocation.

Why Do You Want To Do This?

Rebalancing helps you maintain your preferred risk level and loss tolerance. Remember when we talked about that in the chapter on allocation? Once you determine your allocation, the next challenge is to stick to that plan.

If you determined that the ideal portfolio target allocation is 55% stocks, 40% bonds, and 5% real estate, you don't want your portfolio to move too far from this allocation. Your target allocation should have been primarily determined by your loss tolerance, so if your portfolio allocation drifts too far off target, you start assuming more risk than you intended or vice versa.

Occasionally, you must get rid of some of the high performers and nourish the low performers for growth to happen while maintaining your loss tolerance.

For example:

If your target allocation is 60% stocks and 40% bonds and the stock market is doing well, then perhaps your portfolio changes with the increased growth in the stocks so that now stocks make up 70% of your portfolio and the safer bonds make up only 30%.

There is no doubt that the increased value you of your portfolio pleases you. However, you're now in a position of higher risk if the stock market uptrend should reverse. So, if you want to minimize your risk, you want to lock in some of your gains and reduce your stock investments back to your original target allocation of 60%.

In the opposite scenario…

Let's say you're 60% stock and 40% bond

allocation has changed due to the stock markets suffering a period of negative returns (like happened in 2008).

Now your portfolio is 50% stocks and 50% bonds. Your risk has lowered considerably, but you have more loss tolerance than you current allocation was aiming for. All you have to do is readjust your portfolio back to its original target allocation by selling some of the bonds and buying more stocks… and you buy them while they're cheaper.

In essence, rebalancing is a methodical way of selling high and buying low — exactly what you want to be doing!

What Happens If You Don't Rebalance? Can You Sometimes Make More Money That Way?

The reason you choose your original allocation was that it had a high probability of helping you reach your goals. If you let your portfolio stray from its set allocation goals, you become guilty of allowing your portfolio to drift off course.

A perfect example of this is what happened in 2008. Many investors were caught up in the euphoria of higher stock market returns from the preceding 5 years. Like gamblers in Las Vegas, they just keep letting it roll. Well-intentioned investors saw their balances going up and didn't want to miss any of the gains by rebalancing.

I witnessed this behavior when I was advising participants in 401(k) plans in the aftermath of the 2008 financial collapse.

People told me that they never looked at their allocation targets after the initial allocation was set — whatever they started with, they just kept adding more into the same investments at the same percentage from each paycheck.

These well-meaning people were oblivious to the fact that they may have started with a portfolio allocation of 60% stocks and 40% bonds based on their loss tolerance and years until retirement, but they'd drifted far away.

After five years of positive stock market returns, their portfolio allocation was now 80% stocks and 20% bonds. They were so happy with their statements that they had ignored the new risk of a stock heavy portfolio. And there was more risk.

The horrible year of 2008 hit and their portfolios dropped by 30, 40 or even 50% — people lost thousands to millions of dollars. If they had periodically rebalanced to their original allocation over the intervening years, the pain of the losses endured in 2008 would have been much less severe.

The research on the next page confirms this:

Research Box

A 2007 Forbes article reported that a Wharton School Pension Research Council study of 1.2 million individual participants in 1500 retirement plans found that over a two year period, 80% if the participants had made no portfolio adjustments and 11% made only one adjustment. (cont.)

A 2004 study by John Americks and Stephen Zeldes reported in, "How Do Household Portfolio Shares Vary With Age?, found that of 2,000 participants in TIAA-CREF retirement plans—75% of them had made no changes to asset allocation during the decade through 1999.

Don't let the market movements change your investment strategy. When you see the movement causing your allocation to drift from your original allocation goals, just rebalance back to your target allocation. I call this risk-based rebalancing.

What Happened And Who's To Blame For The Losses In 2008?

You can blame the participants, advisors, or a combination of both when it comes to the previously mentioned retirement plans — there is probably plenty of blame to go around.

However, you need to remember that risk and reward are always related. Human nature is to seek reward.

Rebalancing back to target allocations during a bull market is a resembles a parent telling a child that it is time to leave a party just as everybody is starting to have fun.

But, it's common for financial advisors to find clients who drift 20%, 30%, and 40% off their target allocation due to inertia or inattention. Even worse is when it happens out of greed.

Rebalancing is all about discipline.

Many financial advisors use an Investment Policy Statement (IPS) in their practice. This IPS demands discipline from both the client and the advisor. It reminds you to stick with your planning, and disciplines your advisor so he doesn't get tempted to stray away from your target allocation either. We all make mistakes, but discipline helps you reduce the frequency and severity of them.

What Do You Get For Your Rebalancing Efforts?

One of the major effects of rebalancing on return is the “rebalancing bonus” — the excess return obtained from buying low and selling high.

So, by taking the opportunity to reduce your position in asset classes that have performed well (and may be at high levels), selling those assets, and bringing the proceeds into other parts of portfolio which may have not performed as well, the probability is that the underperforming assets will now become the overachievers.

By rebalancing, you not only reduce your risk but also increase the overall performance of your portfolio. You receive the rebalancing bonus. In the opposite vein, those sectors of the investment world that have struggled are likely to become good values and eventually start to rise again.

It doesn’t matter what the “darling” investment is this year, at some point its hot streak or cold streak will end and ultimately head in the opposite direction. Winners become losers; losers become winners.

When Do You Rebalance?

Never sell an investment for below-market performance over a one, two, or three year period. In the investment world, these time periods are considered “short-term.”

Have you ever seen someone at the grocery store that keeps changing lines and ends up making no progress? The same is true for investments — the recently successful investment is more likely to revert to the mean averages than it is to continue to outperform, and vice versa.

You might wonder why a particular investment manager or fund can’t continue to outperform year after year. The fact is that as a group, the managers are so good that they make it impossible for any one manager to outperform the market that they together dominate.

Eventually everything reverts to the mean — mutual funds, individual stocks, bonds, currencies, and even football teams. That doesn't mean reverting to the mean is bad.

Reverting to the mean also means underperforming asset classes revert to the mean as well...and they become out performers.

“Mean reversion is the Rodney Dangerfield of investing: It gets no respect. Mean reversion is as important to investing as the law of gravity is to physics.

~ Vitaliy Katsenelson

If you accept the fact that asset classes eventually return to their average over time, then it's easy to see why rebalancing is a winning strategy.

Rebalancing forces you to buy low and sell high. I’m not saying this is easy. In fact, it’s difficult to do because it often means that you make the choice to go contrary to the current market movement.

Do You Have Any Advice That Will Make It Easier?

Absolutely! There are a couple of strategies.

First:

Most successful investors either have a predetermined trigger for rebalancing or they rely on their investment advisor to make the changes for them.

Some investors rebalance based on time. They pick a certain time of the year when they look at your portfolio, determine the misalignments within the portfolio, and make adjustments that bring your portfolio back to their target allocation. Some investors pick a time close to the end of the year.

Automatic rebalancing takes out the emotion of having to make the decision to buy something that has underperformed and sell something that has outperformed. And, that's what rebalancing should be — a non-emotional decision eliminating what is usually flawed decision making.

Second:

Another strategy is called “opportunistic rebalancing.” Opportunistic rebalancing means that you rebalance when the opportunity presents itself.

For example, a sharp rise or decline may happen in March or September. When it happens, you or your advisor take the opportunity for rebalancing maneuvers.

How Often Should You Rebalance?

That’s a very common question, but there is no clear answer. What is clear is that you should rebalance.

Because investment sectors tend to trend — they continue to move in the same direction for an extended period of time — it’s often the best idea to rebalance opportunistically.

If you love chocolate and saw in the newspaper that the grocery store had marked down your favorite candy bar by 50%, you'd most likely stock up and take advantage of the sale. Somehow with investments, many people do the opposite and end up buying high and selling low.

For example, if you look at charts of the movements of stocks over the years, you'd notice that each year there is usually only a few times of appreciable movement interspersed between long periods of what appears to be nothing going on. It is at these times of volatility where an observant investor makes rebalancing changes.

However...

If you don't have the time or an advisor doing your opportunistic rebalancing, then the discipline to perform rebalancing on a fixed schedule is far superior to "setting and forgetting" or simply ignoring your portfolio all together.

Either strategy works. Academic studies haven't determined the most opportune point to rebalance, but they have shown that it's an important investment strategy to perform.

Fortunately, market movements help dictate your adjustments. There will be many years when you don't need to rebalance at all. As my interior designer friend says, "You don't want to move the furniture around too much!"

Summary

Rebalancing is vital to keeping your risk and loss tolerance in an acceptable range.

Successful investors learn to be dispassionate about their investing and allow mathematical probabilities to be their friend — that's the backbone of the rebalancing strategy.

Chapter Takeaways:

- Rebalancing helps you maintain your selected risk level.
- By rebalancing strategically, you earn the "rebalancing bonus" of higher returns.
- Rebalance opportunistically or on a set schedule — either way, just do it!
- If you are opportunistically rebalancing — pick a trigger point and stick with it.
- If you are calendar rebalancing — pick a date and stick with it.

At this point you might be wondering what risk really is plus how you know when to take extra risk and when to avoid it. Your life changes, right? Does your risk and loss tolerance change too?

In the next chapter, you'll learn the answers to those questions.

Chapter 4

“Take calculated risks. That's quite different from being rash.”

~ General George S. Patton

Risk And Reward

How Much Risk Should You Take?

Managing money is similar to playing blackjack. The difference between an amateur and a professional gambler is their understanding of risk and how to allocate capital based on the odds of being able to win in any given situation.

How much risk you should take in your portfolio is a hard question to answer. However, by the end of this chapter, you'll see that you can practice risk reduction and achieve enhanced performance at the same time. You just have to take a "big picture" view of your portfolio.

Investors generally don't mind risk — it's loss they dislike. Like most people, you probably don't mind the idea of taking risk for a good return. However, most investors are "risk uninformed." Most people don't understand investing risk from a historical and conceptual perspective. By not knowing, investors take on unacceptable risk.

Why Would You Accept The Unacceptable?

The problem is that performance is visible while risk is invisible — usually until it's too late.

Consider it this way. You’re taking a trip to your friend’s house to attend a party. It rained all day today and the temperature dropped below freezing without you realizing it. You can’t see the extra risk of black ice on the road. If you’re an experience driver, you know it might be there even if you can’t see it. You know bridges will be a greater risk, and since you’ve driven to your friend’s place several times, you know the road and the places that will require extra attention.

If you’re new to driving, you may not realize that your risk increased exponentially when the temperature dropped below freezing. If you’re a new driver, you may not even realize that something like black ice exists. You won’t be cautious, aware of conditions that make your short trip dangerous, or realize that allure/risk ratio of driving to your friend’s party has changed significantly.

Just like black ice, the unseen risk of investing without understanding the historical and conceptual perspective of the market can be dangerous.

What Can Help?

The consequences of going from rich to poor should dominate your asset allocation decisions. You may think you'll never go through a layoff or that the price of your house won’t drop significantly, but that's irrelevant. It could happen.

If you have $10 million dollars, turning that sum into $20 million doesn't really change your life. It certainly isn’t painful. However, going from $10 million to $3 million, $1 million, or just a few hundred thousand will dramatically change your life.

You need to plan with a virtual certainty that you'll have a big bear market affecting your portfolio at some point.

Let’s say there is a 5% chance that your financial plan might fail. If that 5% shows up and you can't make it, that's bad asset allocation. You need to think of a Plan B — maybe you’ll retire later or buy a less expensive car.

Can you believe that most advisors don't even discuss Plan B's with their clients? They dismiss it or say, “don't worry about it.” But then Plan A blows up.

The name of the game for many investors is not necessarily to get rich, but rather to avoid becoming poor. The mindset must not be to try to beat the market. Instead, you want to not take a beating by the market.

You see, when you invest, you could be wrong about how things will progress.

Start by imagining that stocks will deliver great returns over the coming decades. Despite that, imagine you invested conservatively with stock exposure of less than 50%. Clearly, you'll make less money — even a good deal less — than if you'd taken a more aggressive route.

What is the consequence of your mistake? You'll be driving a Camry in retirement instead of Lexus and vacationing in Miami instead of Europe. Disappointing maybe, but hardly disastrous.

Now imagine that you took the riskier route, but stocks didn't do what you expected and you lost money. If it went exceptionally bad, the consequences might leave you taking the city bus to your retirement job because you can't afford a car or vacation.

You should never treat the highly unlikely as impossible. These highly unlikely events are commonly called "Black Swan" events.

For example, the Chicago area experienced 2 hundred year floods within a 10 month period in 1986 to 1987. During the decade of the 2000's, the US stock market suffered two 50% declines within a ten-year period.

"The inconvenience of going from rich to poor is greater than most people can tolerate.

Staying rich requires an entirely different approach from getting rich. It might be said that one gets rich by working hard and taking big risks, and one stays rich by limiting risk and not spending too much."

