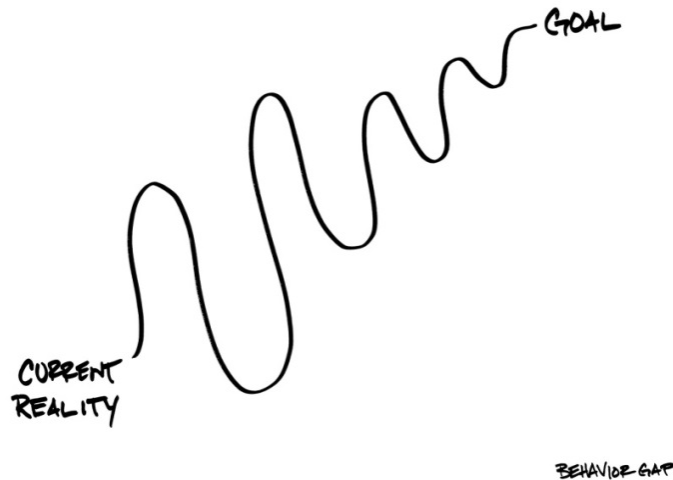


## Planning and Process for Your Destination and Journey

Paul Byron Hill, CFP Professional Financial Strategies, Inc. ©2016



The observation that financial plans for personal investors may be worthless might seem a bit disingenuous coming from a Certified Financial Planner. When I was young and full of book knowledge, I spent hours in client meetings to refine detailed budgets and even more detailed financial modelling. While clients seemed impressed by my expertise, looking back at the outcomes of that work, much of those efforts were relatively unproductive.

After several years in practice I suddenly realized that the *process* of planning had far more value than the plans I produced. Yes, a sophisticated analysis every couple years provides a “big picture” evaluation to give direction. But goals get regularly refined or modified due to events occurring since the last analysis. Or, assumptions must be modified due to more research or improved investment vehicles. But without the client’s active participation and involvement in setting goals and making hard choices related to achieving goals, the plan itself didn’t mean much.

I believe today that planning is ever complete. After all, our knowledge of markets and the future is imperfect: will inflation will be 3 or 2 percent? Will the client keep his job or be healthy enough to work until the planned retirement? Even the most thoughtful and well-designed plan is still only a model. It’s inherently a work of fiction. The best plan provides only a framework to think more clearly about getting from point A, where you are today, to point B tomorrow—and what impediments may impact that trip, and decide what detours to avoid and what side trips to add. The planning process may best be seen as a communication tool to help client and advisor mutually consider the alternatives and gain clarity about what’s important. Progress from point A to B is rarely linear.<sup>1</sup>

The planning process itself is what has real value—what clients learn about themselves with an objective look at their situation, and prioritizing goals as they clarify their values and dreams—and think through the challenges to achieving those goals, and work through contingent possibilities. Reviewing a series of models completed over several years makes plan less important than the process as the client focuses on the aspects of their planning that is under their control, such as matters of saving and spending or taxes, or the lifestyle they want for their families.

## CAPTURING RETURNS FROM MARKET VOLATILITY

Capital markets work surprisingly well. Prices reflect the aggregate expectations of market participants. Risk aversion, investors' tastes and preferences, and expectations about future profits are among the many inputs that affect aggregate expectations and consequently market prices. These inputs vary each day. That implies aggregate expectations vary daily. Markets constantly adapt to changing expectations and continuous new information. As a result, we expect prices with differing levels of market volatility to fluctuate, and to fluctuate wildly at times.<sup>ii</sup>

The volatility of oil prices of the past year, plunging to levels previously unimagined, or the surprise collapse in Chinese stock markets, provide an opportunity to revisit fundamentals. While many January losses recovered by the end of the quarter, those with painful memories of the Global Financial Crisis or the tech bust, habitually monitor stock and bond prices daily, attempting to avoid another loss of wealth, perhaps day-trading ETFs or owning some hedge funds to limit potential losses. But their portfolio volatility and fears are only aggravated.

Warren Buffet reputedly has two investing rules: Rule #1, Don't lose money. Rule #2, see rule #1. Yet unless investors are content with low returning T-bills, they must endure the possibility of periods with negative market outcomes of lesser or greater durations. How does a professional planning process manage inconsistent behavior and emotions during cyclical downturns in the financial markets? Through setting the right expectations. First, investors must embrace market cycles and volatility as normal. Second, as part of the planning process, investors can learn about the science of capital markets. Let's start with the basics of priced and unpriced investment risks.

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### Exhibit 1: FOUR-FACTOR MODEL OF EXPECTED RETURNS WITH RANDOM ERROR TERM

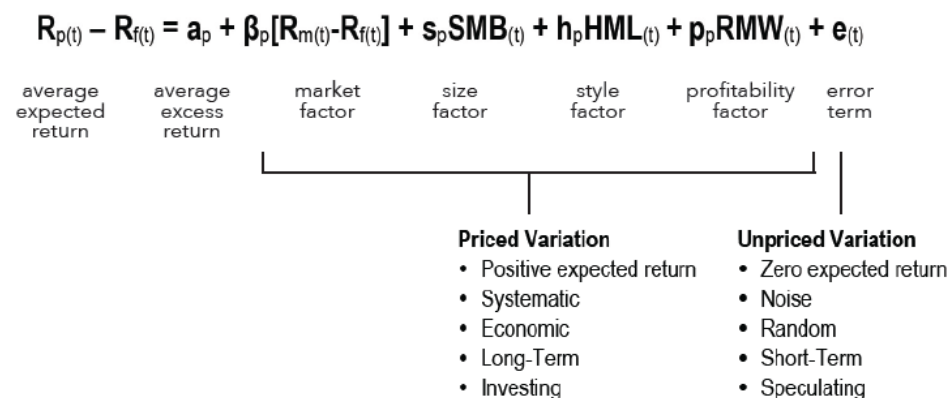


Exhibit 1 is a fundamental multifactor equation that distinguishes investing from speculating. Investing is all about structuring portfolio exposures to dimensional priced risk factors driving expected returns. Our multifactor model employs market, size, style and profitability as factor premiums. All factors are "priced" because research shows investors are compensated for risk associated with those premiums. Expected return is defined statistically as the probability-weighted sum of all possible rates of return. That is, expected return is the *mostly likely* geometric return. All things being equal, the lower the volatility of a fund or portfolio, the higher the compounded return.

