

# Planning Perspectives Investment Policy for an Informed Process

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PROFESSIONAL  
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Consultative Wealth Management

*"Haste makes waste."*

—Benjamin Franklin, *Poor Richard's Almanac*

This is a prologue in a series exploring integrity in personal wealth management.

## Key takeaways:

- Informed investors act through a well-planned investment policy process for decision-making.
- Lowest expected return in equities is during business cycles top, when optimism is strong.
- Greatest expected return in equities is during business cycle's bottom, when pessimism is strong.
- Unplanned reactions to short-term stock, sectors' or market movements causes mistakes.

**Professional Financial helps successful people make informed decisions** about wealth for planning major concerns. The wealth management consultative process addresses more than investment planning. It involves advanced planning to achieve the values, goals and dreams of affluent families. Still, much of the value an advisor may add lies in preventing clients from making costly mistakes.

One of the foremost ways a wealth advisor helps clients avoid costly investing mistakes is to establish a clear and credible investment policy. The investment policy strategy must be founded on an integrated planning approach, a philosophy and a process that an investor can stick with over the long-term.

Benjamin Graham, known as the "father of value investing," is most remembered for his book, *The Intelligent Investor*. "The purpose of this book," writes Graham in the very first line, "is to supply guidance . . . in the adoption and execution of an investment policy." Warren Buffet, now the richest man in America, was a disciple of Benjamin Graham. While Graham was practically financially ruined by the early Great Depression, he had enough confidence and discipline in sticking to his theories that he was able to recoup his fortune by the end of the difficult decade leading into the global catastrophe that was World War II.

An investment policy is a written statement committing both the client and the wealth manager to a set of defined investment boundaries. The purpose of an investment policy is to enable disciplined decision making as well as to encourage effective communication between client and wealth manager through changing times. First, the investment policy clearly states objectives for guiding how the advisor will manage the investment process (including legal standards of fiduciary skill and care) such as an allocation strategy, allowable asset classes, normal allocation ranges and permissible risk variations. With an investment policy, clients are committing themselves to sticking with a relatively consistent risk exposures achieved through the astute asset allocation of a portfolio structure. Second, it clearly states how the client will evaluate the investment portfolio over time, broadly states general expectations for returns and establishes clear boundaries for client behavior as well as a time horizon for evaluating outcomes over the course of business cycles. Generally,



for structured portfolios with a balance of equity and fixed income securities, that time period should be *at least* five to ten years, preferably measured in one-year intervals.

Smart strategy for investment policy is based on an informed economic and investment philosophy. This philosophy provides a sensible theory for how markets work, and subsequently, a prudent way for investors to invest accordingly and so be reliably rewarded by the relationship between risk and expected return. Tested and debated historical data and scientific research—not what sells simply because it happens to be popular—supports our investing approach and the empirical strategies we employ. Investing in the uncertain world in which we live should not be timing vague speculations of the future, nor general opinions about “opportunities.” Successful investing, we believe, must be solidly based on an informed knowledge in the science of capital markets to withstand changes of popular opinion.

usually are unable to stick to a plan for long periods when risk doesn’t seem to be rewarded—or at least adequately rewarded based on their limited personal experiences or what they hear from friends or see in the financial media. Investors, upon becoming impatient for a greater return, especially as an alternative to saving more or spending less, often take ever bigger chances. But speculation can be an expensive lesson, sometimes prohibitively expensive for those close to retirement. Prospective clients have the choice to learn from us, or experience learning from the market.<sup>1</sup>

Without informed expectations for portfolio returns based on a strongly held investment philosophy and a reliable way to measure those progressive results over long period of time—a procedure explained as part of an investment policy—most investors eventually become susceptible to all the confusing noise from the media, from salesmen or from well-meaning friends (bragging about winners but forgetting their losers). Confusion leads to doubts, which can lead to second-guessing their investments or the abilities of their advisor, and then to a failure of commitment.

The conflict between fear of loss and greed for gain may be most acutely felt when clients review their quarterly reports and do not see an outstanding performance for a couple quarters or even a couple years. It’s easy to have faith when standing on the glorious mountaintop; doubts begin to arise sitting in a deserted valley. Going up is fun; going down is not so easy. While one-year and five-year client returns may be above general market benchmarks, some clients may still find themselves disappointed when they remember a decade or so of higher returns, or when the media intensely focuses on a familiar stock market segment doing unusually well where they are not concentrated.