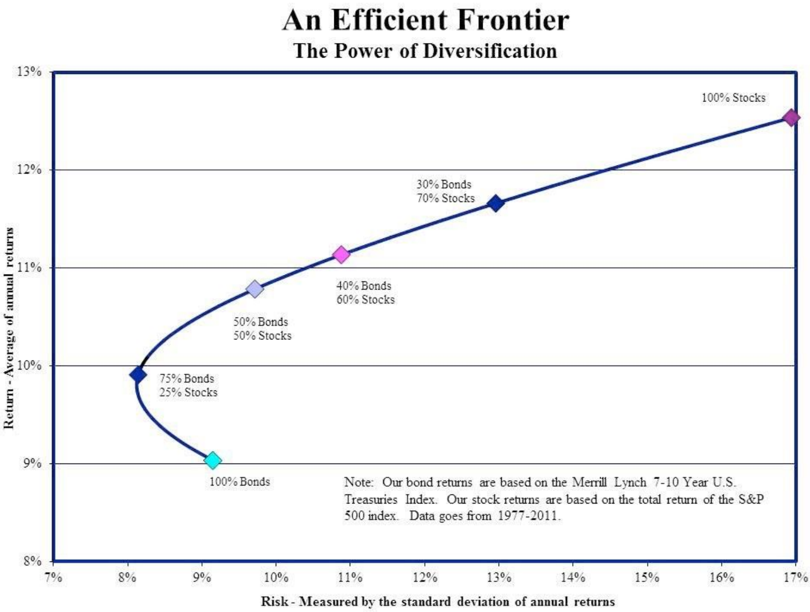
~ *Investment Management*—edited by Peter Bernstein and Aswath Damodaran

Preparing for the unforeseen is commonplace in many areas of life. Home builders know that, in most cases, the weather is relatively mild. However, they must build houses to withstand tornados, rains, and extreme temperatures anyway.

Ship builders know that, in most cases, the seas are relatively safe. However, they also know that typhoons and hurricanes happen. Therefore, they design ships not just for the 95% of sailing days when the weather is calm, but also for the other 5% when the storms blow and ship is tested.
Harry Markowitz, winner of the Nobel Prize in Economics, developed the Modern Portfolio Theory.

Part of this work was the Efficient Frontier — no, it's not a galaxy from Star Wars — it's an investment concept that explains the trade-off between risk and reward. You can see this idea in action when comparing different investment allocations. Lower returns have lower risk just like you'd expect.

The next chart illustrates:



Tell Me More About Risk Tolerance vs. Risk Capacity

There is a relationship between risk tolerance and risk capacity and vice versa.

If my 80 year-old mother wants to go rollerblading, I'm going to try to talk her out of it. After all, if she fell and broke her hip, it could even be life-threatening for her. While she may have the risk tolerance, she doesn't have the risk capacity for the sport.

On the other hand, if my friend's 5 year-old son doesn't want to go rollerblading because he's scared of falling down despite the fact that he has knee pads, elbow pads, and a helmet on, I'd still encourage him to try. The chances of him falling and breaking a bone are small. And even if he did, his young bones would heal quickly and never be worse for wear. He has the risk capacity but not the risk tolerance.

In bull markets, investing doesn't seem risky. However, it is more risky because you're paying more for your shares — you have greater risk of going from wealthy to poor. A bear market is less risky because prices are down. However, that's not how an investor feels emotionally.

So What’s That Got To Do With You?

If you’re reading this book, most likely you’re an average investor. The average investor, for many reasons I’ll cover later, tends to look for the home run, the big win, the power serve, etc. That behavior results in unnecessary risks and unnecessary losses. One of the secrets of investing is not taking big losses.

Charles Ellis wrote a famous article published in 1972 in the Financial Analysts Journal titled, A Loser's Game. In his article, he compared professional investing to amateur tennis. He noted that the amateur tennis player who doggedly returns the ball over the net consistently without trying to get the ball precisely in the corners for serving aces is usually the winning player.

While the player who tries to overpower the ball and hit low percentage shots down the alleys tends to end up on the losing side.

As a young child, you probably learned that there are great advantages to staying out of trouble. As an investor, you should take that same childhood lesson to heart.

It’s the losses that prevent overall good performance. Success in investing is not as much about winning as it is about not losing. If you can eliminate large losses, gains tend to take care of themselves.

One way to understand the relationship between risk and reward is to know some of the history of the financial markets. Without this history, you're at the mercy of the frothing media who spin out meaningless predictions which no one seems to take the time to go back and check for accuracy.

Just remember the Buffett's Rules:

Rule #1: Don't take big losses.
Rule #2: Don't forget Rule #1.

Summary

Don’t bet that the improbable is the impossible.

Risk and "expected" return are always related. There is no such thing as expected low risk, high return investments. If your investment portfolio is the equivalent of the chocolate cake diet, it’s based on unrealistic expectations that will leave you with more regret than a “too good to be true” diet.

Chapter Takeaways:

- Risk and “expected” return are always related.
- Study the history of the markets.
- Don’t take on excessive risk that is outside your “loss tolerance.”

In the next chapter, you’ll learn the basics of how you should manage your investment portfolio.

Chapter 5

“For all long-term investors, there is only one objective – maximum total real return after taxes.”

~ Sir John Templeton

Portfolio Management: How Should You Allocate Your Resources?

Hope is not a strategy.

Portfolio management or investment management is simple, but it’s not easy.

It’s simple because the principles of successful investing are relatively few and are easy to understand. The full summary goes like this: investment management is a combination of managing risk and managing emotions.

However, portfolio management takes discipline, and we all know how hard that is sometimes.

It’s like starting a fitness program. You plan it all out, maybe even write it down on paper, and it looks fool proof. But then you start the actual program and things don’t go quite like you expected. Before long, you’re off-track, making no forward progress, and possibly even worse off than before you started.

Portfolio management is an art and a science, similar to medicine, and I like to think it should be more science than art. Your portfolio should be allocated and managed based on what has worked in the past instead of on someone's — yours or anyone else's — gut feeling or forecast.

No investment strategy works all the time. The trick is knowing the difference between a bad investment strategy and one that is temporarily out of favor. The problem for most people is that results are easier to assess, and they're more objective than evaluating processes.

However, a well thought out strategy is an important starting point. Although your investment strategy may not always succeed as you planned, you shouldn't measure the integrity of the plan by the results — don't confuse outcome with process. Either it was a good strategy or it wasn't, regardless of the outcome.

That may seem counter intuitive at first, so let's look at it in a different way.

Let's pretend that you really enjoy singing in the shower. One day, you realize that you like music so much that you decide you want to be a professional singer. You get out of the shower, call your boss and quit your current job, record a video of you singing, post the video on YouTube, and then you sit back and wait to be famous.

I think we both realize that as far as strategies go, that's not the best plan for going from completely unknown to a famous singer. For most people, that strategy will fail miserably. Truly talented artists can work for a lifetime without ever becoming well known.

However, we also know that occasionally the internet works in mysterious ways and unknown people become huge hits very quickly. Regardless, in our pretend world, your strategy for success would still be a bad strategy even if you became famous overnight.

It is a mistake to assume good results are the result of a good process and that bad outcomes imply a bad process.

In contrast, the best long-term performers in any probabilistic field — such as investing, sports team management and horse racing betting — all emphasize process over outcome.

Here is an example from the sports world:

It's the fourth quarter and the game is on the line. Your leading scorer, LeBron James, has had a miserable shooting night, but it’s time to attempt a tie-breaking shot. Who do you give the ball to? Most coaches would hand it to 4-time, NBA Most Valuable Player LeBron. They know that you always want to put yourself in the position with the best chance of winning, and given LeBron’s history in most other games, he’s your best chance despite how he’s currently playing.

What Is A Good Strategy?

Start by creating an Investment Policy Statement (IPS). An IPS outlines your investment allocation strategy and how far you'll let your portfolio deviate from your target allocation.

Meir Statman, behavioral professor at Santa Clara University, said, "When at high speed, the car in front of us stops quickly, we instinctively hit the brake pedal hard and lock 'em up. It doesn't matter that all the studies show that when the brakes lock, we lose control."

Statman suggests that just as drivers need anti-lock brakes, investors need anti-lock brakes for their portfolios too.

This is where a well written Investment Policy Statement comes in. Humans instinctively react to investment situations in ways that might have saved our lives fighting on distant battlefields long ago. But today, those reactions are counter-productive — just like locking up your brakes.

When the market drops, our instinctive fear to flight response is so strong that even the most rational investors find themselves caving in to their own fear. And market tops often happen soon after the staunchest of bears throws in the towel and turns bullish.

In The Odyssey, Sirens lured ships to their island with their sweet songs and then killed the sailors. As his ship neared the Sirens' island, Odysseus, aware of the Sirens power and his own inability to resist their songs, ordered his sailors to put wax in their ears and tie him to the mast (note that he doesn't put wax in his own ears).

As his ship passes the island, Odysseus endures the agony of the Sirens' songs and orders his sailors to change course towards the island. But of course, the sailors don't hear him because of their ear plugs. The ship stays on course and they all live.

Like Odysseus, investors need a mechanism to stay on course — their Investment Policy Statement (IPS) and perhaps their advisor. When the declines come, as they inevitably do, and your stomach starts to ache in pain, your IPS will help you use your head instead of your stomach or emotions to make decisions.

“We need to learn to set our course by the stars, not by the lights of every passing ship.”
~ General Omar Bradley

Your IPS acts as a seat belt to keep you in your seat when chaos reigns around you.

Earlier you learned that asset allocation was the most important decision you needed make to develop the right portfolio for your unique situation. Once you have determined the allocation and created your IPS, it’s best to let the portfolio do its work with periodic checkups to make sure it is still in alignment with your goals.

It's important to have a clear investment strategy, one that you can stick with in good times and bad. The vast majority of individual investors and many professionals aspire to beat the market by finding some special key they think that everyone else has missed. More often than not, the market beats them.

“Investing is not entertainment—it’s not supposed to be "interesting." It's a continuous process, like refining petroleum or manufacturing cookies, chemicals, or integrated circuits. If anything in the process is interesting, it's wrong.”

~ Charles Ellis, from *The Loser’s Game*

How Do You Know You’re Basing Your IPS On Good Strategy?

Modern Portfolio Theory (MPT) is the basis for most investment strategies.

The most important thing for you to remember about MPT is this: It is the returns on your portfolio as a whole that count, not the results of the individual investments within the portfolio.

As part of the emotional roller coaster syndrome, noise investors tend to focus on investments in isolation, but academic studies tell us that they should do just the opposite. Evaluate each investment with regard to its singular contribution to the portfolio’s total return. Avoid evaluating risk on an asset by asset basis.

“Investing is like throwing horseshoes, you get points for being close. You don't have to get a ringer.”

~ Richard Ferri, CFA

The basis of the theory is that if you put relatively uncorrelated assets together, you should have more stable returns — it’ll likely reduce volatility and lower risk.

Deena Katz, professor of personal finance at Texas Tech University and partner in Evensky and Katz Wealth Management, explains modern portfolio theory this way:

“Let's say you have the opportunity to purchase two stocks: one is a swimsuit company and the other is number one umbrella company; both in California. If you buy only the swimsuit company, on days when there is rain you won't make any money. If you buy only the swimsuit company, you will make money only on sunny days. If you buy both of them, theoretically you will balance profits and losses every day. This basic concept is that what drives most investing today.”

The next time you hear someone say MPT doesn't work, just remember that it's the equivalent of saying that anatomy and physiology don't work because someone suffered from a disease.

The goal of Portfolio Optimization is to mix your assets in a way that produces the best possible return for the given level of risk and the least amount of risk for a given level of return.

Don’t confuse Portfolio Optimization with Portfolio Maximization whose goal is to maximize returns and doesn't care about risk.

The stock market has proved to be a wonderful investment vehicle: since stocks have produced positive return on a yearly basis approximately 70% of the time — the challenge is to avoid severe losses in years like 2000-2002 and 2008.

Avoiding Severe Losses

There are critical components of portfolio management that no investor should ignore. Thankfully these components are relatively easy to understand. However, they are often hard to implement.

Much of portfolio management is really about knowing and understanding probabilities and odds.

“Odds are, you don't know what the odds are.”
~ Gary Belsky and Thomas Gilovich, co-authors of *Why Smart People Make Big Money Mistakes*

Portfolio managers look at a number called the standard deviation to mathematically measure how risky an investment or portfolio is. The standard deviation is widely accepted as the most appropriate way to measure the risk of investment portfolios since the work of Harry Markowitz in the late 1950's. Markowitz, who won the Nobel Prize for his research, is widely considered the father of portfolio management with his efficient market hypothesis theory.

You might think of standard deviation in terms of how far your car tends to steer to the right and left of the centerline of the highway. In financial markets, it’s a measure of how far and how often your particular assets deviate from their historical average return.

You should view standard deviation in your portfolio as you would view the result of your blood test. Knowing you’re within a “normal range” is comforting and exactly what you want.

For example, since 1900, the S&P 500 Index traded on average at about 15 times earnings (Price/Earnings Ratio). However, it spent only a quarter of the time between Price to Earnings Ratio of 13-17, the “mean zone” two points above and below average. In the majority of the cases, the market reached its fair valuation only in passing from one irrational extreme to the other.

What Are Some Other Concerns For My Portfolio?

A. Expenses

Costs are an added weight to your portfolio that slows its growth.

According to FINRA, the average large cap equity mutual fund charges 1.35% in fees, although many are more than 2%.

Expense ratios are expressed as an annual figure, but they’re debited from your account on a daily basis. However, this charge doesn’t appear on your monthly statements, making it hard for you to notice it. To find it, you must look in the fund's prospectus, where you’ll see the expense ratio expressed as a percentage.

Many investors think that the expense ratio covers all fund expenses. In reality, the expense ratio represents the percentage of the fund's assets that go purely toward the expense of running the fund. The expense ratio only covers perennial fixed costs such as salaries, administrative costs, investment advisory fee, distribution fees, marketing costs, utilities, computers, research services, overhead, and other similar expenses.

However, it excludes the many variable costs needed to operate a fund. The variable expenses that take the biggest bite out of investor's returns are brokerage commissions and trading expenses. When fund managers buy or sell a security, they pay brokerage commissions just like you would if you were to buy or sell a stock or bond. Of course, a fund pays lower commission rates than you would pay because of the volume.