The original one-factor Capital Asset Pricing Model was fundamental to changing how investors perceived risk and return. The old CAPM view was that economic risk, being a limited resource, should be taken only if the risk taker is compensated. The expected return of market risk is proportional to beta, or covariance systematic with the market. The market premium is a function of covariance with the market. There is an error term at the end of both models, an expression to describe all the residual, non-priced risk the model left unexplained. It is statistical "noise." Unpriced random variation has zero expected return. But noise generated by random market volatility is easily confused with factors dimensional driving expected returns. Key to the planning process is helping investors recognize priced variation that compensates their risk-taking relative to the many unpriced variations that do not.

## YOUR FINANCIAL FIRE DRILL

Many investors today expect a market decline. They don't know when, why, or by how much. Yet, most of those with stocks and bond holdings call themselves "long-term investors." That would imply a willingness to endure investment "risk," including market volatility when portfolios decline. Neurological studies scanning the brain show those areas responding to monetary loss to be as the same as those responding to physical mortal danger. A planning process that does not help "long-term" investors understand their emotional responses to volatile account values, might well see an advisor's skillful efforts developing a sound financial plan completely negated.

In a *Wall Street Journal* column looking back at the Global Financial Crisis years of 2007-2009, Jason Zweig once asked readers if they were ready for the next market crash.<sup>iii</sup> Citing a series of published experiments by behavioral economists, Zweig observed that the stress of a collapsing stock market and facing financial losses fundamentally changes how people make financial decisions. I recall clients literally hysteric over the telephone back in those days. In fact, the daily stress from unending panicking calls was so traumatic, I developed a heart arrhythmia.

The purpose of any fire drill is to increase the odds of surviving a real fire if it were to occur. A financial fire drill is similar: it demonstrates the frequency and potential magnitude of market declines for a client's portfolio strategy. The exercise is also intended to reinforce the easily forgotten point that global markets often swiftly recover in unexpected ways and invariably at unexpected times. *Exhibit 2* illustrates the need for a financial fire drill as part of the planning process by showing the potential opportunity cost of abandoning a well-planned strategy. A "financial fire drill" may make it easier to ignore troublesome media chatter and distressing emotions at social gatherings by setting realistic portfolio loss expectations *before* a market decline to aid disciplined behavior *during* the crisis.

### Exhibit 2: MSCI WORLD INDEX PERFORMANCE

Past Five Major Market Declines (1973-2009)

				VALUE OF \$1 MILLION INVESTED					
HIGH	LOW	MONTHS	TOTAL RETURN	AT LOW		5 YEARS AFTER HIGH		5 YEARS AFTER LOW	
Mar 1973	Sep 1974	18	-41.1%	Sep 1974	\$589,308	Mar 1978	\$954,069	Sep 1979	\$1,251,259
<b>Aug 1987</b>	<b>Nov 1987</b>	<b>3</b>	<b>-20.5%</b>	<b>Nov 1987</b>	<b>\$795,274</b>	<b>Aug 1992</b>	<b>\$1,122,892</b>	<b>Nov 1992</b>	<b>\$1,100,767</b>
Dec 1989	Sep 1990	9	-24.3%	Sep 1990	\$756,622	Dec 1994	\$1,197,426	Sep 1995	\$1,379,932
Mar 2000	Sep 2002	30	-46.8%	Sep 2002	\$532,005	Mar 2005	\$864,820	Sep 2007	\$1,284,615
<b>Oct 2007</b>	<b>Feb 2009</b>	<b>16</b>	<b>-54.0%</b>	<b>Feb 2009</b>	<b>\$459,709</b>	<b>Oct 2012</b>	<b>\$864,642</b>	<b>Feb 2014</b>	<b>\$1,142,808</b>

In USD. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. MSCI data © MSCI 2014, all rights reserved.

*Exhibit 2* shows how the MSCI World Index was impacted during the last five major market declines. On average, a downturn of a magnitude of 20 percent occurred every eight years. The global equity index we selected here had declines ranging from 20.5% to as much as 54.0%. The declining periods lasted from three months to 30 months.

Consider the wealth effect of the smallest decline (1987) and largest decline (2007-09) using this index (periods indicated by bold text). A portfolio valued at one million dollars at the market high point in August 1987 would have fallen to \$795,274 by November 1987. One million dollars invested in October 2007 would have fallen over 50 percent to \$459,709 by February 2009. No money is assuming added in these examples to mitigate the numerical appearance of the decline, or to magnify returns from progressively dollar-cost-averaging into a declining market. Nor do we consider the negative wealth impact of untimely liquidations that do not participate in market recovery.

