Intelligent Investing

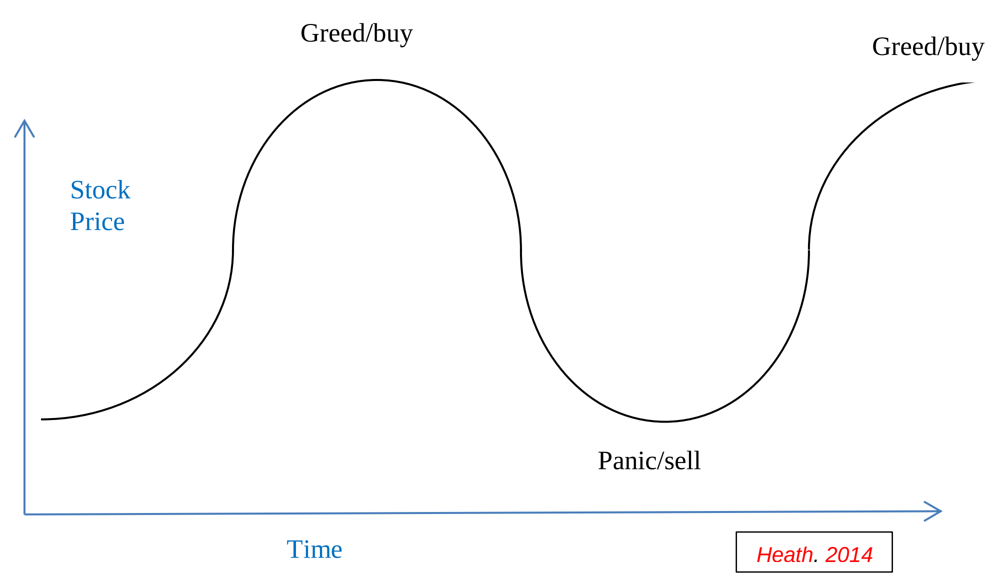
Money means different things to different people. Everyone is in a unique financial position, with their own personal goals and timelines. This means the one-size-fits-all investment articles on the internet and other media are of limited value, and can even be detrimental to your financial health.

If you wish to achieve your financial goals, you need to make wise financial decisions that apply to your specific situation. This article explains the typical process we use in The South Bay Group at Morgan Stanley to provide our clients with customized investment portfolios that reflect each client's particular needs.

From our experience, many investment professionals make investing seem more complex than it needs to be. We in The South Bay Group believe that investing need not be complicated.

The biggest problem is that investors typically get caught up in the noise of the day and let their emotions dictate their actions. Emotions are powerful forces that often cause you to do exactly the opposite of what you should do. For example, when the stock market is doing well, investors often ignore investments that are undervalued and poised to rise. Instead they chase the 'hot' stocks that have increased in value, typically buying expensive stocks at high prices. Then, when the stock price falls, the investor gets nervous and will plan to sell if only the price goes back up to what they paid for it. Instead the price falls further, the panic sets in, and the investor sells at a loss (see Exhibit 1 below). They end up buying at a high price, selling at a low price, then blaming the stock market for their losses. As a result, these investors often earn poor returns, and miss out on accomplishing their most important financial goals.

Exhibit 1: Emotional Investing



Yes, it can be hard buying investments when others around you are selling, and selling when others are buying. However, the good news is that there are methods you can use to tune out that noise and utilize an investment strategy that has the potential to achieve long-term investment success. Many institutions such as large corporations and endowments use these methods. In our team, The South Bay Group, we believe that our clients should have access to the same institutional-class investment approaches as these companies and endowments enjoy.

There are two institutional-class methods, and we can use both of them depending on a client's needs. The first, and easiest, method makes use of low cost index funds. We design a portfolio corresponding to the investor's desired combination of risk and return. The portfolio would consist of a fixed percentage allocated to stock funds, and a fixed percentage allocated to bond funds. The objective is to keep the allocation between stocks and bonds constant throughout the years, thus the portfolio is rebalanced on a regular basis. Taxable accounts are typically re-balanced annually, while retirement/tax-deferred accounts are typically re-balanced quarterly. This buy-and-hold approach (called the ***Strategic Method*** of investing**)** keeps investment costs low, and taxes to a minimum. This approach is suitable for clients whose primary concern is to keep realized gains (thus taxes) to a minimum. However, the downside to this method is that not many people are comfortable with a buy-and-hold approach when the financial markets are falling.