Even so, considering that mutual funds trade millions of shares constituting billions of dollars, their trading costs are huge. And the more the fund trades, the more expensive brokerage commissions become as an expense to your fund.

Typically, funds spend tens of thousands of dollars — perhaps even millions — in trading costs per year, and these expenses are not included in the annual expense ratio or even disclosed in the prospectus. To find these and other expenses, you must look at the fund's Statement of Additional Information (SAI).

According to Morningstar, the fees described in the SAI can be equal to or even exceed the annual expense ratio.

Research Corner

Trading expenses are difficult to determine, but in 2007 an analysis by researchers at Virginia Tech, the University of Virginia, and Boston College found the average fund, based on a sample of 1706 US equity funds from 1995 to 2005, incurred annual trading expenses of 1.44% per year during that period. This is in addition to the 1.32% average annual expense ratio. These two figures put the total cost of the average mutual fund at 2.76% per year.

(cont.)

Edelen and his co-authors analyzed portfolio holdings and transaction data for nearly 1,800 equity funds from 1995-2006. Their findings are reported in "Shedding Light of 'Invisible' Costs: Trading Costs and Mutual Fund Performance," which appeared in the Financial Analysts Journal. "Our results suggest that invisible trading costs have a detrimental effect on fund performance that is at least as material as that of the visible expense ratio," said Roger Edelen, associate professor of finance at the UC Davis Graduate School of Management. In the funds the researchers analyzed, the average annual expenditures on trading costs, or aggregate trading costs, were 1.44%, while the average expense ratio was 1.19%. And there were considerably more variation in trading costs than expense ratios.

Edelen, Evans, and Kadlec (2007) also found stronger negative correlation of fund performance with trading costs than with expense ratios.

To summarize the above research points, investors should be more concerned about fund trading costs than about the fund’s expense ratio.

Unfortunately for investors, finding the fund trading costs isn’t easy. You’ll see them buried in the prospectus of the fund but not clearly delineated like the expense ratio is.

What Do These Hidden Costs Do To Performance?

Russel Kinnel, Morningstar’s Director of Mutual Fund Research, did a study in 2010 that looked at mutual fund performance and determined that expense ratios are the most dependable predictor of performance — the lower, the better. Therefore, expense ratios should be the primary test for fund selection.

“The shortest route to top quartile performance is to be in the bottom quartile of expenses.”
~ Former Vanguard Chairman John Bogle

Just like any business, controlling costs leads to higher returns.

The Edelen, Evans, and Kadlec study also found an additional cost, although it’s not really an “expense.” This is the cost borne to a fund due to the flow of investors in and out of the fund. For many mutual funds, the cost of accommodating flow processes (i.e. transactions made because investors are moving in and out of the fund) is the largest component of transaction costs. The researchers found that, for the average mutual fund, this cost of flow decreased investors' returns by 0.75% annually — almost a whole percentage point!

In addition, hidden transaction costs occur every time a security is bought or sold. Transaction costs caused by fund turnover include brokerage commissions, bid offer spreads, and market impact costs. Together, they may easily exceed the expense ratio and other costs disclosed in a prospectus.

In a study titled, Portfolio Transaction Costs at US Equity Mutual Funds, researchers Jason Karceski, Miles Livingston, and Edward O'Neal found that the average brokerage commission costs for mutual fund managers was 0.38% of fund assets.

Spread costs are an additional cost over and above the broker's commission. Every time a security is bought or sold there is a hidden spread which is the difference between the market maker's bid and ask prices. A 2004 study prepared for the Zero Alpha Group found that the average annual spread between bid and ask prices was .34%. The spread costs are highest for small company and foreign company stocks especially emerging market stocks.

Market impact costs are another hidden cost. Fund managers usually buy and sell securities in large blocks. This really forces the fund manager to buy more stocks than is offered at the prevailing price; the result is that a manager and his broker will have to raise their offer above the prevailing price in order to find enough sellers. The reverse is true when selling large blocks of stocks — mutual fund managers are often forced to sell a lower price to attract sufficient buyers. Barra, a research firm, produced a study of market impact costs that found the average stock fund with $500 million in assets and turnover rate of 80 to 100% could lose 3 to 5% a year to market impact costs.

Operating expenses plus trading costs can bring a fund's overall expenses to 2.5% or more. Think about it for a moment. If, in a given year, the relevant benchmark for a fund's returns is 10%, then a fund that is trying to beat the market would have to return more than 12.5% to achieve this goal. That is to say, the fund would have to outperform its benchmark by 25% before costs just to match its benchmark. This, my friends, while possibly achievable during a few years, history tells us it's impossible to do over the long term.

Finally, all of the above costs don't include taxes, which you pay. Depending on your tax circumstances, taxes can significantly reduce your net return on the average mutual fund investment.

The point is that costs do make a difference and since costs are more predictive and controllable, you should pay attention.

B. Volatility

Many investors can't stomach the volatility inherent in the markets with the constant ups and downs that confront them. However, you shouldn't confuse loss with volatility.

Volatility is like parenthood — you get some great years and some tough years. It's likely that when the kids hit their teens, there's going to be some trouble along the way. It doesn't mean you'll lose your kid, though.

Let's look at some statistics so that once you see volatility put in context, it might not be as scary.

Statistics

Evidence from a study by Benoit Mandelbrot and Richard Hudson examined the daily index movement of the Dow Jones Industrial Average from 1916 to 2003. If daily returns were normally distributed, statistically we should expect to see only 58 days during that period when the price changes of the index were more than 3.4 percent. In actuality, it occurred on 1001 days. We should expect a price change of more than 7 percent only once every 300,000 years—it happened 48 times during that period.

For the decade of 2000 to 2009, the S&P 500 lost about 1% per year. But not one single year produced a return within even 5% of the annualized return. There were just 3 years that produced returns within 10% of the annualized returns. So years in which the performance is near the long-term performance record are scarcer than most people think. **(cont.)**

The S&P 500 has dipped over 10% exactly 94 times since 1928. That's just over one time per year. 15% drops happen every other year and a 20% dip every 3 years.

You need to buy stocks in spite of their volatility — just like you need to take your medicine even if it tastes bad.

Volatility alone is not bad. Knowing that the market goes up about 70% of the time and having to endure some scary downdrafts during the climb is just part of the journey. It's like riding in a car on a bumpy road; if you have your seatbelt on and aren't driving fast, you'll probably get to your destination unharmed.

Over one-third of the time, large company stocks annual total returns lagged behind those of super safe Treasury bills, often by significant margins.

The S&P 500 has returned about 9% a year over the long run, but few years see returns even close to that. Since 1871, the index has risen or fallen more than 20% in one out of every three years. Less than one out of every five years sees a gain of between 1% and 9%. According to Ned Davis Research, there have been 294 dips of 5% or more in the S&P 500 since 1928. Therefore, three or four times a year, an average investor can completely screw up and do something stupid like trying to time the market by jumping in and out.

Investors tend to think that volatility is worse in the present than in the past. This is probably because whatever was causing the volatility in the past has been resolved, making current environment appear more treacherous.

If you have a long-term time horizon, then volatility is an inconvenience but also often an opportunity.

The Be Patient Strategy

"Never underestimate the value of doing nothing."
~ Winnie the Pooh

You can learn from the experience of goalkeepers. A study revealed some fascinating patterns when it comes to trying to make saves on penalty kicks. In soccer, when a penalty is awarded, the ball is placed 11 m from the goal in a simple contest between the goalkeeper and the kicker. The goalkeeper may not move from his line until the kick has occurred.
Given that in the average match 2.5 goals are

scored, a penalty kick — which has an 80% chance of resulting in a goal — tends to materially influence the result of the game. So, unlike in many psychological experiments, the stakes are significant.

The researchers examined 311 penalty kicks from top leagues around the world. A panel of three independent judges was used to analyze the direction of the kick and the direction of the movement by the goalkeeper.

Roughly speaking, the kicks were equally distributed with about one-third of the kicks going to the left, center, and right of the goal mouth. However, the goalkeepers displayed a distinct action bias: they either dived left or right 94% of the time, hardly ever choosing to remain in the center of their goal.

Yet, they would have been much more successful if they just stayed in the center of the goal. According to the statistics, when the goalkeeper stays in the center of the goal he saves some 60% of the kicks — far higher than saving rate when he dives either left or right. However, goalkeepers stay in the center only 6% of the time.

Without boring you with even more numbers, the result showed that goalkeepers could almost double their save percentage by doing nothing. In other words, just standing there was the optimal strategy.

The goalkeepers were asked why they choose to dive rather than stand in the center. The defense offered was that at least they feel like they're making effort when they dived left or right, whereas standing in the center and watching a goal scored would feel much worse.(1)

What goalkeeper is going to do that? Can you imagine how silly that would look? Everyone is expecting action. Every other goalkeeper in the world dives to a side of the goal. Just standing there would be embarrassing.

Most investors do the same thing with their portfolios — feeling the need to take action when doing nothing is usually the best strategy.

Once you build a low-cost, diversified portfolio, you should avoid making very many changes in response to short term events.

“Benign neglect, bordering on sloth, remains the hallmark of our investment process.”
~ Warren Buffett

The more you check your portfolio the more likely you are to encounter a loss simply because of the volatile nature of stock prices. If you could only avoid the temptation to keep checking your portfolio, you’d be better off.

Researchers have found that people are willing to invest more when they see the performance of holdings less frequently. (2)

“All man's miseries derive from not being able to sit in a quiet room alone.”
~ Blaise Pascal

C. Tax Management and Tax Loss Harvesting

Another critical component of portfolio management is tax management. While it is never a happy time to have investments in your portfolio that are in a negative position, it is inevitable.

Taxes are probably the biggest expense that you will incur, much greater than management fees or other expenses.

“The difference between a taxidermist and a tax collector?
The taxidermist takes only your skin.”
~ Mark Twain

You should tax manage your portfolio but don’t let your cost basis dictate your investment decisions. Your investments don’t know what you paid for them.

Many investors are reluctant to sell their losers. Remember, you don’t have to make it back the same way you lost it. You should just cut your losses and put the money back to good use in a new investment.

Interestingly, psychologists have found that when they gave people various trinkets — candles, crayons, pencils, etc. — and then offered them five cents if they would exchange any of their new stuff. The people were much more willing to trade for another trinket of the same kind (a crayon for a crayon) than for a different trinket (a crayon for a piece of candy).

Ben Franklin once commented that the only unavoidable things in life are death and taxes. However, taxes can be minimized, deferred, and possibly avoided altogether for individuals with prudent, careful attention to the tax consequences of investing.

The focus of tax management leads to the following portfolio implications:

- Minimized turnover
- Actively managed dividends
- Aggressively offset gains with losses within your
- investments

Mutual funds are notoriously tax inefficient. Due to the way they operate, mutual funds are forced to pay out gains and losses each year. If the manager has to sell holdings to meet the demand of investor withdrawals, it typically forces the manager to sell shares for a gain that causes shareholders to pay even more in taxes.

For taxable investors, the consideration of taxes should underlie every investment decision because...it’s not what you make; it’s what you keep.

According to Lipper data for the 10-year period through 2007, taxes took away 15% of the gross return (the total return before all costs and taxes are taken into account) of the average US diversified equity fund. The tax bite was much worse for the average US taxable bond fund — eating away over 40% of the gross return, almost double the effective operating expenses and loads combined.

These results were during a period that includes the 2000-2002 bear market in stocks, tax loss carry forwards, and favorable tax code. Changes in tax codes, and as tax loss carry forwards are exhausted, taxes will likely become an even greater burden for investors in stock funds.

According to Morningstar, historically for domestic stock funds, about 2% points have been lost annually to taxes. This tax cost represents an approximate 20% reduction from the equity markets long-term average annual return of around 10%.

On the other hand, not selling an investment just because you don't want to pay taxes is seldom a wise choice. Many an investor, in an effort to avoid paying taxes on gains, has subsequently lost his profits when the investment returns reversed. Think of paying capital gains taxes as a "success tax." However, it is important to keep in mind not to let the tax tail wag the investment dog. The point is to maximize investment return, not to minimize taxes.

Therefore, you should be sensitive to your tax situation and the cost basis of your investments without letting the tax situation dominate your asset allocation and rebalancing strategies.
Tax management is one of those strategies that on

the surface doesn't appear to have as much value as other investment strategies. However, the results are tremendous. Every dollar saved is a dollar in your pocket. Better yet, those extra dollars, when reinvested, continue to generate additional returns for your portfolio. All of that contributes to a virtuous cycle that leaves you with a much bigger portfolio at the end of the game.

A study done by Robert Arnott showed that by the management of taxable assets over a 25 year span, assuming a modest 8% return on stocks, an investor can earn an average of almost 2 percentage points of cumulative net gain just from using effective tax management strategies. And that's net of all the taxes that you would face at the end of the period for liquidating the portfolio. It's a very important source of after-tax gain and is both reliable and predictable.

“The only thing that hurts more than paying an income tax is not having to pay an income tax.”
~ Lord Thomas R. Dewar

Taxes are usually an afterthought when talking about investments. Taxes are a negative subject and not something most people except CPA’s want to talk about. However, when you consider that efficient tax management of your portfolio can enhance your portfolio’s overall performance, then the subject matter becomes more interesting.

Summary

Trading costs and taxes are major costs not included often accounted for by investors. These factors, along with the diminishing value from inflation and return reduction due to high operating fees, combine to become the silent killers of portfolio return — eroding value.

Chapter Takeaways:

- Tax efficient portfolios net you a higher return because you only get to spend what you get to keep.

- Hope and Hype are not good investment strategies.

- Make sure you have an Investment Policy Statement in place to guide you and/or your advisor.