Now consider the extent of the MSCI World Index's rebound in the two periods. Five years after the 1987 high, the initial \$1 million would have been worth \$1,122,892 (August 1992); the 2007 \$1 million portfolio was still only \$864,642 as of October 2012<sup>iv</sup>. Finally, for those inclined to liquidate and wait out a crisis, consider the index value five years *after* its low in both periods. As a practical matter, few investors would have the foresight to sell at the high; the temptation would be sell on the way down on the theory of "protecting the principle" from more loss. But

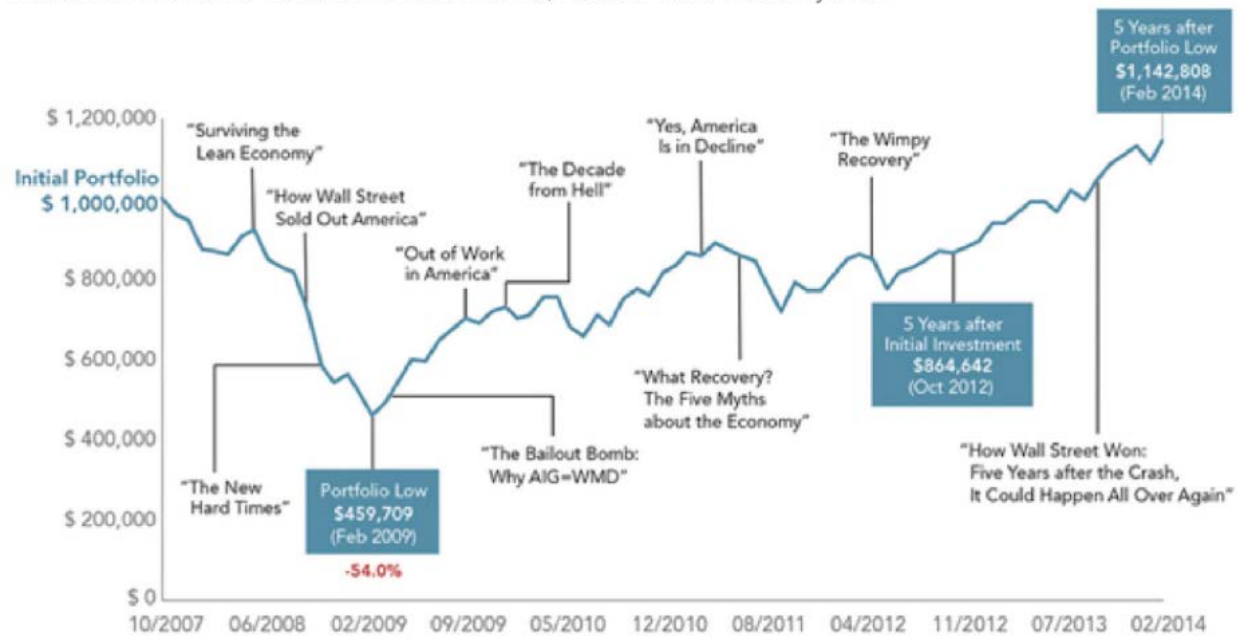
then you must decide when to re-purchase. The initial \$1 million invested in 1987 would have a value of \$1,100,767 by November 1992; the 2007 investment would be worth \$1,142,808 by February 2014. The practical problem for a fearful investor living in real time is guess the lowest point—but when money is still pouring out like a fire hose from distressed sales of panicked investors, how many have the courage to run directly unprotected into the fire?

While academic exercises like these have educational value, financial drills use only the rational part of our brain. They do not prepare investors for the emotional trial of unrelenting bad internet reports—featuring financial blood on the street 24/7 to maximize advertising revenues, exploiting the perverse attention from investors. A fire drill can remind you the location of the closest exit, and how to use the stairs, and walk to strategic gathering points. But practicing the motions alone does not replicate the noise, chaos, and heat of a real fire as terrified people are screaming. Like a fire drill exercise, data alone cannot summon the intense anxiety occurring. To replicate panic from possible death, investors must feel the heat triggering those adverse changes in investment behavior.

Few have experienced the heat and terror of a fire, but investors who've had time to accumulate sufficient wealth to consider retirement have experienced at least one, two or even more painful market declines themselves. As account values increase, it does not get easier. So let's take our financial fire drill another step. By combining rising and falling index values with anecdotal headlines of the time, let's recall the thoughts and feelings you may have experienced yourself, just as clients review passing news headlines from our quarterly *Global Market Review*.

### Exhibit 3: MSCI WORLD INDEX PERFORMANCE

Growth of Wealth and Select *Time* Cover Stories, October 2007-February 2014



The cover stories above are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news.