The commitment of an investor to sticking with the asset allocation specified in their investment policy is directly affected often by how often he decides to check his investments, and what benchmarks he selects to measure results. Both a short-term perspective and misguided benchmarking—particularly benchmarking against currently popular market segments—can also contribute to confusion and exacerbate emotional conflict and thus

Figure 1: **FACTORS OF CAPITALISM**



Our philosophy is that investors, as suppliers of financial capital, may expect a reward to help businesses develop. We believe that markets work, and securities in competitive liquid markets are priced fairly, at least for investing purposes. Capital markets price stocks, bonds or commodities through exchanges so they become worth or not worth owning by investors. The aggregating process of trading collectively incorporates all the information known about a business (and its stock and other respective assets), including what is known today, what happened yesterday and all predictions about tomorrow. Prices change as new information occurs. This instantaneous random information processing defines what is known in academic circles as the efficient market hypothesis.

Without a philosophy together with an adequate knowledge of economic history, individual investors



investor discipline. Most behavioral studies show that the pain of loss is at least twice that of the greed of gain.<sup>2</sup>

In times of financial crisis, investors' risk aversion increases dramatically. The pervasive 24/7 financial media makes knowing about bad news events almost unavoidable. In times of bad news, clients' commitments to the investment horizons stated in their investment policies tend to decrease dramatically. In times of panic, fearful investors no longer think about investing long-term—carefully watching their accounts drop, they become concerned about next month, next week, even the next day. Yet, these times are precisely when commitment to the investment policy and the investor's personal planning discipline becomes most important.

### A Tale of Two Retired Engineers

Earlier this year a client—a retired engineer we'll call Bill<sup>3</sup>—who had been with us ten years cleverly produced an Excel chart comparing the actual net returns of his moderate risk portfolio, from which he had withdrawn monthly income for the past decade, to the hypothetical performance of a Vanguard index model he devised with the tools provided by that gigantic, well-known index mutual fund firm. It incorporated an estimate of the income he had been withdrawing each month for ten years to supplement his family's social security income.

Lo and behold! Bill could show that *if he had bought and held* certain allocation of their market index funds

starting from a certain point during the middle of the last decade, then he would have had a significantly higher return. His mistake was that he failed to read familiar tobacco-type warnings included with industry illustration tools: "All simulated strategy performance information is based on performance of indexes with model/back tested asset strategies; the performance was achieved with the benefit of hindsight; it does not represent actual investment strategies." In short, figures may not lie, but liars can figure as much as they want. Playing too much with simulations with too little knowledge of financial history easily becomes like a fantasy video game. The game looks very different to a real player risking his life and livelihood on the field each day, as opposed to participants safely watching protected in the stands.

Bill's question to us was, "What am I paying for?" For the sake of explanation, let's ignore all the financial planning and tax services he benefited from over the years, and consider just his performance. Bill signed an investment policy on two occasions, making a commitment each time to evaluate his portfolio and its performance along certain guidelines. While one guideline was for a ten year period, his modeling compared a much shorter timeframe. His second investment policy in 2009 was re-stated after Bill insisted on changing his risk strategy during what happened to be one of the worst months of the panic (which was unknowable at the time). He insisted on dropping his equity allocation by 20% and may have dropped it more without our guidance. We can only speculate if Bill may have cashed out entirely like millions of other investors had he not been our firm's client; and who knows when he may have invested again?

Comparing Bill's model to his actual performance presented several problems. First, the model Bill used to compare assumed keeping the same equity allocation for his investing period. Yet Bill had disregarded his commitment to his investment policy during the panic, and consequently reduced his return by what we estimated was about the amount of the gap he complained about in his model. Second, for two years before he officially became a client, Bill had invested on his own with different major fund company, known for its active management style. The fact that Bill decided

#### Exhibit 1: A TALE OF TWO RETIRED ENGINEERS

	Period	Abel	Bill	Vanguard
		40%E, to 50%E 1 Yr	50%E, to 40%E 4 Yr	50%E, to 40%E 4 Yr
<b>Retirement Start</b>	1/2001	\$1,000,000	\$1,007,385	\$1,007,000
Total Income Withdrawals	10 Yr Max	(\$609,260)	(\$443,556)	(\$443,556)
<b>Account Ending</b>	12/2012	\$2,406,112	\$1,007,000	\$972,372
Contribution Adjustment		\$187,036		
<b>Advisory Advantage</b>			\$908,319	\$1,246,704

Source: Advent from custodial data. Simulated Dimensional models and returns for benchmarking fully described in Wealth Management Plan Part 2 and Planning Perspectives for 3Q2012. Vanguard allocations follow Exhibit 2, except Vanguard Benchmark E50 follows Professional Financial 50% equity benchmark with Vanguard substitutions: 25% VTSMX, 25% VGTSX, 40% VBILX, 10% VBISX. Dimensional 50% equity simulation linked to live client data to incorporate period client could have invested with Professional Financial, but invested through Fidelity Investments. Vanguard model is correctly adjusted to 40% equity after November 2008, but assumes a consistent 60% equity allocation prior to that time. All simulated strategy performance information is based on performance of indexes with model/back tested asset strategies; the performance may have been achieved with the benefit of hindsight; it does not represent actual investment strategies. Indexes are not available for direct investing. Provided for educational purposes only.