- Expenses and costs are important yet often hidden and you should aim to keep them low.

In the next chapter, we'll look at market timing. By the time we're done, you'll have all the ammunition you need to determine if trying to get in and out of the market is a profitable endeavor for you to take on.

Chapter 6

“The evidence on investment managers’ success with market timing is impressive – and overwhelmingly negative.”

~ Charles D. Ellis

Market Timing

Why Don’t I Just Get In the Market When It’s Going Up and Get Out When It’s Going Down?

Market timing is the holy grail of investing.

The belief that some people know ahead of time when to sell to avoid downturns and when to start buying to take advantage of the upswings is the proverbial triumph of hope over experience.

The ability to know when the markets will rise and fall implies knowledge above all others and riches beyond your imagination.

However, like the Easter Bunny, the Loch Ness Monster, and the Abominable Snowman, consistently successful market timers just don’t exist.

If they existed, they would be the richest people on earth. They wouldn’t share this information through $197 per year subscription newsletters or ask you to hire them to make you rich too.

"The market timers Hall of Fame is an empty room."
~ Jane Bryant Quinn, financial columnist

No one has a proven history in the ability to consistently get out of the market before a fall and get back in before its rise. Plenty of people claim that ability, but they're just salespeople who prey on customers who don't know the truth.

We all want to believe someone has special knowledge that will give us an edge, but if they did, they wouldn't be working so hard to earn your business. They probably wouldn't be working at all. They'd be extremely rich and would have no need for your business.

Need more proof? Take a quick look at the latest issue of the Forbes magazine list of the wealthiest people in the world. You'll notice that not one of them is a market timer.

"I can't recall ever once having seen the name of a market timer on Forbes' annual list of the richest people in the world. If it were truly possible to predict corrections, you'd think somebody would have made billions by doing it."
~ Peter Lynch, former Fidelity Magellan Fund manager

Inevitably, someone appears on the investment landscape that seems to have made a prescient forecast and becomes the media darling on every investment news program spouting the glory of their latest forecast.

The most recent darling is, Nouriel Roubini, who for a number of years before 2008 predicted a collapse in the US housing market and the subsequent worldwide recession. It should be noted that even though he predicted a sharp decline in stock prices in his writings for a number of years prior to 2008, he admitted in a New York Times interview that he was 100% invested in stocks when the market declined.

I'd like to make a prediction that the market will go down, followed by an increase. It'll happen, because that's the nature of the market. However, that doesn't make me a successful market timer. It's only valuable if I can tell you ***exactly*** when it will go down and up...and no one can do that.

Let's look what the research studies have revealed about how difficult it is to be a successful market timer.

Research Box

From 1901 to 1990, the stock market return was approximately 9.5% per year. SEI did a study in 1992 that showed to just equal the average annual return of the stock market, a market timer needed to correctly select the timing of getting in and out of the market with about 70% accuracy. If market timers called 100% of the down markets and only 50% of the up markets, the timers still couldn't beat the return of the overall market.

Researchers Jess H. Chua and Richard S. Woodward in Gains from Stock Market Timing calculated that for market timing to pay off, investors require the forecast accuracies of at least: 80 percent bull and 50 percent bear, 70 percent bull and 80 percent bear, or 60 percent bull and 90 percent bear.

What Are The Track Records Of Market Timers?

The CXO Advisory Group tracks the forecasting records of market timing “gurus.” The best of the gurus has a 63% accuracy rate, still well short of the required 70%.

The most interesting thing is that the average accuracy rate of all 51 forecasters is a little bit less than 50%. In other words, you could replace the whole group with coin-flippers or dart throwing monkeys and you would have the same, or maybe even a little higher, level of accuracy.

What Can You Learn From This?

There are two lessons:

1) Don't waste your time listening to these market timing “experts” since nobody knows what the market will do in the short-term. If the so called gurus can’t successfully forecast the direction of the market, there is no reason to believe that you can do it.

2) Don’t waste your time trying to come up with a market timing plan yourself. Experience and research both show that it’s pointless.

In his book, *Investment Policy*, Charles Ellis writes about an unpublished study of 100 pension funds: “...their experience with market timing found that while all the funds had engaged in at least some market timing, not one of the funds had improved its rate of return as a result of its efforts at timing. In fact, 89 of the 100 lost as a result of “timing” — and their losses averaged a daunting 4.5% over the five-year period.” (1)

Research Box

A Goldman Sachs study examined mutual fund cash holdings from 1970 to 1989. In their efforts to time the market, fund managers raise their cash holdings when they believe the market will decline and lower their cash holdings when they become bullish. The study found that mutual fund managers missed this call on all nine major turning points.

In other words, trying to market time — even as a finance professional — doesn't work. You'll miss the rise and fall almost every time. Let's look at a few statistics:

Statistics

If the odds of correctly timing a market movement are 50-50, then chances of correctly entering and reversing a market timing trade are 25%. (cont.)

The chances of correctly executing 2 market timing trades are six in 100, and the odds are only one in 1000 that the market prognosticator will be able to correctly time their entry and exit from the market on five separate occasions (this is a failure rate of 99.9%).

In fact, academic surveys that measure the predictions of many of Wall Street's leading economists and market strategists indicated their actual success rate at predicting interest rate movements is less than 50%.

In other words, some the world's most successful economists are less accurate than a coin flip.

In the search for discernible patterns that would help you decide when to be in the market and when to exit, it’s all been tried.

With the advent of the supercomputer, millions of calculations and scenarios have searched for these patterns. After half a century, no one has discovered a system that works.

For those who attempt it, the practice of market timing is a bit like trying to catch a falling knife — it can be painful if you miss.

The Problems

One of the main problems with attempting market timing is that historically a large portion of a gains coming out of a bear market are made during the first year. So if you miss that critical period, you're likely to miss a significant amount of the gains made as the market bounces off its bottom. Attempting to time the market and failing can have a profound effect on your portfolio.

By market timing, investors missed the best days to be in the market.

Why would someone miss the best days?

The answer is that the market moves up and down very quickly.

Research Box
According to one study, 70% of the best days in the market occurred within two weeks of a worst day (14 out of 20 days), and 100% of the best days occurred within six months of the worst day (20 days out of 20 days).
From 1926 to 2008, there were 170 months out of 996 (17.1%) where the stock market return was more than 5%. There were 103 months with losses greater than 5%.

What do all those statistics mean? It boils down to the fact that you have a 66% greater chance of missing a large gain than experiencing a large loss if you try to time the market.

And what happens if you miss the best days?

Well, it's not good. Missing a single day probably isn't going to set you back very much. Missing several days over the life of your investments can cost you big time. Just look at this next chart:

Investment Period Total Return	S&P 500 Average Annual
Remained Fully Invested	**7.81%**
Missed the 10 Best Days	**4.14%**
Missed the 20 Best Days	**1.70%**
Missed the 30 Best Days	**-0.39%**
Missed the 40 Best Days	**-2.31%**

Twenty-Year Period That Ended 12/31/2011 (Source: Standard & Poor's Corporation. The market is represented by the unmanaged Standard & Poor's 500 Index and includes reinvested dividends. One cannot invest directly in an index. Past performance does not guarantee future results.)

Professor Javier Estrada's research in his paper, *Black Swans and Market Timing: How Not to Generate Alpha*, revealed, on average across all 15 markets (including the US) that an investor who missed the 10 best days missed half the value offered by those markets. That's half of your potential earnings down the drain.

During the period 1990-2006, on average across all 15 markets, missing the 10, 20, and 100 best trading days resulted in a reduction in the value of an investment of 43.3%, 62.3% and 95.2%, respectively. Note that the 10, 20, and 100 best days represent only .23%, .47%, and 2.34% of the total number of trading days.

In all of those 15 markets, except Australia, missing the hundred best days in each market resulted in negative returns to the investor. Ouch!

Professor Estrada's findings are highly instructive to those who are tempted to deal with uncertainty by making a big bet about the future. Being out of the market at the wrong time can be fatal to your long-term investment health.

So, What Do You Do?

The message is clear.

As tempting as it may be to try, successful market timing is not a realistic possibility. Anyone who thinks they can pull it off is fooling themselves, and they're taking a huge risk with their portfolio performance.

I'm not saying buy and hold investing works all the time. An article in the February 2011 Financial Analyst Journal reported that buy and hold only works 99.8% of the time based on research from 1926 thru 1999 across all 6 major US asset classes.

I'm just saying that a 0.2% chance of a greater return isn't worth the risk that 20 years from now you'll have less money.

Wait A Minute. I Thought You Told Me That Rebalancing Is Good. How Is It Any Different Than Market Timing?

Some will argue that rebalancing is market timing. The difference is the motivation of the investor and it's also a degree.

The market timer wants to be out of the market to eliminate the risk of exposure to the market. The rebalancer wants to lower the risk by reducing, not eliminating, the exposure to an investment allocation when it becomes under or over-weighted within the portfolio.

In terms of degree, think of it this way:
Let's say you carefully planned a camping trip. You packed your car for a weekend camping trip and set out on your way. When the weather suddenly changed, you needed to stop at a sporting goods store and stock up. And then there was an accident on the highway and you decided to get off at the next off ramp to avoid the traffic. Despite those changes, you eventually arrived at the campsite in the same vehicle but not exactly on your original schedule. That's tactical investing and making changes along the way.

Now, if after packing for your camping trip and starting your drive to the campsite you decided that the car is not large enough, or fast enough, or isn't fuel efficient for your family, that's different. If you pull over at the next auto dealership and trade in your vehicle for a new one that you think is a better vehicle to get you to your destination, then you have participated in the travel equivalent of market timing by overhauling your carefully thought out plan rather than making adjustments.

Why Does Market Timing Still Exist If It Isn't Useful?

Despite all of the data and research, there will still be people in the financial industry claiming successful market timing. The newsletter industry is particularly ripe with hucksters eloquently proclaiming superior skills when the evidence is to the contrary.

It may be just a case of supply and demand. Investors seem to want these predictions in the media, and the so-called market gurus are eager to provide them. It's just human nature to want a magical shortcut to the good life.

In the face of analysts' forecasts being clearly wrong you'd think their stunning errors would embarrass the market timers. But what typically happens is that the timers have an endless array of excuses for their forecasting failures.

Philip Tetlock has done one of the most comprehensive studies of forecasters, their accuracy, and their excuses. When studying experts' views on a wide range of world political events over a decade, he found that across the vast array of predictions, experts who reported having had 80% or more confidence in their predictions were correct only around 45% of the time.

Across all predictions, the experts were little better than coin tossers.

After each of the events passed, the forecasts were shown to be either right or wrong. Tetlock returned to the experts and asked them to reassess how well they thought they understood the underlying process and forces at work. Despite the inarguable evidence that they were wrong, the experts showed no sign of cutting their faith in their own understanding of the situation.

Instead of any self-insight, Tetlock uncovered five frequently used excuses why the experts' forecasts were wrong:

1) The "if only" excuse—"if only" the Federal Reserve had raised rates, "if only" tax rates hadn't been raised — then the prediction would have been true. Effectively, the experts claim that they would have been correct "if only" their advice had been followed.

2) The "ceteris paribus" defense — something outside of the model of analysis occurred, which invalidated the forecast, and made it not their fault.
3) The "I was almost right" defense — although the predicted outcome didn't occur, it almost did.

4) The "it just hasn't happened yet" defense — the expert wasn't wrong; the predicted event just hasn't occurred yet.

5) The “single prediction” defense — you can’t judge me by the performance of a single forecast.

These excuses allowed failed forecasters to continue making outrageously poor forecasts without any acknowledgement that they really got it wrong. (2)

This list of excuses outlined can also be found frequently in the world of investing. Two psychologists explored the excuses produced by financial analysts and by weathermen.(3)

The weathermen were disarmingly honest when they got a forecast wrong. When they made errors, they most frequently cited the reason for their failure as “personal experience” followed by an acknowledgment that they were trying to forecast the inherently unforecastable.
Strangely enough, financial analysts gave a very different set of excuses. Their most common defense was that they shouldn't be judged on the basis of just one forecast — the single prediction defense. The second most common was the excuse that something else happened outside the scope of the model — the ceteris paribus defense.

No effort has been spared in the search for discernible patterns that would lead an investor to decide when to be in the market and when to exit.

With the advent of the supercomputer, millions of calculations and scenarios have searched for these patterns. After a half a century, no one has discovered a system that works. If they had, they would have become the richest person on Earth. A quick glance at the Forbes 400 list of the wealthiest people in the world reveals not a single market timer among them.

So while market timing sounds great in concept, is a difficult strategy to pull off. Trying to predict the market's direction over near-term is an exercise in futility.

Summary

There are plenty of marketing gurus and financial analysts hoping that you won't have done enough research to know that market timing has no place in your financial plan.

They might argue that even though they missed an accurate prediction last time, you shouldn't judge them by the performance of a single forecast.

I'll argue (and so should you) that research shows that you can't trust their last accurate prediction either because it's also the performance of a single forecast. Flipping a coin has a better chance of being more accurate in the end than an investment advisor attempting to market time.

Chapter Takeaways:

- Avoid the temptation to try to time the market.

- There is no academic evidence that anyone can consistently time the market and get in when things are going up and get out before the downturns.

- Missing only 10 of the best days during a 20 year time period dramatically reduces returns.

- Rebalance your portfolio during good times and bad to take advantage of the market's volatility.

You know you don't want to be a market timer, but you do want to be a rebalancer. How do you know which stocks to rebalance and which ones to leave alone? I'll cover that in the next chapter, we'll talk about active vs. passive investments.

Chapter 7

"The great enemy of the truth is very often not the lie — deliberate, contrived, and dishonest, but the myth — persistent, persuasive, and unrealistic."