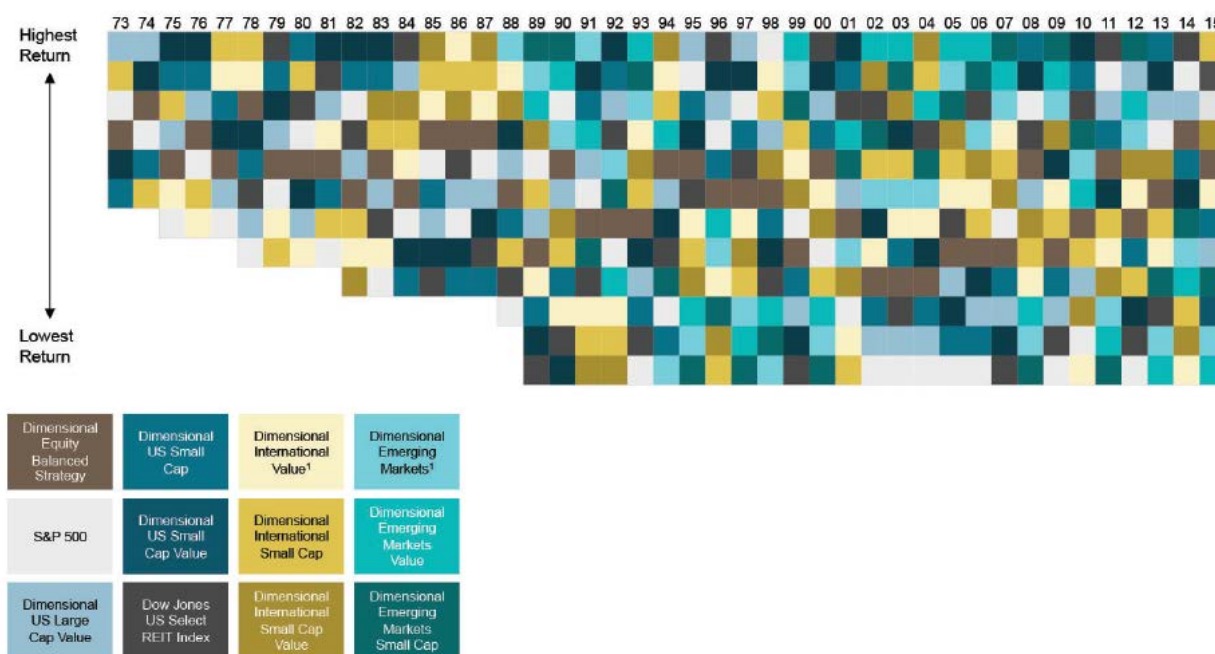
In USD. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not guarantee of future results. MSCI data © MSCI 2014, all rights reserved.

*Exhibit 3* needs to employ your imagination. MSCI World Index values during the 2007-09 are graphed from the market decline and then years following the index's initial high and subsequent low. Select headlines from *TIME* magazine cover stories are artifacts of popular sentiment of what investors read and thought at those points in time. While headlines rarely cause market movements, these sample the news and issues widely broadcast which preyed upon the hopes and fears of investors back then, watching their portfolios change, and deciding what to do. Those headlines notably even into recovery provided NO reasons for ANY investor to put more money in equities—or not to liquidate, or to maintain a rebalancing discipline at a time which, in hindsight, was the opportunity of lifetime.

Veteran clients of Professional Financial, who stayed disciplined through that time of market volatility and decline, enjoyed a successful financial experience. They learned to have confidence in dimensional multifactor strategies. But newer clients with less experience and education, and negative memories of losing large amounts in the tech bust, needed financial fire drills. Pessimistic news accompanying falling market prices caused much stress. A unceasing internet and media cacophony created an ongoing anxiety of not knowing when the pain would end. They often lay awake at night with devilish doubts whispering to them whether “this time really is different.”

### Exhibit 4: COMPARING GLOBAL EQUITY TO COMPONENT EQUITY RETURNS BY YEAR

1973 to 2015: Annually ranking Dimensional Equity Strategy to its global components by relative returns



**Sources:** Dimensional Fund Advisors LP for Dimensional Index data. S&P 500 and US Select REIT from S&P Dow Jones Indices LLC. Dimensional Global Equity Strategy Index constructed: 20% S&P 500 Index; 20% Dimensional US Large Cap Value Index; 10% Dimensional US Small Cap Index; 10% Dow Jones US Select Real Estate Securities Index; 10% Dimensional International Value Index; 5% Dimensional Small Cap Index; 5% Dimensional Small Cap Value Index; 3% Dimensional Emerging Markets Index; 3% Dimensional Emerging Markets Value Index; 4% Dimensional Emerging Markets Small Index. Past performance is not guarantee of future results. Indices are not available for direct investment, and performance does not reflect expenses of an actual portfolio.

### A FIRE DRILL INCLUDING DISCIPLINED RESPONSE

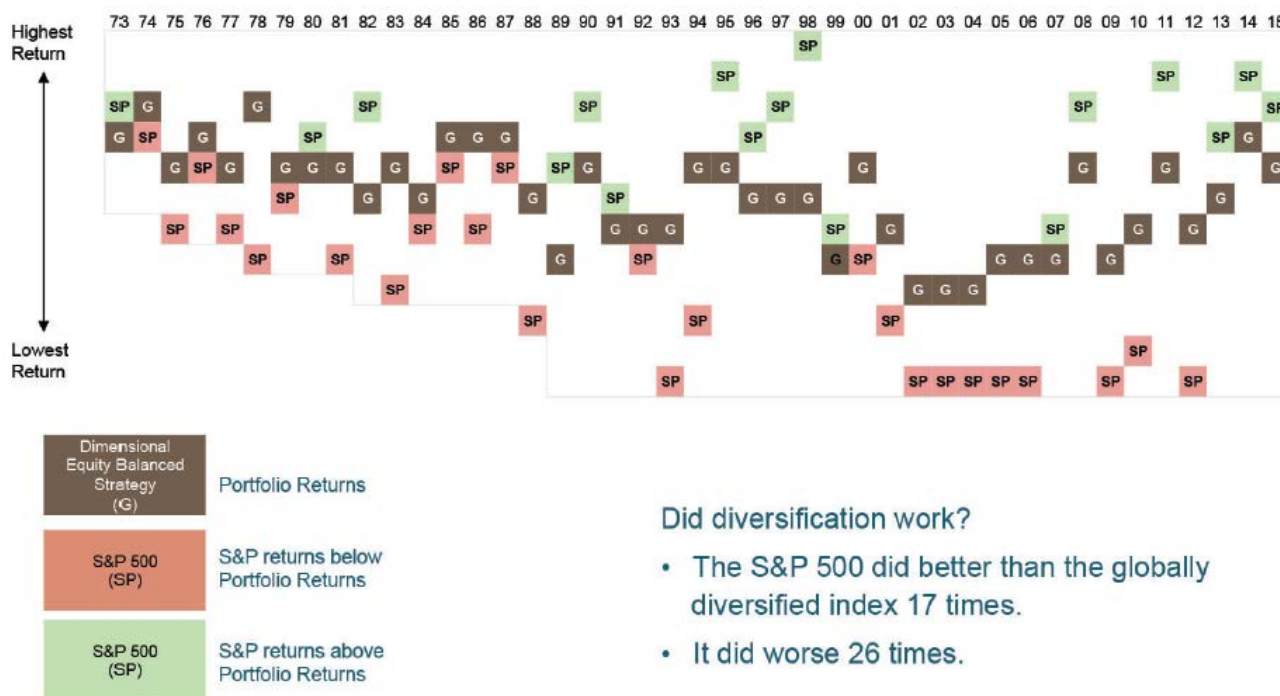
A few investors have the ability to ignore the internet or the media and focus exclusively on family, careers or avocations. But almost all investors experience investment volatility monthly or quarterly upon receiving custodial reports showing their account outcomes. No one actually experiences their life in measured five-year blocks. Modeling as we have done above with the benefit of hindsight creates an illusion in the construction of portfolios. Investment policy statements may be used professionally to guide client evaluations based on five or even ten year time horizons. But even the most informed and disciplined investors habitually use calendar-year time blocks as a heuristic for measurement, even if they force themselves to think in five-year time frames. So *Exhibit 4* continues our fire drill examining the ranking of asset classes over a series of calendar years but omitting annual return figures.