to change to our firm after only two years was not due to a successful experience.<sup>4</sup> Excluding those years for comparison was an incomplete comparison, since we not only had detailed information from first meetings, and he made the choice not to hire but to invest on his own. Ignoring periods of poor performance by an investor in evaluating their won skills at choosing advisors or investments is not uncommon, but can lead to over-confidence.

As it so happened, we had another client, an engineer who had worked at the same company who we will call Abel. Abel had invested as much as Bill at the time we met and he became a client. However, he maintained the same level of equity risk Bill had in his last four year through his advisory relationship with us, except for one year in 2009, the worst year of the panic, when he increased his risk to the former level of Bill. He then resumed his original policy, both due to his risk preferences and because he needed more safety for monthly retirement income distributions.

*Exhibit 1* summarizes the comparison (with privacy adjustments). We compare both Bill's return outcome and his Vanguard index fund model from the first year we had common data. Adjusted for additional saving by Abel for continued employment before final retirement, after advisory fees, the net difference is \$900,000. It is \$1.2 million compared to a restated Vanguard model matching the same period.<sup>5</sup> For the last four years, Bill's portfolio return and benchmark returns were similar, as he noted. However, his evaluation period was not complete. By omitting to fully back test his Vanguard model, he inadvertently data mined his study, causing a wrong conclusion. The Vanguard model, prior to the last four year, would have done significantly worse than his actual return experience for the same period. He did not ask himself: if you had invested in the same Vanguard model beginning in 2001, would you still be invested exactly the same way for twelve full years? For someone who switches advisors relatively quickly, impatient for returns, it seems unlikely that such an investor would still maintain a low performing plan in the year he imagined starting.

## Exhibit 2: INVESTOR RETURNS FOR US MUTUAL FUNDS VS. INDEX BENCHMARKS

20-Year Annualized Returns (1993-2012)

Period	Investor Returns			Barclays		
	US Equity	Asset Allocation	US Fixed Income	S&P 500 Index	Aggregate Bond Index	Inflation
20 Yrs	4.3%	2.3%	1.0%	8.2%	6.3%	2.4%
10 Yrs	6.1%	2.4%	1.2%	7.1%	5.2%	2.4%
5 Yrs	-0.8%	-0.2%	1.6%	1.7%	6.0%	1.8%
3 Yrs	7.6%	4.7%	2.9%	10.9%	6.2%	2.1%
12 Mo	15.6%	8.8%	4.7%	16.0%	4.2%	1.8%

Source DALBAR, Inc., "Quantitative Analysis of Investor Behavior for 2012." Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method captures realized and unrealized gains, interest, dividends, trading costs, sales charges, fees, expenses and other costs. After calculating investor returns in dollar-weighted terms, two percentages are calculated for period examined: Total investor return rate and annualized investor return rate. Total return is determined by calculating the investor return dollars as a percentage of the net of sales, redemptions and exchanges for each period. Past performance is not a guarantee of future results. Indexes are not available for direct investment. This information is provided for educational purposes only.

## The Cost of Missed Opportunity

Of all the mistakes investors make, the most egregious is failure to follow their investment policy. By abandoning investment policy to chase returns without direction from an informed investment philosophy, investors often become their worst enemies. An investment policy strategy is worthless unless the investor is committed to evaluating outcomes based defined boundaries of time horizons and benchmarks. The amount of wealth lost by investors due to lack of discipline to their investment policy strategy and second-guessing short-term returns is enormous. Moving in and out of markets at the wrong times typically results in the loss of returns gained from indexed "buy and hold" broad market portfolio allocation.

Perhaps many investors think this way because major mutual fund and other financial services firms advertise winning performance, showing happy retirees skiing snowy mountains or sailing exotic shores after becoming customers. However, in the 20 years leading up to 2012, for example, the research group DALBAR found the average US mutual fund investor underperformed the S&P 500 by half, or nearly 4 percentage points a year. See *Exhibit 2*. While the S&P stock index of US stocks earned an average annualized return of 8.2%, investors in US stock mutual funds generated only a 4.25% return. While Barclay's US Aggregate Bond Index earned 6.3%, investors in US bond mutual funds gains only 1.0%



for the same period. Even more illustrative is a 50/50 allocation of equity and fixed income mutual funds: the return was 2.3% over 20 years, or less than US treasury bills, an investment believed to be the most “risk-free” an investor looking for safety and income can own.