~ John Kennedy

Active or Passive Investments?

Should You Use Active or Passive Investments?

Two cars were driving fast and in opposite directions along a winding country road that was bordered by high brush, making it hard to see around the corners — one was driven by a man and one by a woman.

As the two drivers approached a bend at high speeds, they just managed to see each other in time to avoid an accident. As they passed each other, the woman shouted to the man, "Pig!"

Insulted, the man yelled back, "Cow!"

The man, angered at the woman’s audacity, accelerated around the corner and hit a pig.

The above story is a good example of how erroneous assumptions can get us in trouble.

Magazines, cable news shows, and newsletters continually promote the idea that certain people in the investment world know more than the rest of us, and therefore, we should diligently follow their advice.

Every year, the stock market's best stocks leap 150%, 200%, or even more while the worst performers can only lose 100%. The big winners skew the market average returns upward more than the losers bring the averages downward. It's for that reason that the majority of stocks end up with below-average returns. The odds of you or anyone else picking the best winners is not in your favor.

Successful investing involves being compensated for the risks you take with your hard earned money. Consequently, you shouldn't take a risk that has no compensation.

A company wouldn't make an investment in a new plant and hire new workers unless it thought it would earn a return (compensation). It's not smart for you to make an investment without a reasonable chance of return, either.

Since the risks of owning an individual stock can be diversified away, the market doesn't compensate investors for taking on the risks of individual stock ownership. Thus, buying individual stocks is speculating, not investing.

A Few Statistics

From 1980 to 2008, the US stock market generated annualized return of 10.4%, according to the University of Chicago's CRSP total market equity database representing the US stock market. Surprisingly, all the markets' gains were produced only by the top performing 25% of stocks.
During the same period, the remaining 75% of the stocks in the total market database collectively generated a loss of 2.1%.

This example demonstrates the difficulty in selecting individual stocks that will perform better, or even in line, with the broad equity market. Attempting to enhance your returns by seeking out the proverbial needle in the haystack introduces an additional layer of risk and the potential for increased volatility. A portfolio of even the most carefully selected stocks could easily wind up with none of the best performing stocks in the market and has a good possibility of producing flat or negative returns.

Investors also fall prey to the gambler's fallacy — the idea of letting the winners ride. Of course, there is no proof that this strategy works in either gambling or investing.

Mark Hulbert, publisher of the Hulbert Financial Digest, a newsletter that tracks the performance of investment newsletters, put together a portfolio of "market beaters." He chose managers that managed to beat the market in the preceding year. That portfolio earned a 99% return over the next 15 years. Not a bad return, except for the fact that a portfolio of "market losers," — those funds have lagged the market the previous year — returned nearly 50% more over the same period. In contrast to these seemingly impressive returns, the stock market as a whole rose about 600% over the same period, demonstrating the mistake of confusing luck and skill.

Brad Barber, professor of finance at the University of California, Davis, and Terrance Bodine, associate professor of finance at the University of California, Davis, studied the performance of individual investors by examining over 100,000 trades covering the period of 1987 to 1993. Their conclusion: individual investors aren't as bad at stock picking as many people think — they were worse!

Barber and Bodine's study found that the stocks that individual investors pick trail the overall market, while the stocks that they sell beat the market after the sale. The longer the time span that study covered, the more their performance trailed the market. Investors shot themselves in the foot with their trades, and the poor performance didn't even take into account the transaction fees and taxes the investors paid for the privilege of "playing the market." These costs would further depress trading performance.

Barber and Bodine concluded that investors shouldn't be trying to pick stocks. They further stated that investors probably don't realize just how badly they're doing. So if the individual investors were trading in a rising market, their portfolios generally showed gains. Unfortunately, time and money spent trying to pick stocks ate into their profits instead of enhancing them.

Some investors will turn to Morningstar to help them select their investments. But, even Morningstar themselves admit that its star system has no predictive value — in essence, it has had great success in "predicting" past performance.

To beat other money managers, you must either have information that others don't or interpret known information in a different and more accurate manner.

If anyone could consistently outperform the benchmarks, it should be pension funds. Since they are so large, they have access to the best investment minds in the country and around the world. They certainly would never hire any managers lacking a track record of beating the benchmark. Typically, pension funds have consultants to help them choose the investment managers to use. With all these factors in their favor, surely pension funds are among life's winners. But they aren’t.

"The Performance of U.S. Pension Plans" study looked at 716 defined benefit plans (1992-2004) and 238 defined contribution plans (1997-2004). They found that there was no persistence of plan performance. As outlined previously, past performance was no predictor of future performance.

In another interesting study covering pension plans by Amit Goyal and Sunil Wahal, they reviewed the investment manager hiring and firing decisions of retirement plans from corporations, unions, foundations, and endowments. The data set came from approximately 3,400 plans from 1994 through 2003. The data encompassed over $737 billion of managed assets and the withdrawal of $117 billion from investment managers.

What they found was that plan sponsors hired investment managers that produced large benchmark beating returns 3 years before their hiring. The subsequent hiring of these managers did not produce benchmark-beating returns for the plans. In fact, they produced about what the benchmark did. After firing investment managers for underperformance, those very same investment managers frequently outperformed following their termination.

Lastly, if the plan sponsors had kept the terminated investment managers, their performance would have been greater than those delivered by the newly hired managers.

Active vs. Passive

One of the great debates in the investment management world is whether investors who actively trade their portfolios do better over time than less active investors.

In general, the investment management profession attracts bright, hardworking, motivated individuals. So it would make sense that with these characteristics, the newly hired men and women should add value to their clients.

Active management implies that someone is diligently working on your behalf to help you gain an advantage while passive implies someone being lazy and sitting around not doing anything.

First the idea of passive investing is really a misnomer and one I think that was coined simply because it is the opposite of “active”. Instead think of passive as simply the concept that rather than trying to beat the market averages by marketing timing, making bets in certain sectors and making lots of trades, you should buy the entire market, keep expenses to a minimum, limit the amount of trading and be as tax efficient as possible. Now that’s not being passive; that’s being smart.

Nobel Prize Winner William Sharpe, in his paper *The Arithmetic of Active Management* stated:

"Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.”

It’s not that you can't win; it’s just that the odds of you winning are so low you shouldn’t spend time trying.

The evidence, based on before-tax numbers, proves that. Since actively managed funds are intrinsically more tax-inefficient, it’s a certainty that the percentage of actively managed funds that did outperform would have been lower on an after tax basis.

In addition, survivorship bias eliminates the poor performers from the statistical calculation.

Survivorship bias occurs when mutual funds that have terrible records disappear, are often merged with successful ones, and are not included in the calculation of performance. With the dead bodies hidden away, the surviving funds look better than they deserve.

What causes highly active investors and investment managers to trail in performance? It's really a simple matter of costs — there's a commission or transaction fee each time a trade is made.

There are also market impact costs which affect active managers much more heavily. Market impact occurs when a fund manager wants to buy or sell a large amount of shares. The quantity of shares can cause the price to be pushed higher if he is trying to buy a large number of shares or lower if he is trying to sell several shares. This becomes an implicit cost to the fund.

Research from Barra notes that a typical small or mid-cap stock fund with $500 million in assets and a turnover rate of 80 to 100 percent could lose 3 to 5% per year to impact costs.

The cost of cash is another cost factor. A study done by Russ Wermers found that the non-equity holdings reduced returns for the average actively managed fund by 0.7% per year.

Turnover in the portfolio by way of increased trading in search of higher returns has costs that harm this endeavor. Stock mutual funds lose about 0.1% of return for every 10% turnover. 100% turnover equals a loss of 1%.

Over one 10 year period, Morningstar found that low turnover funds rose an average of 12.87% per year, while high turnover funds gained only 11.29% on average.

In addition, Werners found that the returns of active managers were reduced by approximately 0.8% due to operating expenses, 0.8% due to transaction costs, and 0.7% due to holding non-equity securities, i.e., cash. This total negative impact of 2.3% presents a significant hurdle to scale, not to mention the tax consequences of the high turnover.

Even with this research, there's still an argument that active management is favored in down markets.

S&P Indices Versus Active (SPIVA) Funds Scorecard states, "The belief that bear markets favor active management is a myth. A majority of active funds in eight of the nine domestic equity style boxes were outperformed by the indices in the negative markets of 2008. The bear market of 2000 to 2002 showed similar outcomes.”

The evidence for individual investors reveals a similar scenario. The heaviest trading investors at an American brokerage firm trailed those of indexers by more than 7%, on average, while the lightest trading investors trailed by only one-quarter of one percent. (1)

Summary

Investors and advisors alike continue to debate whether actively managing a portfolio by making lots of trades, moving from sector to sector and trying to move in and out of the market is superior to carefully allocating to asset classes based on an expected return basis.

Despite the claims by active managers that somehow they are the exception to the rule, year after year in almost every category, actively managed funds trail their passive counterparts.

Chapter Takeaways:

- On average, actively managed funds do not outperform passively managed investments.

- Your after tax return is what you should be concerned about.

Okay, let's take a break from some of the academic research and take a look in the next chapter at why smart people like you — even if you knew all of the information previously outlined in this book — still might find yourself making dumb mistakes when investing.

Chapter 8

"The investor's chief problem—and even his worst enemy—is likely to be himself."

~ Benjamin Graham

Emotional Investing

How Do I Take My Emotions Out of My Investing?

“Your ultimate success or failure will depend on your ability to ignore the worries of the world long enough to allow your investments to succeed. It isn’t the head, but the stomach that determines your fate.”
~ Legendary mutual fund manager, Peter Lynch

Let’s look at an example:

10,000 people toss a coin and guess heads or tails. The person who guesses 10 in a row is determined the winner and crowned "Coin tossing guru.”

Statistically, since there is a 50% chance of tossing heads or tails, we should expect that there should be 5,000 people left after the first coin toss. After the next coin toss, statistically there should be 2,500 people left. As the coin tosses continue, after the 10 coin toss, we would expect that there will be 10 people left. Let's crown them all as gurus.

What is the likelihood that these same 10 people would win the second coin tossing contest if they competed? None. They were all just lucky.

So, just because a certain money manager or mutual fund beats the market for a few years, you shouldn't jump to the conclusion that they are smarter or more skilled. Most likely, it was dumb luck.

“Success in investing doesn't correlate with a high IQ. Once you have an ordinary intelligence, what you need is the temperament to control the urges that get other people in trouble in investing.”
~ Warren Buffett

The odds of beating a benchmark in any one year is 50%. Then the odds of beating the benchmark 3 years in a row is the same as flipping a coin and getting heads 3 times in a row — an occurrence that is expected 12% of the time.

So with thousands of fund managers in the investment field, shouldn't we expect 12% of them to beat their benchmark for 3 years in a row simply by random chance? Since this is statistically likely, why would you place any predictive value on the likelihood that the managers in the top 12% will continue to outperform? You shouldn’t.

Mark Carhart did a study that tracked fund performances back to 1962. He concluded that the top 10 performers in any one year are more likely to fall to the bottom 10 percent than to repeat in the top 10 percent.

CNBC often trots out the latest manager that has beaten the market averages, anoints them as the latest flavor of the month, and implies they are someone we should listen to for investment advice for the next 10 minutes.

Since there is no evidence of persistency of performance in fund returns beyond what could be randomly expected, a logical person must not attribute a particular funds outperformance to skill instead of luck.

Constantly Monitoring Your Investments

If you weigh yourself every day, it causes you to have a tendency to feel happy if you lose weight and to feel sad if you gain weight. Ultimately, weighing yourself daily leads to erratic behavior. This same behavior can happen for people who check their portfolios every day.

Like people who overeat during stressful times, investors tend to adjust their portfolios in a poorly planned way during stressful market changes.

The seemingly well informed person, the kind that religiously reads the financial press and watches business television, is the one who feels most compelled to try to finesse his exit and entry points. The suspicion that “sophisticated” investors are the most prone to try and outwit the market was given validity by a study carried out by London-based Ledbury Research, consisting of more than 2000 affluent people from around the world. (1)

The survey found that 40% of those questioned admitted to practicing market timing rather than pursuing a buy and hold strategy. Yet the market timers were more than 3 times more likely to believe they traded too much.

These investors tend to follow the markets and financial media fanatically, extrapolating recent short term movements into big picture narratives that fit their predispositions. Most people are risk averse and since we experience the unhappiness of a loss at twice the level as the happiness from a gain — the more often you know about a loss, the unhappier you become.

The combination of hyperactivity, lack of self control, and loss aversion causes investors to make bad investment decisions.

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The combination of hyperactivity, lack of self-control, and loss aversion causes investors to make bad investment decisions.

In more recent times, Bernie Madoff's claimed returns were unbelievable to most thinking people, but greed took over some of his victims. The list of Madoff's victims number Wall Street anti-fraud crusader former New York Attorney General Eliot Spitzer, TV broadcaster Larry King, film director Steven Spielberg, LA Dodger legend Sandy Koufax, DreamWorks CEO Jeffrey Katzenberg, singer John Denver, numerous philanthropic foundations, and several billionaires.

According to a DALBAR study, the average stock investor earned 5% annually while the S&P 500 index earned 9.2% annually for the 20 years studied through 2013. That's a huge difference!

This seems to be proof of the self-destructive tendencies of investors to buy high and sell low, going from fear to greed, and never learning from their mistakes. The study concluded, "Investment performance is far more dependent on investor behavior."

I'm Just Not As Smart As Those Rich People.

Once you have ordinary intelligence, what you need is the temperament to control the urges that get people into trouble investing.