Merton Miller, a Nobel laureate, would regularly declare: “Diversification is your buddy.” Attempting to bet on future winners is a guessing game. Diversification improves the odds of holding some of the best performers. Informed diversification and the discipline of staying diversified effectively manage risk in five key ways:

1. Reduce risks that have no expected return
2. Smooths out some the more stressful bumps
3. May prevent you from missing major opportunity
4. Capture more of what global markets have to offer
5. Reduces stress from volatility by eliminating investing guesswork.

What we fail to find in *Exhibit 4* over 43 years is *any discernable pattern to the rotation amongst the top performers*. Most investors are aware that concentrating into just a few stocks exposes you to uncompensated risk. But diversification goes beyond mitigating the impact of one company’s poor performance. A well-diversified portfolio broadly holds many different companies across selected asset class that increase the opportunities to capture returns among those stocks in the group that will perform well. Diversification by multifactor dimensions and by countries globally is a logical extension. But in managing volatility, a globally diversified portfolio putting “eggs” in many “baskets,” is better positioned to weather large month-to-month market gyrations. With about 12,000 publically traded stocks in 44 developed and emerging markets, the global equity market is large. No one can reliably guess which equity markets will outperform (or underperform) from year to year. But by holding a globally diversified portfolio, however, investors can be reliably positioned to capture returns wherever they occur.

**Exhibit 5: CONTRASTING GLOBAL EQUITY TO US LARGE CAP EQUITY RETURNS BY YEAR**  
 1973 to 2015: Dimensional Equity Strategy index relative to US S&P 500 index performance



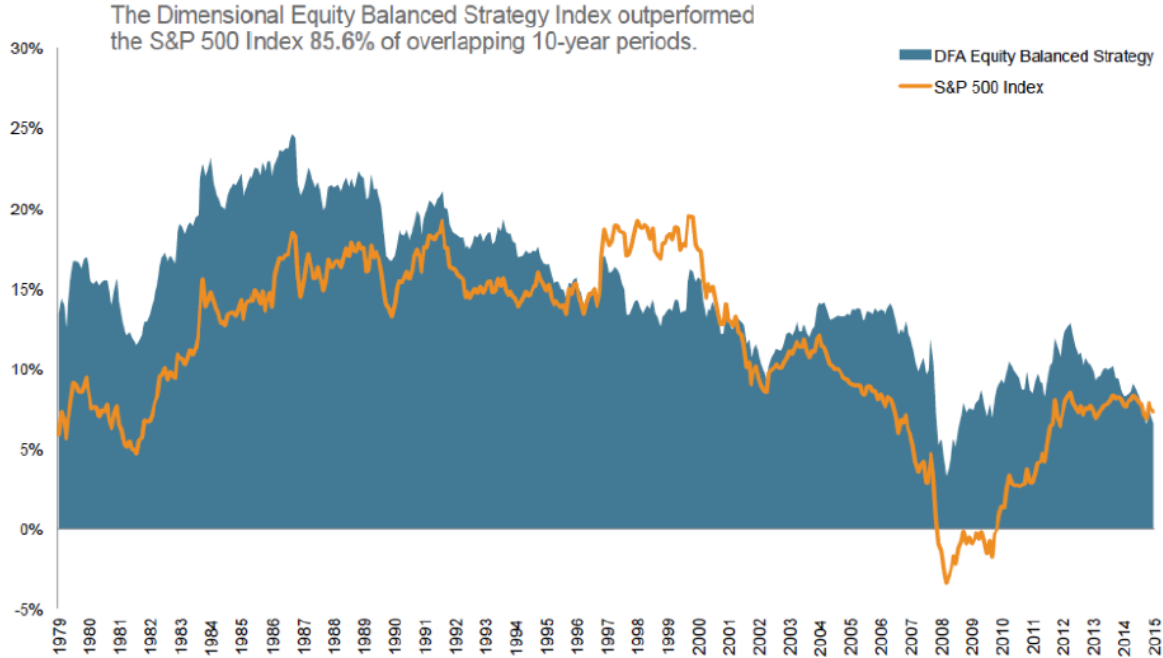
**Sources:** Dimensional Fund Advisors LP for Dimensional Index data. S&P 500 and US Select REIT from S&P Dow Jones Indices LLC. Dimensional Global Equity Strategy Index constructed: 20% S&P 500 Index; 20% Dimensional US Large Cap Value Index; 10% Dimensional US Small Cap Index; 10% Dow Jones US Select Real Estate Securities Index; 10% Dimensional International Value Index; 5% Dimensional Small Cap Index; 5% Dimensional Small Cap Value Index; 3% Dimensional Emerging Markets Index; 3% Dimensional Emerging Markets Value Index; 4% Dimensional Emerging Markets Small Index. Past performance is not guarantee of future results. Indices are not available for direct investment, and performance does not reflect expenses of an actual portfolio.

