# THE EDUCATED INVESTOR

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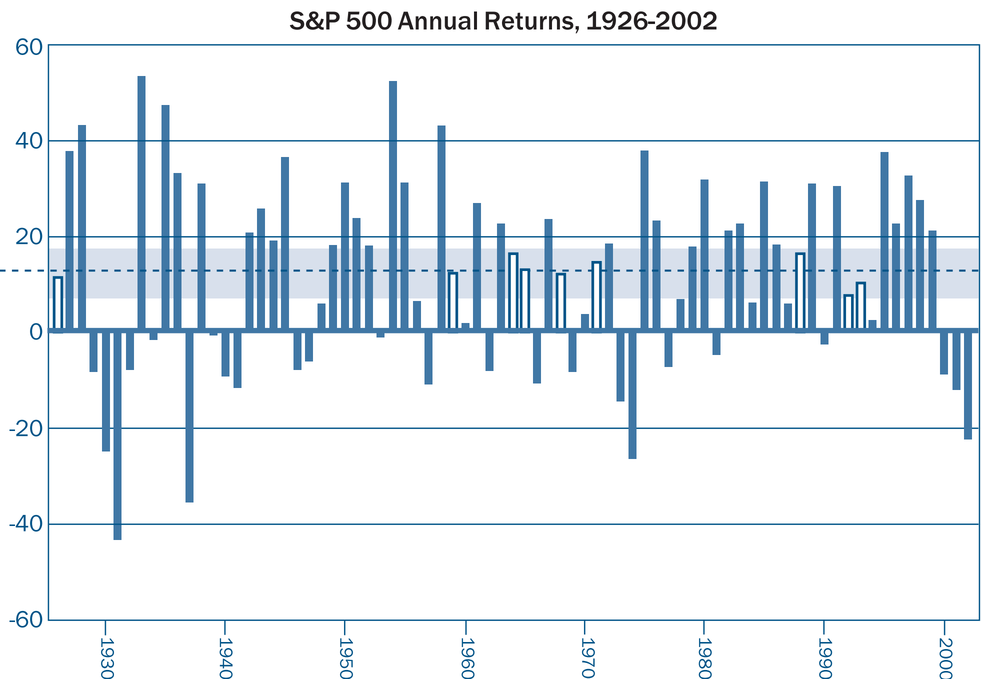
FOCUS
Asset Management Company


## Luck or Skill?

The financial markets provide great opportunities to create financial wealth. They also provide great opportunities to lose it. Just within the past decade, the S&P 500 has experienced annual returns as head-swimmingly high as 37.4 percent and as gut-wrenchingly low as –22.1 percent. Across an even longer timeframe, while the average annual return for the S&P 500 from 1926 through 2002 was 12.2 percent, there were only *nine* out of 77 years in which the annual return actually fell within even 40 percent of that target (i.e., between 7.32 and 17.08 percent).




**There's no predicting the market.** While the average annual return for the S&P 500 for the past 77 years has been 12.2 percent, only nine of those years (depicted in white) actually fell within close range of that average.

Similar volatility exists not only within the S&P 500 (large-cap growth), but within each asset class (small-cap, value, international, etc.). Further, each rarely moves in tandem with the others. How can an investor possibly know where good fortune will smile next?

Some try to seek the guidance of a star fund or advisor who seems to be riding high. We read of market gurus such as Bill Miller, manager of the Legg Mason Value Trust. He is the only manager to date to beat the S&P 500 Index for 12 consecutive years (and counting). It is tempting to reason that such high-riding performance cannot possibly be only luck, and that it can be relied upon to predict future success from Miller.

We can't tell you how much longer Miller's winning streak will continue. However, the historical evidence is that even the greatest success stories — even funds or managers with stellar track records that last as long as a decade or longer — are better treated as luck that may slip away at any time, rather than skill that can be relied upon to indicate future success.

A basic knowledge of statistics provides us with the understanding of why this is so. With thousands of money managers playing the market, odds are quite high that a few out of the collection will randomly turn in performances like those of Bill Miller's. While there are only one or a few such performances, they are far more likely a result of random chance, despite our human desire for it to be otherwise.

Let's use an additional illustration as supporting evidence. Suppose the multi-billion dollar pension plan of "Deep Pockets, Inc." has decided to fire its current manager and search for a replacement. As part of its time- and resource-intensive analysis of candidates, Deep Pockets screens for several criteria.