Anand Chokkavelu, CFA wrote an article titled, *"Are You Too Smart To Be Rich?"* He notes that we learn all our lives that smart equals rich. When you think back to high school and recall who was voted the most likely to exceed, the class valedictorian probably comes to mind.

However, Chokkavelu suggests there is a mountain of evidence suggesting that being extra smart will not make you rich.

In the early 2000's we witnessed the collapse of Enron. This firm was supposedly run by "some of the smartest guys in the room." More recently we only need to look back a couple years and see how "the smart guys" brought the US and world economy to its knees.

Economist Jay Zagorsky ran a study to determine whether brains translate into riches. His conclusion? "Intelligence is not a factor for predicting wealth. Those with low intelligence should not believe they are handicapped, and those with high intelligence should not believe they have an advantage."

In his book, *Outliers*, Malcolm Gladwell explored how the successful become so. He concluded that, "Once someone has reached an IQ of somewhere around 120, having additional IQ points doesn't seem to translate into any measurable real-world advantage."

Berkshire Hathaway billionaire Warren Buffett seems to agree, "If you are in the investment business and have an IQ of 150, sell 30 points to someone else."

Now you might say, “You’re quoting Warren Buffett who is not only smart but one of the wealthiest people in the world. What gives?”

The gap seems to be arrogance. It wasn’t an excess of brains alone that sunk Enron, Lehman Brothers, Salomon Brothers, etc., on Wall Street. It was excess arrogance about their oversized brains — believing that because they were so smart they could do no wrong and that anyone who questioned them just didn't get it.

To the contrary, Warren Buffett is famous for admitting his mistakes. Anyone who knows his history knows he has made plenty of money. People also realize that he is not an arrogant man and has made plenty of bad investments.

As an investor, you have to be like an emergency room physician or a fighter pilot and control your emotions. Rely on logic and calculation to make the right decisions.

What Do You Use To Make Good Decisions?

There is a science to smart investing, and it’s based on empirical evidence of what has worked in the past.

“The four most dangerous words in investing are, ’It’s different this time.”
~ Sir John Templeton

If you don’t know the history of the financial markets, you are prone to media guru persuasion — gurus who are more interested in spouting their point of view than assisting you in your investment decision making.

One of the challenges you face is separating the noise — cable television shows and financial magazines full of ads touting the latest hot fund — from legitimate and valuable information. Jane Bryant Quinn labeled much of the information you hear on these shows and read in these mag-azines as "financial pornography.” They might make interesting reading or viewing for enter-tainment value, however, you’re unlikely to learn anything from them.

Producing these television shows in studios with flashing lights, dazzling graphics, and often loud and boisterous guests, is done on purpose. Not surprisingly, the investors who pay attention to these shows frequently hold underperforming portfolios.

By not spending any time studying how markets work and the history of financial markets, investors tend to fall back on bits of investment folklore and "conventional wisdom" that fails the test of reality. You might as well join the flat earth society.

If you don't have the time or inclination to spend significant time on your financial matters or when you look in the mirror you don't see Warren Buffett, you probably need some help.

Hiring a Personal Chief Financial Officer is one answer for you. A Personal CFO can be the advisor and sounding board that makes the difference between your financial success or failure.

The problem is not that you, as an investor, aren't smart. It's just that being smart enough isn't the most important trait in becoming a successful investor. Warren Buffett says that anyone with an average IQ has more than enough neurons to be a successful investor.

The most important determinant to become a successful investor is your ability to fight your emotional makeup and stick with a plan especially during down times.

Knowing the right thing to do and doing it are two different things.

What you may need is someone who can help you eliminate the emotional aspect of your investment decisions, remind you how financial markets react, and bring a sense of logic and history to the current situation.

A reminder that a significant down market happens on average of every 3-4 years and that a 25% decline is highly likely can help you make good decisions instead of emotional mistakes.

The following table summarizes the frequencies of market declines of various magnitudes:

Magnitude of market decline	Frequency of occurrence
>5%	3 times a year
>10%	Once a year
>20%	Once every three and a half years
>30%	Once every ten years

>40%	**Once every twenty-five years**
>50%	**Once every fifty years**

Summary

As humans, it's difficult to control our emotions. Unfortunately, this lack of control can have devastating effects on your investment portfolio.

Chapter Takeaways:

- Ignore the talking heads that are constantly making predictions.

- Become a student of the history of the financial markets.

- Rely on research from academic sources rather than Wall Street Investment (I mean marketing) departments.

Emotions are a tough thing to control and often make us make bad decisions. That's why it's often wise to get some guidance to help you take the emotion out of your decision making. How do you find good guidance—we'll take a look at this issue in the next chapter.

Chapter 9

“The greatest lesson in life is to know that even fools are right sometimes.”

~ Winston Churchill

Choosing Guidance

Be Careful Who You Listen To

If you are one of the many investors who like to tune in to financial shows to pick up some wisdom, you should heed the words of famed investor Bernard Baruch who said, **"Something that everyone knows isn't worth knowing."**

Warren Buffett's mentor, Ben Graham, told this story over 40 years ago to illustrate why investment professionals behave the way that they do:

An oil prospector died, went to heaven, and was met at the pearly gates by St. Peter with some bad news. "You have qualified for residence", said St. Peter, "but as you can see, the compound reserved for oil men is packed. There is no way to squeeze you in." After thinking for a few moments, the prospector asked if he could say four words to the present occupants.

That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, "Oil discovered in Hell."

Immediately the gate to the compound opened and all of the oil men marched out to the nether regions.

Impressed, St. Peter invited the prospector in and told him to make himself comfortable. The prospector paused, "No", he said, "I think I will go along with the rest of the boys. There might be some truth to that rumor after all.”

Be careful about getting your investment advice from Wall Street gurus and the financial media. Many times, they don’t align their self-interest with your financial success.

Getting your investment advice from these outlets is akin to getting your medical advice from the National Enquirer. However, acquainting yourself with the results of academic studies of how markets really work is bound to help you increase your portfolio returns — kind of like getting your medical information from the New England Journal of Medicine.

Investors want to find the guru that tells them he can market time or beat the market by actively trading stocks, and Wall Street feels obliged to help them even when they know it’s not possible.

Don't Confuse Information For Wisdom

Information is not knowledge or judgment. The internet and cable financial shows are full of information. However, you need to interpret the data to bring wisdom from the information. As you can imagine, our Homeland Security department sifts through a lot of information to detect a piece of data that is of value. Investors or their advisors must do the same.

Author Michael Mauboussin points out that the talking heads on television satisfy a human need for an expert, without providing the value of an expert.

Philip Tetlock in his book, *Expert Political Judgment* found that so-called experts who are in the business of making predictions fail miserably. He observes:

- Optimists tend to be more accurate than pessimists.

- The only predictor of a forecaster's accuracy was how frequently he was cited in the media. His academic credentials, field of study, policy experience, access to classified information, or the number of years of work in his field has no effect on the level of forecasting success.

- Amazingly, this relationship of accuracy and media citing was negatively correlated — the more the forecaster was cited by the media, the worse his forecasts.

- The experts, like most of us, suffered from hindsight bias — they claimed to know what was going to happen, but after the fact. This is one way experts become overconfident.

William Sheridan, author of *The Fortune Sellers*, reviewed the leading research on forecasting accuracy from 1979 to 1995 covering forecasts made from 1970 to 1995. He concluded that economists cannot predict the turning point in the economy.

He found that of the 48 predictions made by economists, 46 missed the turning points. The forecasting skill of economists is about as good as guessing. Even the economists who can directly or indirectly influence the economy (the Federal Reserve, the Council of economic advisers, and the Congressional budget office) had forecasting records that were worse than pure chance.

There are no economic forecasters who consistently lead the pack in forecasting accuracy and consensus forecasting doesn’t improve accuracy.

Interesting Study

In one study, eight experienced bookmakers were shown a list of 88 variables found on a typical past performance chart of a racehorse (e.g. the weight to be carried, the number of races won, the performances in different conditions, and so on). Each bookmaker was then asked to rank the pieces of information by importance.

Having done this, the bookmakers were then given the data from 45 past races and then asked to rank the top 5 horses in each race.

Each bookmaker was given access to data in increments of the 5, 10, 20 and 40 variables he had selected as most important. Hence each bookmaker predicted the outcome of each race four times, once for each of the information sets. For each prediction, the bookmakers were asked to give the degree of confidence ranking in their forecast.

With five pieces of information, accuracy and confidence were quite closely related. Sadly, as

(cont.)

more and more information was made available, two things happened.

First, accuracy flat lined. The bookmakers were as accurate when they had five pieces of information as when they had 40 items to help them.

Secondly, the degree of confidence expressed in the forecast increased massively with information. With five pieces of information the bookmakers were around 17% confident; by the time they had 40 items of information, confidence had exploded up to more than 30%. So all the extra information wasn't making the bookmakers any more accurate, but it was making them increasingly overconfident. (1)

Interesting Study

Another group of psychologists have recently found very similar patterns when it comes to American football. They tested football fans' ability to predict the outcome and point spread in 15 games. To take part in the study, participants had to pass a test demonstrating that they were highly knowledgeable about college football. Thus, the survey participants could safely be described as experts. (cont.)

To see if more information really was better information, a computer model was given the same data as the humans. In each round, the computer model was given more information, replicating the conditions the human players faced.

The results were reassuring for those who argue that more is always preferable to less. With just the first set of information, only six items, the computer model was about 56% accurate. As more information was gradually added, the predictive accuracy rose to 71%. So for the computer, more information was better. (cont.)

What about the humans? Much like the bookmakers, the football experts accuracy didn’t improve with additional information. It didn't matter whether they had six or thirty items of information; their accuracy was about the same. However, the participants started off at 69% confident with six pieces of information and rose to nearly 80% by the time they have 30 items of information just as the bookmakers, confidence but not accuracy increased with the amount of information available.(2)

Beware of Morningstar ratings

Morningstar uses its famous five-star system to rank thousands of mutual funds based on their risk-adjusted performance. The top 10% of Morningstar listed funds earn a five star rating, the next 22 1/2% get four stars, the middle 35% get three stars, the next 22 1/2% get two stars, and the bottom 10% get one star. So that should make it easy to pick a winning fund, right?

Mark Hulbert wrote in Forbes magazine, February 2004, that over the past decade Morningstar’s five star equity funds earned an average of 5.7% against the 10.3% return for the Wilshire 5000.

One study of the performance record of funds rated five stars by Morningstar failed to find reliable statistical evidence that these funds performed any better than funds rated four stars or even three stars. The study also found that Morningstar ratings did only marginally better than other, far more simplistic, predictors of future performance.

So the evidence shows, it’s just not as easy as thinking, “If you can count the number of stars, you too can select superior funds and will therefore enjoy superior results.” There is no relationship between investment performance and investor performance.

To be fair, Morningstar (to its credit) freely admits that its star rating system does not imply future performance. However, the mutual fund industry sees it another way and continually advertises any of its funds that fall into the five-star category, implying continued high performance.

Using Morningstar's rating system is the equivalent of driving forward while looking through the rear view mirror.

While Morningstar admits that its star rating system has no predictive value, 100% of net new investment money going into mutual funds goes to the "five-star" or "four-star" mutual funds.

The system does a great job of “predicting” the past. The one lesson learned is that when investors buy five-star funds, they end up owning three-star funds because the five-star rating was a poor predictor of future ratings.

Recently a study done by S&P Dow Jones Indices *"Does Past Performance Matter? The Persistence Scorecard* revealed similar sentiments. "The S&P Dow Jones team looked at 2,862 mutual funds that had been operating for at least 12 months as of March 2010. Those funds were all broad, actively managed domestic stock funds. (The study excluded narrowly focused sector funds and leveraged funds that, essentially, used borrowed money to magnify their returns.)

The team then selected the 25 percent of funds with the best performance over the 12 months through March 2010. Then the analysts asked how many of those funds — those in the top quarter for the original 12-month period — actually remained in the top quarter for the four succeeding 12-month periods through March 2014.

The answer was just 0.07 percent of the initial 2,862 funds managed to achieve top-quartile performance for those five successive years. That works out to just two funds. Put another way, 99.93 percent, or 2,860 of the 2,862 funds, failed the test.

The study sliced and diced the mutual fund universe in a number of other ways, too, each time finding the same core truth: Very few funds achieved consistent and persistent outperformance. Furthermore, sustained outperformance declined rapidly over time. And the report said, “The data shows a likelihood for the best-performing funds to become the worst-performing funds and vice versa.”

What should investors make of these findings? Keith Loggie, senior director of global research and design at S&P Dow Jones Indices.

“It is very difficult for active fund managers to consistently outperform their peers and remain in the top quartile of performance over long periods of time,” he said. “There is no evidence that a fund that outperforms in one period, or even over several consecutive periods, has any greater likelihood than other funds of outperforming in the future.”

Just like there is usually a different team that wins the Super Bowl each year, (only 8 times in the last 46 years has the same team won two years in a row), last year’s winning investments tend to change from year to year.

Past performance does not guarantee future results. These words are so important for investors to know that the Securities Exchange Commission requires that it be included on sales material.

Please remember them when it comes time for you to invest.

Beware of Cable Financial Shows

Their focus on the short-term begs investors to become traders instead of investors. They feed viewers a daily dose of excitement wrapped in a casino-like atmosphere with its bright flashing lights, breathless announcements of the most mundane trivia, and Red Bull laden guests — high on adrenaline, spouting their forecasts for the next day week or month.

It doesn’t seem to matter that Jim Cramer, on his daily show, spouts out rapid fire recommend-ations and no one seems to pay attention to his record of success. In a 2007 cover story in Barron’s, writer Bill Alpert tracked his recommendations over a 6 month period.