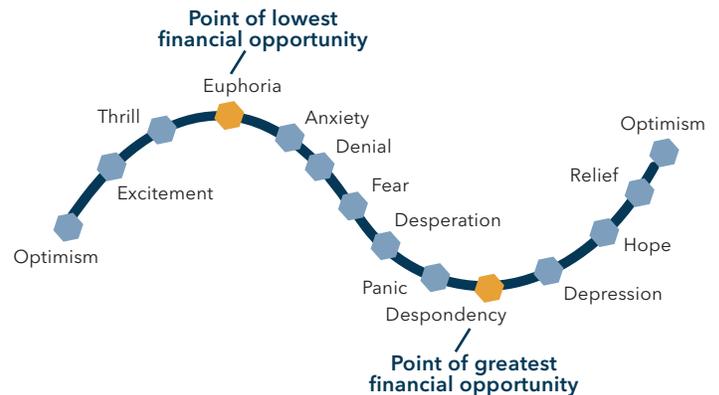
## Confirmation Bias and Poor Choices

About once or twice a year, a client who has been with us for a few years, will terminate our relationship.<sup>6</sup> Surprisingly for some, it never has been because they have lost money over the advisory relationship term or had poor returns at all similar to the average DALBAR investor. These same clients enjoyed returns at least similar to their investment policy benchmarks for two or three years before they left, following a period of several years with much greater returns. A few left because of geographic moves, and the advisory relationship had suffered as a consequence. But the usual explanation lies in their disappointment of getting only benchmark returns for a two or three year period, after having become accustomed to earning much higher returns relative to their risk benchmarks. From time to time we’ve received feedback about the experience of those who have left, both directly and indirectly from friends or acquaintances. I am yet to hear evidence of anyone being better off for leaving; stories of being worse off abound.

One of the saddest situations we’ve experienced was that of an older physician in private practice with his wife, a nurse who worked with him, back in the late 1990s. We spent a couple years cleaning up their complicated financial mess and getting them on the right track. However, growth and tech stocks were popular back then, and our structured, multifactor strategy matched their benchmarks but underperformed hot tech stocks. A broker—unaffiliated with us—convinced the couple that what they needed was a more aggressive growth strategy to retire at the lifestyle to which they were accustomed. The client was also comparing the value of his custodial accounts far more frequently than his investment policy recommended. One day, rather than save more as we planned due to previous mistakes, without notice, they switched to this broker. About a year or so later, in 2001 or so, I met the wife in a bank lobby, and

### Exhibit 3: THE BEHAVIORAL CYCLE: WHY INVESTORS BUY HIGH & SELL LOW

Market emotions cycle graph of how investors feel as the markets fluctuate



The many stages of investor sentiment show how emotions can wreak havoc on decision making. As markets rise, euphoria reigns, but when prices tumble, despondency sets in. Hence, people tend to buy when they should be selling, and sell when they should be buying without an investment policy based on an informed philosophy.

Source: Westcore Funds/ Denver Investment Advisors LLC

she approached me, sobbing. Apparently, the investment scheme had been a disaster, and half the investment portfolio we had so carefully rebuilt was lost. I drive pass their office regularly ever since, and see that they still work into what I know to be their eighties.

What these former clients did in each case was to simply project recent past performance into the future—both what they had from us for two or three years, and what scheme the broker or other advisor was showing them as an enticement, constructed with the benefit of hindsight. They did not realize how small was the likelihood of a better outcome—and how large was the likelihood of doing much worse, so much worse that the probability of a large loss could cost them the very goals most important to them they wanted to achieve. Investors and financial advisors tend to tell others about their winners—but few we meet share much about their losses.

## Wealth Preservation Demands Policy in Practice

Informed investors committed to the boundaries stated in their investment policy don’t make the mistake of selling or changing advisors due to good news, bad events, market swings, disappointing returns or economic forecasts. They understand that a successful



financial outcome depends on an asset allocation consistent with their plan at all times so they may fully participate in the fair return of positive market experiences when they occur—usually when least expected. An investor with an informed investing philosophy has confidence in the successful outcome of their plan. Following investment markets and news broadcasts daily creates uncertainty and anxiety. Informed investors with an investment policy don't jeopardize their retirement goals by creating emotional stress leading to second-guessing their planning. Instead, they are in control of their lives because they know, because of the way their portfolio is designed, they don't need to take action each time the world has yet another disaster or crisis.