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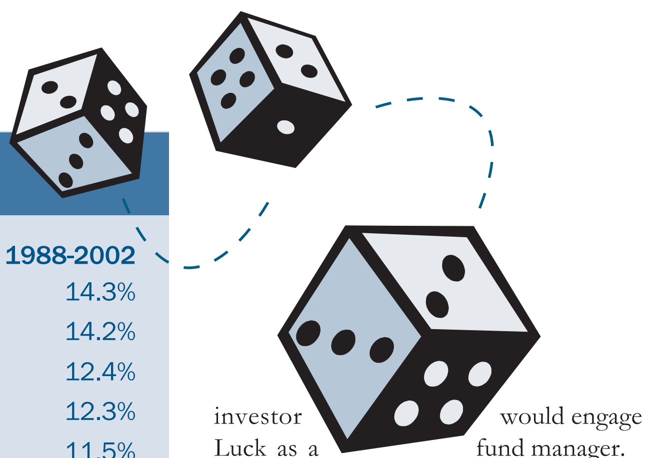
# Luck or Skill? (Continued)



**"Deep Pockets" Pension Plan**
**Due Diligence Report**

| Fund Name | Annualized Returns, 1988-2002 |
|---|---|
| Lady Luck Investment Trust | 14.3% |
| Legg Mason Value | 14.2% |
| Washington Mutual | 12.4% |
| Fidelity Magellan | 12.3% |
| S&P 500 Index | 11.5% |
| Janus Fund | 11.4% |

Sources: Morningstar and the Center for Research in Securities Prices (CRSP). Inclusion of the above information is not a recommendation of any of the funds listed, nor an indication of any past recommendation.

They scan for the following:

- ▲ A record of superior performance during the 15-year period ending in 2002
- ▲ Highly persistent superior performance
- ▲ Long manager tenure
- ▲ Low turnover

The thorough process narrows the choice to five final candidates, compared in the chart above against the S&P 500 Index as a benchmark.

Based on its historical track record, the winner is the (hypothetical) Lady Luck Investment Trust. Not only has Lady Luck significantly outperformed its S&P 500 Index benchmark, but it has done so with a high degree of persistence. The fund has had the same manager during the entire period, and its turnover has been very low.

Based on their analysis, the pension fund investment committee members vote to award plan management to Lady Luck. But as a final bit of due diligence, they bring in the fund manager to explain her winning strategy. Appearing before the committee, she is congratulated on the superior results of her fund and is asked to explain how she achieved it. Luck responds that, since her favorite letter has always been "M," she decided to construct a value-weighted portfolio of all US stocks that began with M, and then to rebalance the portfolio annually. Upon hearing the news, the committee decides to reconsider its earlier vote.

The above illustration uses real returns data — stocks beginning with M really did happen to outperform during the described period. The data was constructed by our allies at Dimensional Fund Advisors relying upon the University of Chicago's CRSP (Center for Research in Securities Prices) database and using a technique known as "data mining," in which one builds predictive models of the real world by discerning patterns in masses of data.

The trouble is, patterns discerned by our able computers are often entirely random rather than a result of legitimate, reproducible causes. In this illustration, for example, computer-generated datamining revealed that a "letter M" strategy would have delivered outperformance during the particular 15-year period. But for a historically successful strategy to be expected to work in the future, we must be confident that there is a clear and rational correlation between strategy and outcome. Of course there is nothing rational that explains Lady Luck's performance, which is why no rational investor would engage Luck as a fund manager.

In other words, just as we have no way to guess which letter of the alphabet might next enjoy 15 years of investment success, we have no way to guess who will be the next winning fund manager. Similarly, an average long-term return for any given asset class must be some unique percentage, but historical patterns indicate how unpredictable those percentages are, and why it is in your favor to spread your investments across numerous asset classes rather than playing the game with Lady Luck.

The good news is that there is a way you can rise above the market mayhem and still expect to achieve the investment objectives you seek:

- ▲ Recognize that your financial objectives are ill-served by relying on luck.
- ▲ Abandon attempts (and the costs involved) in picking winning stocks, funds or fund managers; assume that resulting gains would be more likely from luck than strategy.
- ▲ Instead, implement the academically based tenets of Modern Portfolio Theory to build a globally diversified portfolio that seeks to capture performance based on a passive investment approach.
- ▲ Maintain your portfolio's original structure through disciplined rebalancing.
- ▲ Visit Lady Luck in your leisure time on the golf course, in a casino or at whatever sports or entertainment venue is of interest to you.

## The Rebalancing Act

In an ever-changing market, even the most perfectly constructed portfolio will not remain perfect without continued guidance.

As various asset classes move in and out of favor, a portfolio will begin to "style drift," as its asset class holdings each grow greater or smaller than originally planned. At some point, rebalancing must take place to eliminate the style drift and restore the desired asset allocations. Without a disciplined rebalancing strategy, it is impossible to maintain control over the risks and rewards of one's portfolio and it will float off-course from its original objective.

The catch is, proper rebalancing can be daunting, requiring the investor to maintain an undistracted focus on long-term goals. Essentially, rebalancing goes against our human nature, as it requires us to *sell* some of our recent outperforming asset classes (the ones being hailed as the next big winners by much of the financial press) and *buy* some of the asset classes that have recently been the poorest performers. Going against the market's current trends is very difficult for most investors.

