

THE EDUCATED INVESTOR

FEATURE ARTICLE

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FOCUS
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IT'S IMPORTANT TO BE EDUCATED

Significant portions of the investment industry thrive on an investor's lack of knowledge. We believe there are some products that would rarely be purchased if investors were made aware of their many disadvantages under most circumstances. Likewise, many trades would likely not be made if clients understood the true benefits of a buy-and-hold strategy. We have found that advisors who place their clients' best interests as their top priority prefer clients who are highly educated about essential investment concepts and market functionalities. These professionals understand that the more educated the client, the more likely both the advisor and investor will thrive. In this article, we discuss the importance of investor education as well as the basic concepts that every investor should seek to possess.

The Importance of Education

From our introduction to a client prospect and throughout our ongoing client relationships, it is our desire and intent to educate clients about how capital markets work and to provide them with essential information critical to their financial well-being. We recognize that our advice to invest in passively managed funds as opposed to actively managed funds is significantly different from the advice of most investment advisory firms and also is different from the strategy followed by most individual investors. Therefore, we understand how important it is to share with clients the academic research that leads us to believe markets are generally highly efficient. We also share the data that indicates that it is highly unlikely investors will be able to exploit any inefficiency that may exist after taking into consideration all the expenses of the effort. While clients should be shown at the beginning of a relationship how a well-diversified portfolio can help manage risk, that lesson will need to be often repeated as asset classes come in and out of favor over time. Another lesson we stress is our belief that attempts to time the market, either in terms of individual securities or asset classes, typically lead to investors realizing lower returns than those available from a buy, hold, and rebalance strategy.

Because our investment approach differentiates us from the average investment advisor, it is crucial that our clients understand why we recommend it. Without such understanding, a client may become tempted to abandon his or her diversified portfolio during periods such as the late 1990s, when growth so outperformed value that it became tempting to pour all of one's investments into that single asset class. Put simply, knowledge is the key to discipline. The same holds true during periods like the last three years when value outperformed growth. Clients who do not possess a basic under-

standing of passive investing are more likely to quickly become dissatisfied when their portfolio underperforms the latest hot asset class.

Essential Investment Education

What is the minimum basic knowledge needed to remain a disciplined passive investor? We believe the following key concepts form a strong foundation from which to build.

1. **Markets are efficient.** Public information is of little fundamental value. New information is so quickly incorporated into asset prices that use of this knowledge cannot be expected to consistently yield superior risk-adjusted returns. Information that is not public is also of no value, in that it is illegal to trade on.
2. **Risk and *expected* reward are related.** Investors who expect or need to achieve higher returns must accept the associated risk. Except for the benefits that can be had by diversification, there is no “free lunch” when it comes to investing. Restated, equity-like returns do not come without commensurate risks.
3. **Diversification works.** Global diversification across a variety of imperfectly correlated asset classes is the most effective way to reduce risk. (Correlation is how similarly different investments perform. The higher the correlation, the more similar the performance and thus the lower the diversification.) Diversification is always working ... whether or not we're pleased with the immediate results. For example, there have been times such as the late 1990s when it was tempting to abandon diversification as large-cap growth significantly ran ahead of the pack. However, diversification should be thought of as the equivalent of buying insurance against having all of one's investment eggs in the wrong basket. From 2000 through 2002, those who had placed all of their eggs in the large-cap growth basket learned a painful lesson about the value of diversification.
4. **Markets are unpredictable in the short run, and even in the long run.** In the long run, we *expect* that equity markets will rise more often than fall. However, we must all understand that in the short or even long run, anything is possible. Individuals who correctly predict short-term market movements would do well to attribute their results to luck rather than skill.
5. **Discipline is key to successful investing.** For far too many investors, the variable that ultimately determines the results of their portfolio is not the return on their investments, but is instead their behavior. Emotions can lead investors to make poor decisions at just the wrong times. It is easy to remain disciplined during bull markets. However, it is far more important to do so in bear markets to avoid the far-too-human propensity to sell at market bottoms. Thus the role that emotion plays in the success of an investment strategy cannot be overemphasized. Education is key to ignoring one's emotional reactions and staying the course.

We believe that investors who understand the above basic concepts will be well ahead of the majority of the investing public. They will have a basic understanding of why we warn against holding individual stocks or timing the market, and why we instead place so much importance on evaluating risk tolerance, building a globally diversified portfolio and implementing regular, disciplined rebalancing techniques.

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