Adjusting an equity allocation in reaction to news events or account watching once too often, even briefly, can result in serious negative performance outcomes. *Exhibit 3* looks at the effects of missing the stock market's best performing days. An investor would have gained 9.9% annually if they had the prescience to invest in an S&P 500 index fund back in 1970 <sup>7</sup>, and just stay invested. This period includes all the 1970s recession and inflation, October "Black Monday," the fall of the Soviet Empire, the dot-com boom and bust, Gulf Wars and occupations

and the Global Financial Crisis. All an investor had to do was to stick around and stay invested. Yet that return drops to 6.3% if the investor was out of the market only the *best 25 days of the past 32 years*. By missing 35 or so best days, the technique shows us how to have a return-free investing strategy.

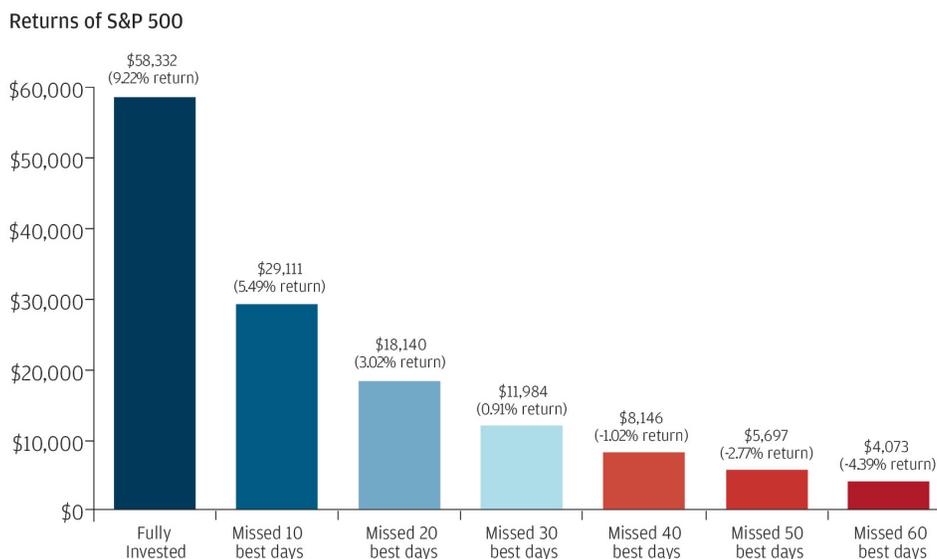
## The Fatal Flaw in Looking Back to See Ahead

Buying or selling based on price changes, past returns performance, or forecasts of growth prospects without the guidance of an investment policy is the a fatal flaw of unacknowledged investment philosophy—a fallacious confusion of the inverse relationship between risk and return. There is a *positive* relationship between distress and returns. As the late Nobel prize-winner Merton Miller stated, a firm's cost of capital is its investors return. Expected returns come from bearing compensated risks, not avoiding them. Expected returns reduce to zero and eventually become negative as business booms, investor confidence resumes, and collective memories of former troubles fade. All this time, with ups and downs, market prices rise.

Investors behavior is the very opposite of economic

### Exhibit 4: TRANSFORMING OPPORTUNITY INTO RISK-FREE OUTCOMES

Performance of the S&P 500 Stock Index with Days Missed December 31, 1993 - December 31, 2013



This chart is for illustrative purposes only and does not represent the performance of any investment or group of investments.

Source: Prepared by J.P. Morgan Asset Management using data from Lipper. 20-year annualized returns are based on the S&P 500 Total Return Index, an unmanaged, capitalization-weighted index that measures the performance of 500 large capitalization domestic stocks representing all major industries. Past performance is not indicative of future returns. An individual cannot invest directly in an index. Data as of December 31, 2013.



philosophy. While stocks become more risky to buy, not less, as prices continue to rise, investors become optimistic, excited, thrilled and then euphoric, pushing market prices ever higher. Yet stocks are less risky, not more, as prices fall. Perversely, few investors—as anxiety, fear and then panic set in—want to buy stocks of troubled companies, especially if markets and their prices are declining—but those are the very stocks with high costs of capital and consequently high expected returns investors should hold, and as they decline are the ones that offer the most financial opportunity. But most investors pursue “growth opportunities” easily seen after a prolonged period of positive returns has dispelled past fears. But by then, as we see explained below, a substantial expected return does not really exist—“gains” that an investor thinks his portfolio holds are much like an Escher optical illusion.

Contrary to popular belief, the best investing opportunities with the highest expected returns are almost always associated with the highest market volatility. Without an investment policy to depend on for guiding good decision-making, despondent and depressed investors may have a feverish crisis of confidence that can last weeks, months or even years—leading to capitulation.