There is an additional consideration. Because rebalancing typically involves both buying and selling portfolio holdings, it generally incurs transaction fees and may have tax implications. Thus it is possible to rebalance too much as well as too little. We suggest two conditions under which rebalancing is advised:

1. Whenever new investment funds are available — either via new cash flow or by foregoing automatic dividend reinvestment and instead using the dividends to rebalance
2. When the asset allocation has shifted "substantially" out of alignment — potentially at the broad level of equities versus fixed income, at the level of domestic versus international asset classes, or at the more narrowly defined individual asset class level

What constitutes a "substantial" misalignment? This is an answer best discussed with your advisor who is familiar with your unique objectives, income expectations and other factors that may impact the construction of your sound rebalancing plan.

## A Path to Prudent Investing

In 1992, The American Law Institute (ALI) published its **Restatement of the Law, Trusts: Prudent Investor Rule**.

Based on the tenets of Modern Portfolio Theory, the Prudent Investor Rule provides trustees with some 300 pages of detailed description on how to adopt a "general standard of prudent investment." Most states followed ALI's lead and passed legislation incorporating its recommendations into their standards for trust management.

Of course much of what is sound advice for trust management is equally sound for individual investors. Following are key concepts described in ALI's publication that also apply to the individual investor:

- Diversification is fundamental to risk management.
- Risk and expected return are directly related.
- Trustees have a duty to avoid unjustified expenses.
- Trustees must balance protection of principal with need for current income.
- "Uncompensated risk" is undesirable, but selecting an appropriate degree of compensated, or "market" risk is unavoidable.
- Because managing risk requires "deliberate assessment and judgment," trustees have "a duty as well as the authority to delegate as prudent investors would."

In short, evidence suggests that prudent investors work with an investment advisor who understands the many factors involved in constructing a properly diversified, cost-effective, accurately risk-profiled portfolio, and who helps them maintain that portfolio through appropriate rebalancing.

## Worth Repeating

Worth Repeating

"Luck or tragedy, some people get runs. Then of course there are those who divide it even, good and bad, but we never hear of them. Such a life doesn't demand attention. Only the people who get the good or bad runs."

— John Steinbeck

"The only sure thing about luck is that it will change."

— Wilson Mizner

# Does Your Fixed Income Need Fixing?

It's hard to read a newspaper without noticing that the fixed income environment seems different than usual (or at least different than has been usual). With the federal funds rate already at a 45-year low, the Federal Reserve recently cut its key interest rate to 1 percent, and indicated rates will remain low until the risk of deflation seems extinguished.

While low interest rates have provided an attractive climate for refinancing mortgages, it has caused confusion regarding the best course of action for the fixed income investor. Following are some tips to consider.

Most individuals invest a portion of their portfolio in fixed income holdings for one or a combination of two reasons:

1. To establish a reliable income stream (such as in retirement)
2. To offset the risk being taken within the equity portion of the portfolio

When we advise investors on their equity investments, we stress that investment decisions should be governed by their willingness, ability and need to accept market risk and its commensurate expected return premiums. This same advice holds true in fixed income investing.

For those investors who have less than $400,000-$500,000 to invest in fixed income, we generally advise selecting one or a few fixed income mutual funds that offer the lowest expenses while fitting into the appropriate risk profiles as described below. For those who invest greater amounts in fixed income, constructing a customized, individual bond portfolio becomes a viable option.

## Income Investors

Income investors who already own one or several fixed income securities and were planning to hold them until maturity anyway may be best served by continuing to hold them. If they instead sold them for the profit they could realize from the increase in bond prices and reinvested the proceeds in new bonds (with new, generally lower coupons), the net result of the transaction would be no better than what they already have.

There is an exception. If you are holding a long-term bond that has recently been downgraded to a lower quality, the added risk of continuing to hold that bond might be more dangerous than the "penalty" taken by replacing the downgraded bond(s) with ones of higher quality. It might be better to take a hit in current income stream than to risk losing the entire principal if the bond defaults.

## Risk-Dampening Investors

In a portfolio focused on risk reduction, shorter-term holdings[1] are generally advantageous, as they tend to offer the optimal balance between yield and accepted risk. As a bond moves further out in maturity, risk grows. As interest rates rise, long-term bond prices are affected much more dramatically than their shorter-term counterparts. Yet, even as the risk grows dramatically with lengthened maturity, growth in expected term premium begins to significantly diminish.

Thus, by shifting longer-term bonds to those having shorter maturities,[1] one can best expect the appropriate balance between risk and reward. Considering details such as your tax bracket, time horizon and liquidity needs, your advisor can assist you in constructing a portfolio of high-quality fixed income instruments (in either a laddered or bulleted configuration) that meets your unique circumstances.

[1] Bonds with around two-year maturities have historically been considered within the "sweet spot" for use in constructing fixed income funds or portfolios, although this can fluctuate based on market shifts. Further, two-year maturity is an approximate guideline, as individual circumstances may dictate the construction of a bond portfolio requiring a wider range of maturities.

FOCUS

## Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**



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