WHITE PAPER

DIFFICULT BUT IMPORTANT INVESTMENT CONCEPTS

“Now listen to me here, this is important” – Bill Clinton

BY **BILL SPITZ**, DIRECTOR

We pride ourselves on providing our clients with education on important investment and financial planning concepts and, despite the risk of overkill, we find that repetition is important because they are not always easy to grasp. In his Presidential speeches, Bill Clinton frequently used the above quotation for emphasis, so we will borrow his oratorical technique and assert that these financial principles are very important.

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Specifically, comprehension of these ideas will help you understand our approach to investing, assist you in evaluating the performance of your investments, help you get through the emotional ups and downs of investing, allow you to filter all of the noise created by the financial media, and generally move you down the path to accomplishing your financial goals. We have written or spoken about each of these ideas frequently, but please bear with us for a refresher course.

The Importance of Controlling Volatility

We have enjoyed a roaring bull market in stocks since March of 2009, and while there hasn't been much volatility, the volatility that we have experienced has all been on the plus side. As a result, many people have forgotten about the importance of controlling volatility, and some of our clients believe our intense focus on it suggests that we are either wimpy or excessively conservative. In fact, there are at least three very good reasons to control volatility, irrespective of the market environment.

The first is simply math; a less volatile portfolio will end up with more money than a more volatile one with the same average return. So, the key to successful investing is to build a portfolio that offers a reasonable probability of achieving the desired rate of return while minimizing volatility. Second, volatility control is particularly important for portfolios that experience annual withdrawals to support a lifestyle or operating budget. Specifically, using conventional spending formulas, a less volatile portfolio will generate more annual spending over time because withdrawals following a significant decline in market value (i.e. volatility) diminish the long term spending stream. Finally, and perhaps most important, a more stable portfolio decreases the probability of an emotional and destructive response to a difficult market environment. Let's be honest, we are all subject to the critical emotions of fear and greed, and most decisions spurred by these impulses turn out to be poorly timed and counterproductive.

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Diversification

If we had perfect foresight, controlling volatility would be easy; we would simply pick the best prospective investment. However, as our crystal ball is always fuzzy, the best means of controlling risk is diversification. The idea is simple enough, we should attempt to find investments that do not move in tandem, so that by combining them, poor performance in any given category should be at least partially offset by better performance in another. This sounds relatively straightforward, but here's the rub. Most investments move together at least to some extent, and it is not easy to find categories that really diversify the traditional asset classes such as stocks and bonds. Second, relationships change over time. For example, bonds and stocks moved in the same direction for decades but have been moving in opposite directions for the past fifteen years. So, actually constructing a diversified portfolio can be problematic and is certainly imprecise.

One important implication of true diversification is that there will always be components of a portfolio that are not performing well. If you have an investment that is designed to zig when another zags, one or the other will always look poor in comparison. The challenge is to keep the respective roles of each category in mind when evaluating performance and not abandon the poor performer when it is in the dog house. This requires considerable discipline as well as a clear view as to the role of each component of the portfolio.

A Portfolio

The importance of diversification leads to the next concept which is that of a portfolio. I find that most people focus intensively on each component of a portfolio without understanding that it is the overall package that counts. In other words, a well-constructed portfolio is much more than the sum of its parts. It sounds a bit like alchemy, but a good portfolio has much more attractive risk: return characteristics than any of its components because it contains a number of segments which serve a very specific purpose and interact with each other in a very specific way.

As was mentioned above, one of the major challenges in investment management is evaluating performance properly. I find that most people become fixated on the return of each component of a portfolio versus its benchmark while giving short shrift to the overall performance of the fund versus its objectives. In a diversified portfolio, there will always be winners and losers both absolutely and relative to benchmarks. So, the critical question is whether the overall package demonstrates added-value and meets the goals for which the fund was created. And, since there is a great deal of "noise" in returns, a critical component of this analysis is a focus on an appropriate time horizon.

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The Windshield Versus the Rear View Mirror

Unfortunately, many decisions in the financial world are based on what has happened and not what will happen. Just to name a few, it is well documented that investors have a strong tendency to extrapolate recent experience such as returns and volatility. This manifests itself in the form of buying investments that have already appreciated and selling at the bottom. Similarly, investors tend to fire managers and/or redeem funds at just the wrong time. And, many investors raise their risk tolerance by becoming more aggressive after a given market has risen when they probably should be moving in the other direction. As just one indicator of the cost of these behaviors, J.P Morgan recently published a chart indicating that the average investor earned an annual return over the past twenty years of 2.3% which was less than the return on virtually every individual asset class and trailed a simple 60% stock /40% bond portfolio by 4.6% annually. The culprit was backward-looking decisions.

