Developing an Investment Philosophy

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After thirty-five years working with individual investors, I have learned the first essential step in successfully managing money is to commit to writing what you hope to accomplish. That step - writing down a sound investment philosophy that will stand the test of time – is often the difference between good and bad outcomes.

Know why you are investing

IN MY OPINION, investors should be in the business of accumulating profits and dividends. Speculating whether the market is going to go up is a loser's game. The single largest drag on wealth accumulation is poor decisions by investors. Poor investment decisions are usually the result of: 1) the lack of a sound written investment strategy and, 2) the inability to stick to the strategy during times of exuberance and despair.

Do-it-yourself or outsource?

MOST PEOPLE WITH MODEST ASSETS should probably simply buy a couple of low cost index funds. People with significant assets are well advised to enlist professional assistance. The modest incremental cost is worth the benefits of service, customization and tailored advice that typically define a full service relationship.

REGARDLESS, ALL INVESTORS SHOULD KNOW how they want their money managed, whether they make decisions themselves or outsource it. This will help select the right advisor AND should help you withstand the urge to change strategies at the wrong time.

For taxable investors

For this purpose, I will address the issues facing taxable investors. By focusing on low turnover investment strategies, one can usually improve the long-term, cumulative outcomes. Incorporating tax loss harvesting strategies can also add as much as 1% annually.[1]

Diversification and rebalancing

Modern Portfolio Theory (MPT) proves diversification reduces risk. Today's application of MPT work well for tax-exempt institutions but does not address the tax impact of allocations shift and portfolio rebalancing to tax payers.

REGULATION PROHIBITS the investment industry from offering tax advice and therefore requires most financial advisors to remain silent on the issue of the impact of taxes.

How many asset classes

Think about diversification in four asset classes: real estate, stocks, bonds, and cash.

- Real estate should be local, cash positive
- Cash and short bonds – up to three years-worth of living expenses
- Stocks - quality, dividend paying

What companies do you want to own?

Many professionals talk about investing in "styles" – value, growth, large, small, international, emerging markets and others. I suggest you defer this issue and start with the basics. If you owned a business, what characteristics would you want your company to have?

CONSIDER SEEKING ENTERPRISES with:

- Lower debt, strong free cash flow
- A history of reinvesting capital at higher than average rates of return
- Consistent earnings, generally growing
- Pays cash dividends and "payout ratio" is about 50% or less

If you were able to assemble a portfolio like this and the companies continued to do well, there would be few reasons you would want to sell them. Companies that can be held for a long time are ideal.

THIS IS EASIER SAID THAN DONE but it could be a starting point. With this investment philosophy you could hire money managers, buy mutual funds, hire financial advisors or make investments yourself.

Questions to ask yourself

What is your primary objective?

- Grow wealth
- Keep wealth at current purchasing power
- Prepare to transfer wealth

If to grow wealth:

- What is your annual budget?
- How much in annual savings?
- What is your tolerance for volatility?
- How involved do you want to be?

Behaviors/attitudes:

- How much of your total portfolio could you stand to see go down 40-50% before it rebounds?
- How many years are you willing to stay with the strategy while holding losses?

Do you have a preference?

- Growth or value investments
- Small companies, "blue chips"
- International, emerging market investments
- Hedge funds, private equity

If passive strategy:

- Which fund, index, or ETF?
- When to buy, how much?
- When and why to reduce or reallocate?

If active risk containment strategy, which:

- Mutual funds, managed ETFs
- Separately managed accounts

- How to select, monitor, reallocate
- Individual stocks, bonds

If individual stocks:
- Which valuation methodology?
- Price/earnings, price/book, free cash flow, return on capital, dividend yield?

Do you prefer?
- Management of investments yourself
- Someone to help you or fully outsource

Reality check

Investing money takes years to learn how to do well. Decide if you should be the pilot or the passenger.

Most people are better off being a well-informed passenger who receives value for the price paid.

Either way, devise an intelligent process before you start. If you follow these steps, you will be better prepared than most and probably have better outcomes as well.

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[1] Tax-Managed SMAs Better Than ETFs, Parametric Advisors, September 2017

CRC 2363656 01/19