Without concerning ourselves with precise annual return figures, *Exhibit 5* illustrates the range of US stock market outcomes relative to a global multifactor strategy index. So a “Dimensional Global Equity Strategy” is compared to a conventional S&P 500 index, comprised of familiar US large companies. As many investors know, the S&P 500 itself is a popular index mutual fund and vehicle for ETF trading. *Exhibit 5* shows that the S&P 500 index did better than the Global index 17 times. But it did worse 26 times or 60% of the time. Again, there was no discernable pattern to make reliable predictions from year to year. What is important to notice is how much more limited is the range of volatility of the global strategy combined with eleven different and distinct asset classes.

*Exhibit 5* does not calculate the effective return differences of annual price changes. *Exhibit 6* looks at overlapping ten year periods for both strategies. Here the dimensional global strategy out-performs 85.6% of the time. While a investors have noticed that a strategy concentrated in the US has performed well in the last several years, it is not sensible to believe that will continue.<sup>v</sup> Moreover, we do not see the relative differences in the growth of wealth.

## Exhibit 6: GLOBAL EXPOSURE FOR HIGHER EXPECTED RETURNS

10-Year Rolling Returns: December 1973-December 2015



**Sources:** Dimensional Fund Advisors LP for Dimensional Index data. S&P 500 and US Select REIT from S&P Dow Jones Indices LLC. Dimensional Global Equity Strategy Index constructed: 20% S&P 500 Index; 20% Dimensional US Large Cap Value Index; 10% Dimensional US Small Cap Index; 10% Dow Jones US Select Real Estate Securities Index; 10% Dimensional International Value Index; 5% Dimensional Small Cap Index; 5% Dimensional Small Cap Value Index; 3% Dimensional Emerging Markets Index; 3% Dimensional Emerging Markets Value Index; 4% Dimensional Emerging Markets Small Index. Past performance is not guarantee of future results. Indices are not available for direct investment, and performance does not reflect expenses of an actual portfolio.

“Home bias” is the tendency of investors, as identified by behavioral economists, to allocate most or all of their portfolio in companies of stocks in funds or other vehicles concentrated of their home country. Until the end of 2014, US large stocks—particularly large growth stocks paying regular dividends—have done unusually well compared to countries outside the US. “Recency bias” projects past performance. Positive past performance is especially assuring for any investor. Thus there has been a tendency for even disciplined investors to question the wisdom of maintaining substantial non-US equity allocations. The particularly poor performance of emerging market asset classes compared to large US stocks has exaggerated those concerns. The recent popularity for investment vehicles based on the S&P 500 is simply “home” bias and “recency” bias influencing investors.

*Exhibit 7* looks at the growth of \$1 decade by decade since 1970 for a hypothetical multifactor global equity index compared to a US S&P 500 index. Many comparisons compare US large cap stocks (using the S&P 500 index as a proxy) with an international index. But here our hypothetical dimensional global index has a substantial 70% allocation to US stocks including the S&P 600, large value, small value and small cap as well as internationals.

The benefit of including and maintaining a substantial international multifactor equity allocation is astonishing. Only two of the five decades shown since 1970, including the current partial decade, show the US-only S&P 500 large stock proxy out-performing a multifactor global equity strategy. But wealth accumulation difference over several decades is enormous: the global strategy is 3.9 times larger—and an astonishing 38 times larger than investing only in ultra-safe US treasury bills, which avoided downside volatility risk but also avoided returns.

### THE SCREAM OF THE LIZARD

Drills help prepare clients for what to do when the fire starts, but prudent planning aims to prevent the temperature from ever getting too hot to handle—or even getting started. Eight years is the average between big market declines. So political or social events may indeed precipitate a significant market decline very soon.

## Exhibit 7: GROWTH OF \$1 BY DECADES

Dimensional Global Equity Strategy Index vs US Large Cap Index  
January 1970-December 2015

PERIOD BY DECADE	DIMENSIONAL GLOBAL INDEX	US S&P 500 INDEX	US TREASURY BILL INDEX
Jan 1970 – Dec 1979	3.50 x	1.77 x	1.84 x
Jan 1980 – Dec 1989	7.32 x	5.04 x	2.34 x
Jan 1990 – Dec 1999	3.59 x	5.33 x	1.62 x
Jan 2000 – Dec 2009	2.06 x	0.91 x	1.31 x
Jan 2010 – Dec 2015	1.80 x	2.08 x	1.00 x
<b>Total: 1970 – 2015</b>	<b>349.47 x</b>	<b>89.68 x</b>	<b>9.20 x</b>

**Sources:** Dimensional Fund Advisors LP for Dimensional Index data. S&P 500 and US Select Real Estate indexes from S&P Dow Jones Indicies LLC. Ibbotson 1-Month US Treasury Bill Index. Dimensional Global Equity Strategy Index constructed: 20% S&P 500 Index; 20% Dimensional US Large Cap Value Index; 10% Dimensional US Small Cap Index; 10% Dow Jones US Select Real Estate Securities Index; 10% Dimensional International Value Index; 5% Dimensional Small Cap Index; 5% Dimensional Small Cap Value Index; 3% Dimensional Emerging Markets Index; 3% Dimensional Emerging Markets Value Index; 4% Dimensional Emerging Markets Small Index. Past performance is not guarantee of future results. Indicies are not available for direct investment, and performance does not reflect expenses of an actual portfolio.