Watching the herd behavior of Wall Street management teams that trade 24/7 makes it hard even for investors with an investment policy to maintain disciplined positions against the “speculative element” of a prolonged market bubble, or the sudden panic that eventually follows. The problem with market bubbles for investors is that they can be seen clearly only in hindsight. It takes superhuman confidence and courage to rebalance and buy in a selling mania screaming doom. But to buy when prices increase just because prices are higher, is to fall for another equally serious fallacy *that stocks become safer as their prices rise*. In fact, the very reverse is true. That illusion was a disaster for investors in 1929, 1972, 1999, 2008 and every market bubble in recorded history.

## Learning from Past Non-Performance

Why does one investor have successful results and another not? Commitment to an investment policy

**Exhibit 5: EQUITY RETURN PREMIUMS AFTER BUSINESS PEAK AND TROUGH CYCLE**  
Monthly, then Annualized: Nov 1945 - June 2012

	Market		Size		Value	
	Mkt -Rf	Annualized	SmB	Annualized	HmL	Annualized
<b>Average Premium</b>	0.58%	6.96%	0.16%	1.92%	0.36%	4.32%
(t-stat)	(3.79)		(1.60)		(3.75)	
<b>Peak + 3 months</b>	-1.50%	-18.00%	-0.51%	-6.12%	0.58%	6.96%
(t-stat)	(1.81)		(0.90)		(1.16)	
<b>Trough + 3 months</b>	2.51%	30.12%	1.81%	21.72%	0.65%	7.80%
(t-stat)	(5.61)		(5.65)		(1.53)	
<b>Trough + 6 months</b>	1.87%	22.44%	1.04%	12.48%	0.36%	4.32%
(t-stat)	(4.35)		(3.60)		(1.17)	
<b>Trough + 9 months</b>	1.48%	17.76%	0.63%	7.56%	0.60%	7.20%
(t-stat)	(3.99)		(2.67)		(2.25)	

The average risk premiums are calculated from November 1945 to June 2012. Trough + 3, Trough + 6, and Trough + 9 refer to the 3-, 6-, and 9-month periods starting from the months after a trough month, respectively. Peak + 3 is similarly defined. Premiums 95% confident highlighted.

Source: Risk premium data provided by Fama/French, available at [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html). Business cycle data provided by the National Bureau of Economic Research available at <http://www.nber.org/cycles.html>

depends on the informational advantage of an economic philosophy based not on speculation but the science of capital markets; a firm belief guides decision-making, and avoids the confusing noise of daily events and economic forecasts. The Global Financial Crisis was truly fearsome, and all too many predicted the end was near. Stocks were sold and cash was held—much too long. Those investors missed one of the greatest recoveries in market history. Much of that pessimistic money still languishes in bank accounts earning nothing, or poured into bonds, recently shocked by a sharp rise in interest rates. Making informed decisions eludes them.

*Exhibit 5* provides historical evidence that expected returns, as economic science theorized, varied over the business cycle in a countercyclical manner: they are high during business troughs where equity prices have declined and investors tend to be risk averse; and low during business peaks when markets rise and investors either are more willing to take market risk or ignore it completely. Liquid capital markets appear to do a good job incorporating all available information into asset prices, including information about business cycles. We see most return adjustments occur *at the outset* of economic contractions (downward adjustments) and *at the start* of economic recoveries (upward adjustments). Given the speed at which equity markets incorporate information and the difficulty in determining business cycle turning points, even *ex post facto*, attempting to forecast business cycle information for timing



investment decisions is not likely to produce reliable and robust increases in expected returns.<sup>8</sup> Certainly those who delay resuming equity allocations until economic times looks safe, wait too long for lasting returns. For executing an investment policy, the need for portfolio rebalancing—the periodic process of repositioning equities or fixed income back to target allocations—offers an opportunity to take advantage of momentum to enhance returns. Predicting the peak or trough of a business cycle is speculative, and unlikely to reward the investor. Yet a strong market is a price indicator that business times are good, as investors become optimistic, and a market is moving toward a peak.

The informed investor will begin selling equities since expected returns are declining. On the other hand, as equity prices decline, it's a forward looking indicator that poor business times are ahead. As price declines accelerate and optimism changes to pessimism, the informed investor should take advantage of the downward momentum to buy, as expected returns will be higher. As Warren Buffet says, be greedy when others are fearful, since what is profitable for investing is rarely comfortable and informed investment philosophy at such times is essential to sticking it out.

## Informed Investing throughout the Market Cycle

Uninformed investors without an investment philosophy and a commitment to an investment policy inevitably suffer from the agony of random drift due to the noise of market movements. In order to be successful, the cost of investing for the informed investor is not the mutual fund or advisory fees he pays. Rather, the true and greatest cost is bearing the pain of his emotions as prices change. Emotions include fear of loss and fear of missing gains. An investment policy is customized for each individual investor so their portfolio's price movements should not to exceed their maximum pain threshold over a business cycle—at least for the most part.