Admittedly, this is a short time period, however, it entailed 3,458 trade recommendations. It comes as no surprise to seasoned observers that Cramer’s record had not even matched a non-traded index. Just like the warning on cigarette packages, watching CNBC should have the warning "watching is hazardous to your wealth.”

Financial media spin out huge amounts of “financial pornography.” Its aim is to get investors like you excited about picking a stock that has a great story and incites the greed gene within all of us. However, the sooner you understand that it's all noise with no value, the sooner you can concentrate on an effective investment plan for your future.

Beware Of Newsletters

Newsletter writers are no better.

John Graham and Campbell Harvey, two finance academics, performed an exhaustive review of 237 newsletters.

They measured the ability of these newsletters to time the market and found that less than one quarter of the recommendations were correct — much worse than a monkey throwing darts that could score 50%. Even worse, there were no advisers whose calls were consistently correct. However, many were wrong with amazing regularity.

Graham and Harvey also looked at the performance of 236 strategies from 132 newsletters. Very few beat the market, and then only by a few percent. But several managed to lag it by 10 to 40 percent per year, a performance so miserable, it couldn't happen by chance. (3) Perhaps you should just do the opposite of the worst newsletters.

Graham and Harvey also cited one very well-known advisor whose predictions produced an astounding annualized 5.4% loss during a 13-year period when the S&P 500 Index produced a 15.9% gain.

Astonishingly, there is even a newsletter which ranks the performance of other newsletters. Its publisher believes that he can identify persistently excelling advisors. The work of Graham and Harvey suggested that in reality, the publisher is the judge in the coin flipping contest.

When it comes to newsletter writers, remember Forbes Magazine founder Malcolm Forbes, who famously said, “The only money made in newsletters is through subscriptions, not taking the advice."

David Freedman, in his book, *“Wrong: How Experts Keep Failing Us and How to Know When Not to Trust Them”*, illustrates an example of how people react to “expert” advice. He describes the case of a patient with back pain.
The patient visits two doctors. The first doctor tells the patient he has seen many cases like this before, however, he really can't say exactly what is wrong and recommends a course of treatment and then waiting to see what happens. The second doctor states he knows exactly what it is and what

he would do to alleviate the condition. Your natural reaction is to choose the second doctor's plan of action due to his extreme sense of certainty, even though he very well could be wrong.

We see the same kind of behavior displayed on financial programs, internet blogs, and magazine articles. The more conviction behind the delivery of the advice, the more credence it's given. Every scammer knows this technique.

"Most information on business entertainment channels have as much benefit to the investor as a minute by minute weather report for the traveler who isn't making a trip for another year."
~ Vitaliy N. Katsenelson, author of The Little Book of Sideways Markets

The truth is that you should be careful on how much credence you give to so called "experts." Recall that Noah's Ark was built by amateurs, and the Titanic by experts.

Beware of Wall Street

Wall Street does its best to follow W.C. Fields' advice, "Never smarten up a chump."
According to a July 2009 Morningstar study, funds whose managers invest over $1,000,000 or more of

their own money in their fund ranked in the 42nd percentile.

That means they outperformed 58% of their peers. Morningstar also found that in 2008, 46% of US stock fund managers, 59% of international stock fund managers, 65% of taxable bond fund managers 70% of balanced fund managers, and 78% of municipal bond fund managers didn't even invest in the portfolios that they managed.

"Investing is a strange business. It's the only one we know of where the more expensive the products get, the more customers want to buy them."
~ Anthony M. Gallea and William Patalon III, authors of Contrarian Investing.

In our 24-hour cable news cycle world, you should be aware that the media in most cases is not your best source of unbiased information. Wall Street firms and cable channels are in a marriage of necessity. The cable shows need guests to fill up hours and hours of programming time. And the Wall Street firms need outlets to espouse their ideas and to market their services.

Of course, the representatives from the brokerage houses are the firms most articulate, attractive, intelligent and well-spoken individuals. Everything they say sounds intelligent, reasonable, and authoritative. What you don’t know is what they are espousing on television may be the opposite of what they are telling their clients.

You see, they have no fiduciary obligations to the many listeners of the program. You can be sure if they are on national television making recommendations, those recommendations have already been made to their clients. A day late, a dollar (if it were only a dollar!) short.

“There are well-dressed foolish ideas just as there are well-dressed fools.”
~ Author Nicholas Chamfort

We have lots of data that we didn't have 20 years ago and the ability to access it. It's like someone with a sharp knife. They can do surgery or they can cut themselves. It depends on what they know and how they use it.

“Today's investors find it inconceivable that life might be better without so much information. Investors find it hard to believe that ignoring the vast majority of investment noise might actually improve the investment performance. The idea sounds too risky because it is so contrary to their accepted and reinforced actions.”
~ Richard Bernstein

One advisor suggested the following disclaimer should be broadcast during the cable financial shows: “The views expressed are the views of our guest and not of this network. They may be unfounded, biased, self-serving and completely at odds with your long-term investment success. No due diligence on all past recommendations has been attempted.”

Or, said another way...

Warning: Paying attention to the following market analysis will likely be hazardous to your long-term investment strategy. It is designed to motivate you to be a short-term trader (most of which eventually fail in the process) instead of being a long-term investor (most of whom succeed).

Beware of the Forecasters

"I'd compare stock pickers to astrologers, but I don’t want to badmouth astrologers.”
~ Eugene Fama, 2013 Nobel Prize Winner in Economics

A history of forecasting the stock market, sports betting, or forecasting the weather is littered with those with little history of success. It seems everyone has an opinion on whether the stock market is going up or down, and market strategists on TV and the radio are given all the more credence due to their implied knowledge and TV presence.

If you're going to forecast, forecast often; eventually you will get it right. But if you forecast a number, never give a date.

William Sheridan, author of *The Fortune Sellers*, analyzed the track records of inflation predictions by different forecasting methods. He then compared those forecasts to the "naive" forecast — simply projecting today's inflation rate into the future. He discovered that the naive forecast was the most accurate, beating the forecasts from the most respected economic forecasting firms in the country. Armed with supercomputers, highly educated and high priced talent, these firms provided no increased accuracy.

In 2006 Jim Cramer wrote in *Registered Rep*, a trade magazine for stockbrokers, “So we got it all wrong. We thought that the individual investor would storm the ramparts, manage the money himself, and take over the world. I, in particular as a founder of TheStreet.com, thought we could turn Wall Street into a Home Depot, where do-it-yourselfers could roam free, taking care of their money and building up colossal nest eggs all by themselves. We ended up costing people fortunes with articles, newscasts, and advertising about how simple it was. The best of us were naive, and the worst of us were self-serving and shameful.”

The best and most comprehensive study of expert judgment was performed by Philip Tetlock. In 1985 Tetlock, fascinated by his previous experience serving on political intelligence committees in the early 1980s, set out to discover just how accurate expert forecasters were in their predictions of future events. Over a span of almost 20 years, he interviewed 284 experts about their level of confidence that a certain outcome would come to pass. Forecasts were solicited across a wide variety of domains, including economics, politics, climate, military strategy, financial markets, legal opinions, and other complex domains with uncertain outcomes. In all, Tetlock accumulated an astounding 82,000 forecasts.

This represents an incredible body of evidence about expert judgment, and Tetlock's analysis rendered several astounding conclusions:

- Expert forecasts were less well calibrated than one would expect from random guesses.

- Aggregated forecasts were better than any individual forecasts, but were still worse than random guesses.

- Experts who appeared in the media most regularly were the least accurate.

- Experts with the most extreme views were also the least accurate.

- Experts exhibited higher forecast calibration outside of their field of expertise.

- Among all 284 experts, not one demonstrated forecast accuracy beyond random guesses.
- Impressive titles and years of experience don’t help because the association between cause and effect is murky.

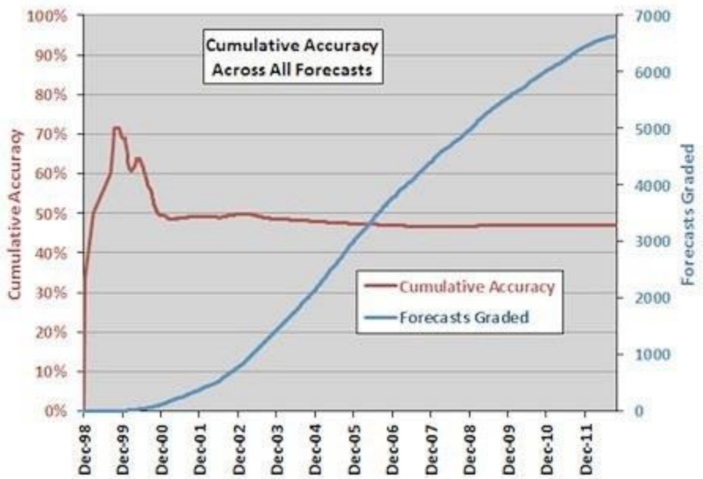
You might be wondering whether there are any similar types of studies conducted specifically in the area of financial markets. You're in luck; there have been several.

CXO Advisory has been tracking and publishing gurus' forecasts of market direction since 1998.

Recently, CXO published a review of all 6,459 forecasts from all the market 'gurus' that they tracked from 1998-2012.

Specifically, the gurus were graded on their ability to call the direction of the market, but were not penalized for missing the magnitude of the move.

Over 14 years, CXO concluded that the average guru's accuracy in calling the direction of the market has been about 47%, or slightly worse than a coin toss. The following chart shows how the accuracy of forecasts has stabilized over time around the 47% mark as the sample size expanded over time. In other words, the experts were less reliable than flipping coins. In fact, the number has become so consistent that CXO has decided to dis- continue the tracking of these forecasts.



Source: CXO Advisory

The evidence does not end there. The following charts, sourced from James Montier's incredibly useful book, Behavioral Investing, show aggregate forecasts from Wall Street's most famous oracles through time, next to the actual trajectory of the forecast variable.

Chart 1. Consensus bond yields forecasts 1 year out vs. actual

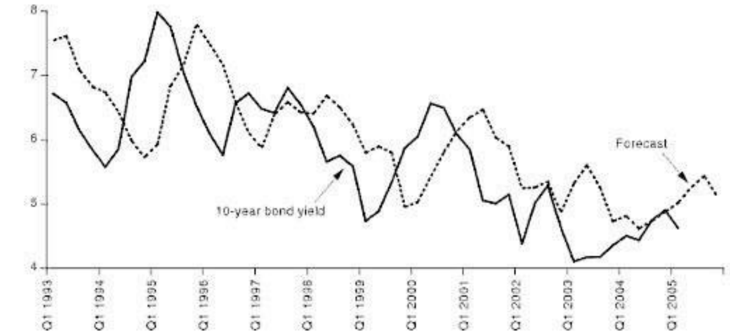


Chart 2. Consensus S&P 500 1 year forecast vs. actual

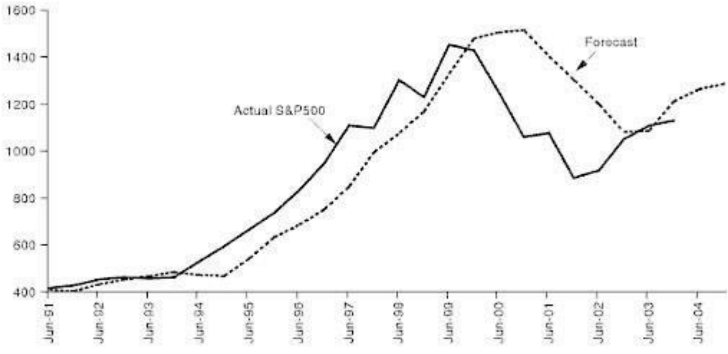
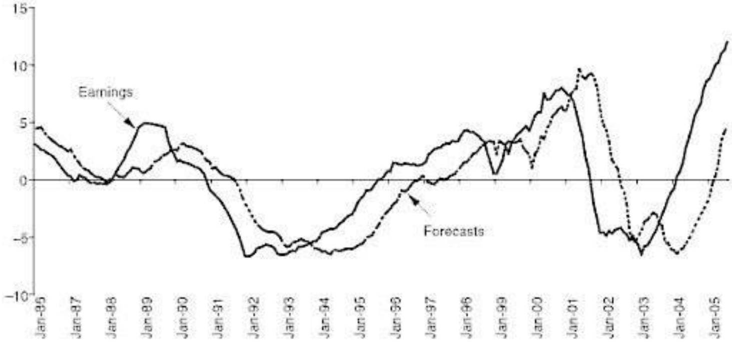


Chart 3. Consensus S&P 500 aggregate earnings 1 year forecasts vs. actual

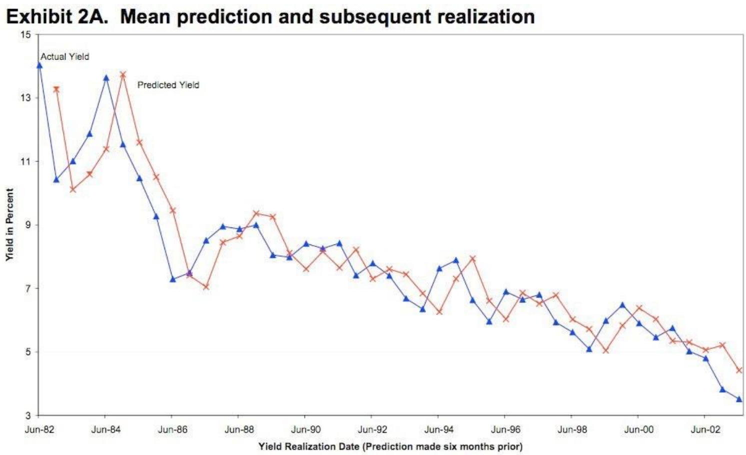


In all cases the analysts appear to do a noteworthy job of describing *what just happened*, but appear to have no vision whatsoever about what is *about to happen next.* This applies to interest rates, the level of stock indices, and aggregate earnings.