Bob Veres writes a well-respected financial industry newsletter. Back in depths of the Global Financial Crisis, Veres captured his own fear, as well as the palpable fear of a nation of investors. He candidly admitted to be gripped by the “roller coaster” of terror—unable to resist the feeling because of what he described as “the lizard-like part of the back of (the) brain” which screams “against all logic and against many things I (know) to be true.”

In the course of regular business cycles, once again we will suffer yet another fearful market decline. Hopefully your portfolio will be diversified and you disciplined. As you stare into the unknown, remember these ending lines:

I’m one of those financial media types, and also a pundit on occasion, and I can tell you that I can hear the lizard’s scream echoing across the financial landscape, so loudly that it’s hard to remember that stocks are on a fire sale now and they are certainly a hell of a lot less risky than they were last August, and that these rides are seldom fatal to those who stay in their seats, and they are usually at least harmful to those who panic, unhook their seatbelts and jump over the side toward the distant anthill below.

I can hardly wait to look back on those charts and wonder what the hell we were thinking getting so panicky about a blip, and I know at that time that the lizard will be giving me a different message: that if only I’d had the sense to buy when everybody else was selling...

This too shall pass, and 99% of your brain knows it. The market belongs to the lizard now, and I am ashamed to admit that I, the pundit, the media guru, still feel that sense of panic on the way down, irrational as I know it is. I feel it so much that sometimes I can barely hear the rational part of my mind over the screaming that echoes that are calling up from a deeper part of my consciousness. I would curse the designer of this roller coaster, as I did the fiend who put that damn thing up at Sea World, but I’m afraid this time it is us, collectively, who designed our own fear machine.<sup>vi</sup>

The stability of net cash inflows in Dimensional’s equity portfolios vs. those of the mutual fund industry as a whole during those Global Financial Crisis years testify to the indispensable service independent advisory firms like Professional Financial provided their clients. Clients who didn’t capitulate to the continuous onslaught of bad news and impending doom following price declines were all the more wealthier for staying the course.<sup>vii</sup>

Perversely, the notion of global diversification came under attack after the financial crisis and as markets recovered. This was because all equity asset classes around the world suffered sharp price drops as correlations among risky assets temporarily rose toward one, leaving no place except bonds to avoid temporary losses. Some investors concluded that global diversification “failed” when it was needed most—as if diversification was a magic panacea.

The research of behavioral economists finds that investors keep confusing the familiar with the safe. Which countries will experience prolonged periods of underperformance is unpredictable. Think about former Asia economic superstar, Japan, that 25 years later still suffers a prolonged stock and bond market depression.



What that contention ignored was that diversified portfolios should include a fixed income such as government bonds, as part of its strategy to dampen overall portfolio volatility to fit individual capacities and capability for risk. During systemic financial crises, the correlation of fixed income allocations, while averaging about zero, tends to turn sharply negative at critical times of extreme volatility. Fixed income benefits not only from a flight to safety from fearful investors, but from liquidity demands from those investors with excessive debt and speculative leverage. As exhibits using five and ten year horizons show, international diversification works over long periods. Diversified portfolios globally or through factor exposures do not avoid short-term systematic crashes. However, investors with long-term planning horizons should care much more about long, drawn-out bear markets which can be significantly more damaging to wealth, as we saw during the “lost decade” of US stocks in 2000-2009 where substantial international stock allocations did well when the return of S&P 500 indexes was about zero.<sup>viii</sup>

## TRUSTED ADVISORS FOR DISCIPLINED INVESTORS

It may take more today to impress the capital markets than only a decade ago. The combination of historically weak GDP growth and low interest rates in the US and internationally implies that the once heroic monetary powers of central bankers have passed. Growth in corporate profits—formerly empowered by monetary policy—has stalled and is in a decline. Political risks from China, from ISIS and from US political change are serious. Many older investors who previously preferred bonds or bank CDs have large stock positions. It seems to us they own shares not because of great confidence in American companies and equity markets, but because their fixed income preferences pay so poorly—cash yielding almost nothing, and many governments issuing negative interest bonds.

Investors should have a philosophy founded in the science of capital markets to guide their decisions and to maintain those decisions when confronted with uncertain times and fearful markets. David Booth, founder of Dimensional Fund Advisors is fond of saying, “The important thing about a philosophy is that you have one you can stick with.” Investments don’t come with a guarantee. Consequently, having an independent trusted CFP® who can help you formulate a sensible investment philosophy and integrate that into a sound investment policy and manageable process, is an essential step toward meeting your financial challenges and gaining peace of mind.