Our practice to use a risk profile questionnaire to more accurately estimate a lower limit for the greatest pain of loss an investor can bear in their portfolio for a quarter or a year and include that figure as a boundary for part of the investment policy. Then we set an upper

### Exhibit 6: THE EMOTIONAL VS. THE INFORMED INVESTOR

A speculator's emotions cause him to buy high and sell low



The investor who speculates will follow the emotions of a crowd, and buy a position high on the upswing based on good news. So if there an unexpected decline during a longer-term recovery in stocks, he'll feel pain first. Meanwhile, an investor who waits to buy low on bad news will not get precise lows, but has a substantial margin of safety to ride volatile market cycles.

limit for an acceptable maximum gain before equity positions must be sold in order to rebalance the portfolio strategy back to the original target allocation range. The informed investor commits to not change simply based on performance as long as the portfolio behaves within its defined boundaries.

An uninformed decision that results in the change investments or investment advisors at the wrong time could easily jeopardize years of successful outcomes. As someone once observed, it is difficult to look objectively at a situation of which you are a part. Investors cannot benchmark themselves. Part of what we do as investment advisors is to provide objective opinions, and to take emotion out of decision-making. We compare client performance with similar clients in similar situations with similar allocations to understand why differences occurred. Usually, it is due to the client behaving in ways beyond the boundaries originally agreed upon in the investment policy.

## No Good Wishes, Even Once Upon a Star

No Dimensional portfolio strategy employed by Professional Financial likely to be exciting for very long, nor



will it beat generalized benchmarks every year. If a coin comes up heads 65% of the time, it makes sense to bet heads, but betting your entire retirement future on the next flip of the coin would be foolish—yet investors make such bets all the time and don't even realize it until it's too late. They don't know how to calculate the likelihood of a potential mistake, abandoning their plan or advisor at a wrong time or choosing a wrong one. Stocks have runs up or down longer than you may guess, simple due to momentum. When an investor takes a big bet and wins, he thinks he's smart, and plays again. When he loses, he blames "bad luck" and quits. The problem is, he's left with no plan.

Value stock strategies have gathered considerable attention over the past year due to their recent out-performance. The benchmark Russell 1000 Value Index gained 25.3% compared to 17.1% for the 1000 Growth Index as of the end of June. The Dimensional US Large and Small Value Portfolios are up 32.9% and 32.4% for the same period. As of now 3, 5 and 10 year Russell Growth and Value Index total returns are similar, after growth held the advantage for years.

Big returns for strategies with "value" and "size" had not been forecast. Many investor benefited from value stocks in the last decade, and endured their risk for the past five years, decided not to stick around and missed last year's gains. Participation in any exceptional returns with equity solutions using size (small/large), relative price (value/growth), and now profitability (high/low) demands an informed investment policy. Dimensional

- 1 The markets send very large tuition bills for its education.
- 2 The "utility" of a "daily investor" is  $-0.464$  (that is,  $.512 - [.488 \times 2]$ ).
- 3 All names and details are changed to protect privacy. Engineer Abel gave us special permission to share his experience. This does not constitute a recommendation.
- 4 One wag's definition of a "sophisticated investor" is this: someone who has invested serious money at least once before, but was not happy with the experience.
- 5 Engineer Bill's cumulative actual returns exceeded his index model by his advisory fees several times over, and those returns exceeded the model return in the original investment policy without regard to the untimely change to a lower equity allocation during a period of lower inflation and interest rates.
- 6 Excluding death, divorce or uncontrollable circumstances.
- 7 Actually, the first retail US index fund was introduced by Vanguard in 1976. So widely ridiculed at the time (who wants to be "average"), only the most independent and disciplined investors with strong understanding of economic philosophy would have bought and kept that fund for such a long duration.
- 8 L. Jacobo Rodriguez, "The Behavior of Market Premiums at Different Stages of the Business Cycle," Dimensional Fund Advisors Quarterly Institutional Review (Third Quarter 2012). See Inmoo Lee, Eduardo A. Repetto, and L. Jacobo Rodriguez, "Business Cycles and Risk Premiums," Quarterly Institutional Review vol 4, no. 1 (2008).