The message is that investment decisions should be based on what is going to happen. Of course, we don't really know what is going to happen, but there are a number of things we can do to decrease the chance that we are looking backward. First, a powerful force in investing is regression to the mean. Just the act of keeping that force at the forefront of one's thinking should reduce the tendency to extrapolate recent experience. More specifically, when considering a change in asset allocation or the addition/deletion of asset classes, one should focus on prospective returns rather than trailing results. Of course, you won't get it exactly right, but there are fairly rigorous approaches to forecasting returns that should give you some sense of where you are in the cycle and decrease the odds of buying high and selling low. As has been mentioned several times, a critical aspect of successful investing is proper performance measurement which includes focusing on relevant benchmarks, understanding the role of each asset class in the portfolio, and considering an appropriately long time horizon. Finally, it is perfectly acceptable to concede that all of this is overwhelming in which case a simple, passive portfolio is a good option.

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The Role of One's Outlook

The investment world is characterized by constant chatter regarding the outlook for the economy, corporate profits, interest rates, politics, demographics, and so on. Of course, we have our own views regarding each of these topics although we have enough battle scars to guarantee a reasonable degree of humility with respect to our prescience. The key question is the extent to which your outlook should determine your investment posture. For example, we frequently get questions such as: "Why do you own European stocks when the outlook for those economies is not as bright as that of the U.S?" Or, "Shouldn't you sell your bonds since it is obvious that interest rates have to rise?"

There are two answers to these kinds of questions. In the next section, we will deal with the issue of valuation. In other words, how does the outlook for a given investment compare with its price? But, let's focus for the moment on the question of your outlook versus the consensus. Markets always reflect the accumulated wisdom of all of participants. In other words, current prices reflect the consensus of all investors, and markets adjust to new information very quickly. That is not to say that the consensus ultimately proves correct, but we should not underestimate its collective intelligence. Since markets already reflect the consensus, your outlook should only impact your investment posture when you have a materially different view. And, there are a couple of major challenges to such a posture. First, it isn't always easy to determine what the actual consensus is for a given component of the outlook. Second, one should be hesitant to assert that you are smarter than everyone else. And finally, if you have a different view that proves incorrect, the cost in terms of performance can be significant. What does this mean for investing? Carefully construct a portfolio that seems likely to achieve reasonable long term goals and avoid the temptation to be influenced by your view of the world unless you have a different view and very high conviction.

Valuation

With the exception of tax exempt bonds, we do not select individual securities which means that we spend our time evaluating the relative attraction of different asset classes. And, while we don't make "all or nothing" bets, we do adjust our weightings based on this analysis. Our decisions are primarily based on a variety of valuation metrics which suggests that we should briefly discuss our fundamental valuation tenets of which there are two.

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As was referenced in the previous section, valuation is all about balancing the outlook for a given investment versus its price. An asset with a poor outlook may well be attractive if its price is sufficiently low whereas one with an incredibly bullish outlook should be avoided if the price more than reflects that outlook. Many investors make the mistake of only looking at one side of the equation. Second, everything in valuation analysis is relative. What does that mean? Recently, we have heard that some investors are shying away from real estate or private equity because they are too expensive. Yes, both categories are selling at high prices versus where they were five or six years ago. But, stocks, bonds, and most other categories are also selling at all-time highs. So, the question is, how do the valuations of all of these categories stack up against one another? Based on outlook and price, we estimate returns on each asset category. When combined with estimates of risk, this allows us to compare asset classes with one another and ultimately construct portfolios.

Conclusion

It has probably been painful, but you have just read the catechism of Diversified Trust's investment approach. We discuss most of these precepts in one form or another in our normal client meetings, but it is easy to gloss over them in the heat of looking at this quarter's performance or discussing what is currently happening in the financial world. But hopefully, this refresher will remind you of what we are all about and help you make sense of the current structure of your portfolio as well as any changes we make. On October 19th, the Wall Street Journal published an article titled How Financially Literate Are You Really? Let's Find Out. The article includes a brief test which you should now be able to ace-good luck!

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