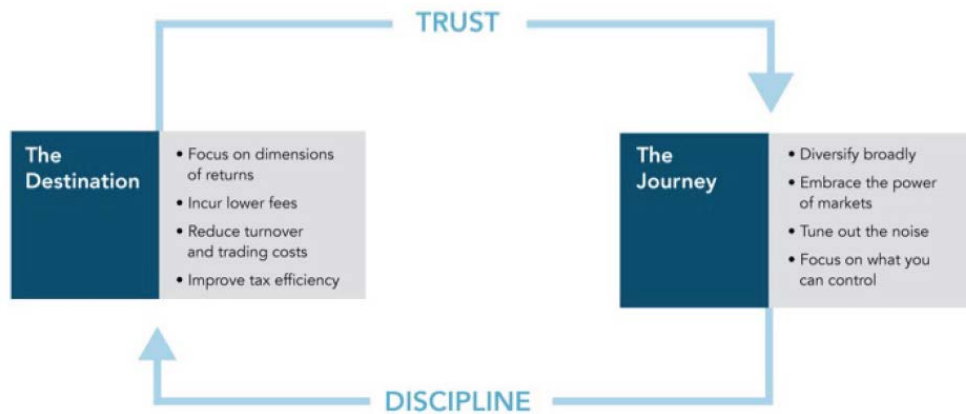
To be a true investor, as opposed to only a saver or a speculator, you must accept as an article of faith **that there is a positive return on capital**. Markets work. That is the economic rational basis for capitalism anywhere. From that single premise, our investment management process is developed from decades of evidence-based research and empirical studies from a network of experts. For instance, but very much to the point of this paper, while your realized return over any period of time may be negative or positive—or even zero as for the last year or so—in *expectation* we believe markets will go up. *Markets adjust prices in such a way that every day there is a positive expected return on capital*. No rational person knowingly invests his capital expecting to lose money. To think otherwise is nonsense.

Yet, we know investors lose part or even all of their capital regularly through making wrong investing choices. Usually, it goes back to believing a false philosophy based on a conventional wisdom: the possibility of selecting winning stocks or skillful advisors. So would-be investors futilely speculate with a collection of bets—playing a zero sum game, becoming a loser’s game after costs.<sup>ix</sup> Investors become speculators when they begin looking for signals indicating patterns of performance promising superior returns. They decide that this time somehow different from past, believing they know more than the collective market. Before reacting emotionally to predict what the future may hold, studying historical data can provide perspective in tough times. Only investors with a plan who remain disciplined throughout disappointing periods will reliably capture elusive expected returns.

## PLANNING THE JOURNEY AND THE DESTINATION

Your personal destination through your wealth management process is a successful financial outcome. At the very least, planning increases the probability of arriving at your preferred destination. Yet the process of making the journey itself is integral to a complete experience. A dictionary definition of “experience” is “the act or process of directly perceiving events or reality.” In the old grand world tours, there were delays, detours and weather that often caused a change of plans. In an investment journey lasting decades or a lifetime, your perception of the planning process is integral to a successful financial experience as life events occur during the long journey. Your confidence in your ability to make right choices, and commitment to planning, directly impacts your destination.

## Exhibit 8: MAPPING A SUCCESSFUL INVESTMENT EXPERIENCE



Understanding the power of modern financial markets, and trusting they can work for you *and not against you*, can be a transformational moment in how your planning occurs. Accepting that market prices are informationally “efficient,” allow you to tune out “the noise” and enjoy the journey. With a trusted advisor having an integrated planning process, there is no need to stress about how global events you hear about will impact your investment planning—by the time you know about it, that information is part of your portfolio. When a prolonged underperformance of an asset class or the portfolio itself is disappointing, it is an expected in the journey. Market volatility of prices should be accepted, because without investment risk, higher return should not be expected

As a client of Professional Financial, your attention should be focused on matters under your control, on those decisions your control that materially impact the quality of the journey and the likelihood of reaching your destination: retirement dates, asset allocation and structure, personal saving and spending levels, tax mitigation, reducing costs and most of all, discipline though a informed commitment to a proven process working with a trusted CFP®, experienced and knowledgeable with access to the right solutions to make smart decisions about money. And knowing what matters and what does not, is liberating, and makes taking the journey worthwhile.

<sup>i</sup> Except perhaps for established Federal employees or tenured professors in major universities, two specialized groups.

<sup>ii</sup> It is interesting to think of the alternative: if prices did not adjust and remained constant, we would be concerned that markets were not functioning properly.

<sup>iii</sup> Jason Zweig, “Are You Ready for the Next Market Crash?” *Wall Street Journal*, June 13, 2014.

<sup>iv</sup> For investors faced with the need to make period withdrawals, sequence risk is a reminder why a substantial allocation of the portfolio needs to be in fixed income for at least a five-years to as long as a ten-year period.

<sup>v</sup> For investors disappointed by recent poor emerging market results, the S&P 500 and the emerging market index both finished last 9 times. However, emerging markets finished first 9 times, while the S&P 500 finished first only once.

<sup>vi</sup> Bob Veres, “The Scream of the Lizard,” accessed at [www.keyfeeonly.com/the-scream-of-the-lizard/](http://www.keyfeeonly.com/the-scream-of-the-lizard/)

<sup>vii</sup> Based on quarterly fund flow data from 2008 through 2012. During the period, net new cash flow for Dimensional’s US-domiciled equity mutual funds totaled \$33.4 billion, compared to a negative \$535.5 billion for the industry. Dimensional estimated net flow data provided by Morningstar. Industry net new cash flow data provided by Investment Company Institute based on the approximately 4,600 US-domiciled equity (domestic and international) mutual funds reported on an aggregate level to the Investment Company Institute. This includes information on Dimensional’s US-domiciled funds during this period.

<sup>viii</sup> Clifford S. Asness, Roni Israelov, John J. Liew, “International Diversification Works (Eventually)”, *Financial Analysts Journal* (May-June 2011). See also Marlena I. Lee, “Measuring the Benefits of International Diversification,” *Quarterly Institutional Review* (Dimensional Fund Advisors), 3rd Quarter 2010. Lee shows that when the volatility of a global market portfolio is compared with the volatility of a portfolio concentrated in a single country, like the US, the evidence shows that ability of international diversification has not diminished.

<sup>ix</sup> The classic discussion of this is Charles D. Ellis, *Investment Policy: How to Win the Loser’s Game* (McGraw-Hill) 1993.

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