Do any experts get it right? What about the experts at the Federal Reserve who are in charge of setting interest rates? Can they predict the magnitude or direction of interest rates just six months hence?

A working paper entitled *"History of the Forecasters: An Assessment of the Semi-Annual U.S. Treasury Bond Yield Forecast Survey"* (Brooks & Gray, 2003) studied the ability of Federal Reserve economists, including Alan Greenspan, from 1982-2002 to discover whether the group of experts that sets interest rates is able to effectively forecast their trajectory through time.

Chart 4.

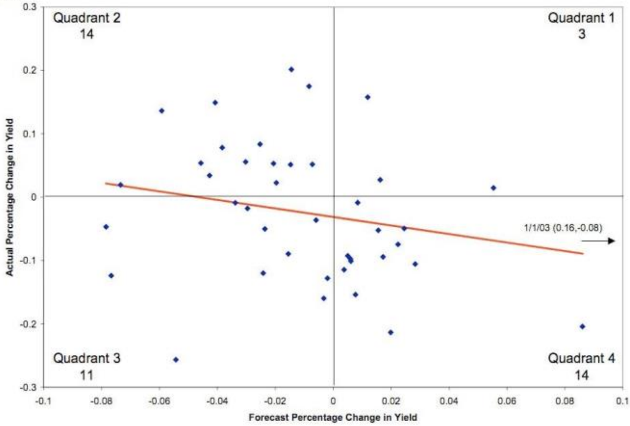


Source: Brooks & Gray, 2003

Again we see a strong talent for describing what has just happened, but no talent whatsoever for predicting what will happen next. Just how poor was the forecasting ability of Fed economists, including sitting Fed Chairman Alan Greenspan, over the 20 year survey?

Chart 5.

Exhibit 4. Actual percentage change in yield compared with forecast percentage change in yield



Source: Brooks & Gray, 2003

The scatter plot above shows how Fed forecasts of interest rates just six months out are *negatively correlated* with actual outcomes. The point is, they can't forecast any better than anyone else.

"Prediction is very difficult, especially about the future."

~ Neils Bohr, Nobel Prize Winner

“What do you call an economist with an opinion? Wrong.”
~ Robert Kuttner, “Debtors’ Prison: The Politics of Austerity vs. Prosperity”

So why do we give them any credibility? The 24-hour news cycle that requires copious content has to have people making Nouriel Roubini predictions or else they'll have a boring program.

The point is, articulate, well-reasoned men and women with great credentials have no better idea of what's going to happen in the future than you or I do.

An interesting exercise would be for you make your own predictions about the future. Perhaps write them down at the beginning of the year, predicting what you think unemployment will be, inflation rates, interest rates, the Dow Jones industrial average, housing prices, etc., and at the end of the year, see how close you are. Then compare your predictions to some of the so-called market gurus and you might be surprised that you’re much more accurate than they are.

“The problem with macroeconomic forecasting is that no one can do it.”

~ Michael Evans, founder of Chase Econometrics, a firm that sells economic data.

Summary

There is lot of information floating around on television, radio, print and on the internet. Remember there is a big difference between information and wisdom.

Chapter Takeaways:

- The conditions are constantly changing and what happened before may not provide guidance into what will happen.

- The confidence level of a “guru’s” predictions is many times inversely related to the likelihood that it will actually happen.

- Morningstar’s Star Ratings system has no predictive value — it is great at predicting past performance.

- Financial shows many times are in the business of selling ad space, not in helping you.

In general, Financial Newsletters have a terrible track record.

Research shows that no one in any industry has a high reliability rate in terms of predictions.

In the next chapter, we will explore whether you should hire an advisor to help you with your investments and financial planning.

Chapter 10

“No amateur tennis player would walk onto the court thinking he could beat the likes of Roger Federer, yet many individual investors enter the stock market thinking they can beat an unknown opponent—who could be Goldman Sachs.”

~ Professor Meir Statman

Do You Need An Advisor?

Should you do it yourself?

That's a question only you can answer. Most important tasks in your life should be handled by someone with expertise — surgery, building a pool, fixing your car, flying a plane — the consequences of doing it wrong are very costly.

After all if you do it yourself, in essence you have hired yourself as your family's investment advisor and financial planner.

Dr. William Bernstein, author of The Investor's Manifesto made the following observation:

"Successful investors need four abilities. They must have an interest in the process. It's no different than carpentry, gardening or parenting. Second, investors need more than a bit of math horsepower. Mastering the art of investment theory requires an understanding of the laws of probability and a working knowledge of statistics. Third, investors need a grasp of financial history. Fourth, they need emotional discipline to execute their planned strategy faithfully. I expect that no more than 10 percent of the population passes muster on each of the above counts. This suggests that as few as one person in 10,000 (10 percent to the fourth power) has the full skill set."

As you saw in an earlier chapter, above average intelligence is not a criteria for being a successful investor.

The June 2001 issue of *SmartMoney* magazine highlighted the investment performance of the Mensa Investment Club. If there was ever a group of investors who should be able to garner top returns, you'd expect it to be this group of individuals. To be a member of Mensa, your IQ must be in the 98th percentile or better.

The article noted that the investment club had returns of 2.5% over the 15 previous years. In contrast, the S&P 500 returned over 15.3% per year during the same period. One member described the club's strategy as buy low and sell lower.

Warren Buffett says:

"Investing is not a game where the guy with a 160 IQ beats the guy with 130 IQ. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

As the markets have evolved over the years, it has become more difficult for the individual investor to independently handle their own financial affairs. Over 40 years ago, individual investors made up the bulk of all trades. Today, institutions make up 90% of the trades with 50% of the bulk of the trading performed by the top 50 institutions. 75% of trades are done by the 100 largest institutions.

Consider that the 50th largest institution pays Wall Street over $50 million dollars in commissions every year in exchange for insights, research, and access to analysts. It has all of the latest technology and sophisticated investment services. It meets with corporate managers on a regular basis. It has its own team of in-house analysts and investment managers — 50 to 100 professionals that average 20 years of experience in the investment field, all working their networks and contacts to get the best information they can get.

The volume of trades on the New York Stock Exchange has mushroomed from 3 million shares to 1.5 billion shares, and if you include derivatives, the volume doubles to 3 billion shares — a 1000 fold increase. The 50 largest institutions now do half of all trading, so when an individual buys or sells, half the time he is trading against one of the fast, smart giants.

Quantifying the Value of an Advisor

Figuring out how much value an advisor could add to your life is hard to calculate. Both Morningstar and Vanguard have taken a crack at it in recent years. In September 2012, David Blanchett CFA CFP®, Head of Retirement Research at Morningstar Investment Management and Paul Kaplan, Director of Research of Morningstar Canada wrote a paper titled, *Alpha, Beta, and Now. Gamma*.

The paper was based on a study in which Gamma was defined as the additional retirement income investors can generate by making better financial planning decisions. Note that this is about financial planning decisions not about trying to find the best investment manager.

The 5 key decisions are asset allocation, withdrawal strategy, tax-efficiency, product allocation (the use of traditional investment products versus guaranteed-income products) and liability-driven investing (which is investing with an eye towards an investor’s specific goals, needs and timeline).

Morningstar researchers did a series of simulations and found that a hypothetical retiree could generate up to 30% more income using a Gamma-efficient retirement-income strategy. According to the study, that is equivalent to an increased annual arithmetic return of 1.82% per year above what the average person making those same decisions was able to achieve.

In 2001 Vanguard came up with the Advisor’s Alpha Concept. Alpha being defined as the extra value or alpha that an advisor could add via financial planning, discipline, and guidance, rather than trying to outperform the market. In March 2014, Vanguard issued a new paper that stated that by implementing certain value-add strategies, the average client could benefit by “about 3% per year.” These strategies included suitable asset allocation using diversified investments, cost effective implementation (low expense ratios), rebalancing, behavioral coaching (not buying high and selling low), asset location, spending strategy (withdrawal order) and total-return versus income investing.

Interestingly, in neither of these pieces of research was there any mention of any value being added due to an advisor’s ability to pick money managers.

What You Should Look For In An Advisor?

If you do choose to work with an advisor, there are things you should look for.

One is experience. The value of an experienced advisor is illustrated in the following story:

A fellow falls in a hole and can’t escape, He calls for help and a man arrives. The new man says, “I’ll go for help.” And he leaves.

Another man arrives and tosses down a rope, but it’s too short to reach the fellow in the hole, so he leaves, too.

A third man arrives and jumps into the hole.

“Why did you do that? the trapped man cries. “Now we're both in the hole!”

“Don’t worry!” the new man exclaims. “I’ve been here before, and I know the way out.”

Your advisor should serve as a Fiduciary. I call this the “F” word. For your family’s sake, you should only deal with an investment advisor who is a fiduciary. By law, a fiduciary is a person who has to put your interests above his own interests. For example, attorneys and CPA’s work under this level of responsibility.

You should know that a financial advisor, financial planner, investment representative, or whatever they are calling themselves these days at the nation’s stock brokerage firms, banks or insurance companies, will most likely not work as fiduciaries. They operate under a “suitability” standard.

The “suitability” standard, which is a much lower standard than a fiduciary and is much easier to legally meet, means that the advisor has determined that the investments he is recommending are “appropriate” for you. For example, the advisor could legitimately argue that a retiree that desires more income would be “suitable” for an annuity product.

However, the advisor could recommend an annuity that paid him a higher commission or that allowed him to win a trip for meeting a sales goal...even if it wasn’t the best annuity for you.

Despite its “feel good” advertising, the brokerage industry is not really on the side of the regular investor. One only needs to witness the government lawsuits against Wall Street powerhouse firms such as Goldman Sachs to understand this point.

As an advisor, it’s hard to see how Goldman Sachs acts as a fiduciary with its client. In fact, one of their arguments in pleading their case was that they weren’t acting as a fiduciary when dealing with some of their clients. So Goldman Sachs doesn’t even pretend to be on the side of the client when involved in litigation.

Fortunately, there is an easy way to deal with the fiduciary situation. Just don’t deal with anyone who won’t agree in writing to act in a fiduciary capacity when advising you on your financial matters.

Advisors who work for Registered Investment Advisor firms are covered under the Investment Advisors Act of 1940 must act in a fiduciary capacity with their clients. Financial advisors who work at brokerage firms, banks and insurance companies most likely will not have that obligation.

Always ask the advisor how he is compensated. I've heard a number of radio show hosts claim that "an investor doesn't pay anything, we get paid from the insurance company." While this line may be technically correct, don't be fooled. The "advisor's" (salesperson) compensation came indirectly from your investment.

What is the Advisor's Job?

Like a pilot, a financial advisor's value is to get you safely from Point A to Point B. Because the pilot never knows when he may hit turbulence, he advises passengers to keep their seatbelt fastened at all times. A financial advisor's job is to get you not to panic during the turbulence.

The pilot knows turbulence is coming. You don't want him to panic or be heroic, but be someone who is consistent, predictable, and disciplined enough to get you to your destination. You want those same traits with your financial advisor.

Be wary of those promising investments or products that just sound to be too good to be true. You've heard these pitches before. "All the upside and none of the downside." Think about it for a second. If it were true, every advisor would be recommending that investment.

Anthony M. Gallea and William Patalon III, authors of *Contrarian Investing* noted: "Investing is a strange business. It's the only business we know of where the more expensive the products get, the more customers want to buy them."
Ulysses, of Greek mythology, had his crew bind him to the mast of his ship to protect him from the call of the sirens that would have lead him to crash his ship into the jagged rocks. A good financial advisor will act as your ropes to keep you and your long term plan safe from the calls from the sirens of the television screen.

Brad Barber of UC Davis and Terrance Odean of Berkley blame return chasing on the limited attention span of individual investors. According to their investor attention hypothesis, most of us have a limited time to devote to researching investments. We can either spend time learning how to evaluate and select investments, or we can simply invest in ones that capture our attention — the shiny object in the water so to speak.

“Investing is counterintuitive. Big winners mean you're more likely to lose. Popularity leads to failure. Success contains the seeds of its own destruction. Past performance doesn't repeat. Information isn't necessarily helpful. And hard work can backfire. Maybe it's no great surprise that most of us struggle when investing—so maybe it's no great surprise that there are so few Warren Buffetts.”

~ Jonathan Clements, The Little Book of Main Street Money

I can't predict what the market will do, and I can’t prevent the market from going down. But I can help you protect or limit your losses and protect you from paying too much in taxes.

In a NASCAR race, everyone wants to be the first car around the track. When clients hire me, I can guarantee them they will never be in the fastest car. My goal is to get them around the track safely so they can retire and meet their goals.

In the end, whether you choose to use a financial advisor or not is a decision only you can make. No matter which way you go, you should concern yourself with the things that can be controlled — diversification, asset allocation, rebalancing, expense control, tax efficiency, costs, estate planning, risk management, and asset protection. Make sure you invest intellectually instead of emotionally.

In conclusion, author Kurt Vonnegut told this story about fellow author Joseph Heller:

Heller and I were at a party of a billionaire on Shelter Island. I said, “Joe, how does it make you feel to know that our host only yesterday made more money than your novel Catch-22 has earned in its entire history?”

Joe said, ”I’ve got something he can never have.”

And I said, “What on earth could that be, Joe?”

Joe said, “The knowledge that I’ve got enough!”

Here’s hoping you have enough!

Thank You!

Thank you for taking the time to read this book. I hope you found it informative and helpful.

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