### Exhibit 7: GREAT GAINS COME IN SPURTS

Growth of \$1 Invested in January 1926  
Through December 2009

<b>S&amp;P 500</b>	<b>\$2,589.94</b>
<b>S&amp;P 500 without best month of each year</b>	<b>\$2.84</b>
<b>CRSP 9-10</b>	<b>\$13,426.76</b>
<b>CRSP 9-10 without best month of each year</b>	<b>\$0.12</b>

Sources: The S&P data are provided by Standard & Poor's Index Services Group. CRSP data are provided by the Center for Research in Security Prices, University of Chicago.

portfolios should not be held except as part of a larger asset allocation. Our investing philosophy has been informed by the finest theoretical and empirical advances in finance during the past few decades. It is our firm belief that structuring investment solutions that efficiently target dimensions of expected returns through Dimensional Fund Advisor portfolios is the most probable way in an uncertain world with frictional markets, to help clients achieve their most important goals.

### APPENDIX: Methodology Issue with Calculating Investor Returns for Performance Summaries

There is a danger in too-strict reliance on investor return calculation numbers for certain clients when evaluating their asset allocation strategy for periods of less than five years. The interpretation is sometimes wrong because comparing some investor asset-weighted returns against benchmark returns is like comparing apples to oranges.



First, while the benchmark approximates the equity-fixed income ratio for the most part, most equity portfolios which are greater than 50% in international equities (and that portion slightly weighted toward emerging market equities) are globally weighted, even though the equity bench is based on a equal weighting. Also, the fixed income benchmark is weighted toward intermediate-term fixed income, while the fixed income portfolios are equally weighted short and intermediate term. Of course, all equity allocations are over-weighted in dimensions of size and value. Since the time of the Financial Crisis until the last 12 months, size and value dimensions have underperformed and longer-term fixed income has over performed. We speculate this is partly due to government central planning worldwide in the financial markets as an unexpected experiment in unlimited “quantitative easing”—massively increasing the quantity of money in circulation to artificially manipulate interest rates to historic low levels and to closely regulate the banking system so money flows don’t stop, in lieu of painful real changes in government tax and spending policies.

Second, and more to the point, reallocating asset classes at the wrong time, or choosing out-of-favor asset classes, is not the only way that investor asset-weighted return calculations will cause investors returns to appear worse than the true investor accumulation experience. For instance, the asset-weighted calculated returns for “The Tale of Two Retired Engineers,” while not shown, were very similar, yet the relative outcome of total assets accumulated after twelve years was obviously vastly different. When using dollar-weighted returns, *the market returns over time due to patterns of contributions and withdrawals also play a big role.* Consequently, an investor return lower than a market benchmark is not necessarily attributable to poor financial advise, which may try the understanding of investors.

Let’s look at two hypothetical examples. Suppose the stock market doubled in year one and then stayed flat

for nine years. Over the 10-year period, the market return would be 7.2% a year (the “rule of 72”). Let’s assume an investor invests \$1,000 at the beginning of every year in a stock index fund that exactly matches the market. Thus, the first \$1,000 doubled that first year and yields a good return over ten years. The other \$1,000 added for 9 subsequent years had no return at all. Our investor now has \$11,000 at the end of 10 years. As a result, the investor’s annualized dollar-weighted return is 1.7% a year for 10 years, not 7.2%

The substantial difference between the market’s 7.2% annualized return and the investor’s 1.7% asset-weighted return wasn’t caused by fund performance or poor market timing. The investor just dollar-cost averaged. While markets did well in year one, our investor simply wasn’t fully invested that one year to capture that year’s good return. So his low return experience was just bad luck, not bad skill.

Now suppose the reverse were true: the stock market had zero return for nine years and then doubled in year 10. Over the 10-year period, the market return is still 7.2% a year. If an investor invested \$1,000 every year in an index fund that exactly matched the market, this investor would have \$20,000 at the end of 10 years, resulting in an annualized asset-weighted return of 12.3% a year. His experience is higher than the market return because in the year when the market return was exceptionally high, the investor had \$10,000 invested versus only \$1,000 invested in the previous example.

Depending whether the market had higher returns in the beginning or in the end, investors are seen either as dumb or smart, even when they made no effort to time the market. What happens is that a number of clients do not systematically add funds or withdraw funds at about the same amount each month or year: There are unplanned withdrawals or additions, some of which are very substantial. Particularly during the highly volatile financial crisis, the impact of rebalancing timely, or not adding planned contributions had a disproportional effect on the terminal wealth values by the end of 2012.

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Past performance may not be indicative of future results. Moreover, no investor should assume that future performance of any specific investment, investment strategy, or product directly or indirectly referred to in any general informational materials or educational sessions, will be profitable or equal any corresponding indicated historical performance level(s). Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client’s retirement portfolio. Consider the investment objectives, risks, charges and expenses of any mutual fund or ETF and read any prospectus carefully before investing. Indexes used for benchmarking purposes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Diversification does not insure a profit or protect against loss in a declining market.