The second method is the ***Tactical Method*** of investing. This is similar to the first method except that the asset allocation is not automatically kept fixed throughout the cycles of the financial markets. The allocation can be changed depending on research into the relative valuation of the various financial markets. For example, when interest rates are higher than normal, more money would be allocated to bonds in order to collect the increased interest payments. Conversely, when interest rates are lower than normal, the bond allocation would be reduced. For a second example, if U.S. stocks became expensive but European stocks were undervalued, the percentage of U.S. stocks would be reduced and the percentage of European stocks increased, with the total percentage of the portfolio assigned to stocks not changing. Occasionally, we would even sell investments completely and hold cash when our research tells us risk is high. This approach is suitable for clients who are interested in managing their risk exposure rather than keeping taxes to a minimum.

Both of these methods enable investors to remove the emotion from their investment decisions, and provide a prudent long-term investment strategy focusing more on buying at lower prices and taking some profits when prices are higher.

Now that we have removed the emotion from the investment process, we can focus on a constructive, long-term process for managing the investments. The investment approach used by The South Bay Group is built upon the foundation of seven specific concepts. These concepts are explained below:

(i) **Gap Analysis**

What does your money need to do in order for you to achieve your financial goals? The objective is NOT to take high risk in the hope of out-performing an arbitrary index such as the S&P 500. The objective is to attain your financial goals with AS LITTLE RISK as possible.

(ii) **Diversify to Potentially Reduce Risk**

Most people understand the basic concept of diversification - don't put all your eggs in one basket. However, an adverse effect may not impact just one investment, it could impact an entire industry or asset class. Therefore, investing across a number of different asset classes can lower risk without necessarily sacrificing return.

(iii) **Seek Lower Volatility to Enhance Returns**

Volatility is the day-to-day up and down movement in the value of your investments. If you have two investment portfolios with the same average or arithmetic return, the portfolio with less volatility will have a greater compound rate of return. Your account value reflects the compounded rate of return.

For example, let's assume you are choosing between two investments. Both advertise an average (arithmetic) rate of return of 8% per year over five years. Therefore, you would probably expect both investments to produce the same final account value.

Let's look at Exhibit 2, below. $100,000 is invested in each of two investments. Investment "A" has low volatility, averages 8% annual return over the five years, and the final investment value is $146,822.

Investment "B" also grows at an average of 8% per year but has much higher volatility (30%-20%+25%-20%+25% divide by 5 = 8%). However, the account value finishes at only $130,000 for an average compound growth of only 5.39%.

With all else equal, over time the investment with the ***least*** volatility will have a ***higher*** compound return.

Exhibit 2: The Effect of Volatility on Investment Returns

	Investment A – Low Volatility		**Investment B – High Volatility**	
Year	Rate of Return	Ending Value	Rate of Return	Ending Value
1	8%	$108,000	30%	$130,000
2	6%	$114,480	-20%	$104,000
3	8%	$123,638	25%	$130,000
4	10%	$136,002	-20%	$104,000
5	8%	$146,882	25%	$130,000
Arithmetic annual return	**8%**		**8%**	
Compound annual return	**7.99%**		**5.39%**	

This information is hypothetical and shown for illustrative purposes only. The illustration is not intended to predict the returns of any particular investment, which will fluctuate with market conditions. Actual results may differ from those depicted in the illustration.

(iv) **Think Globally**

Investors here in the U.S. tend to favor stocks and bonds of U.S.-based companies. For many, it's more comfortable emotionally to invest in firms whose name they recognize than in companies located on another continent. Unfortunately, these investors' emotions are causing them to miss out on one of the most effective ways to increase their returns. Although the U.S. financial market is the largest in the world, it represents only one-third of the total investable opportunity worldwide. There are simply more investment opportunities overseas.

In addition, the economies of many international countries are growing faster than here in America, and are benefitting from all the money Americans spend on imported goods.

Finally, global diversification in your portfolio also helps reduce its overall risk. American and international financial markets do not necessarily move together, and gains in one market can help offset losses elsewhere, thus reducing overall volatility.

(v) **Use Different Investment Vehicles**

In the stock market, extended periods of upward price movements are called *secular bull markets.* Lengthy periods of downward movements are called *secular bear markets.* Regardless of whether the market is in a secular bull or a secular bear period, investors still need to work towards achieving their financial goals.

In a secular bull market, when a broad range of investments are going up, a buy-and-hold approach using low-cost index funds, institutional mutual funds, and/or separately managed stock accounts can be beneficial. These are typically 100% invested at all times, so you get maximum benefit from the stock market increasing in value. Routinely scheduled rebalancing will help maintain the required asset allocation. However, with over 2,000 indices available to choose from, many of which overlap each other, it is important to use the appropriate combination of investments.

However, a different approach is called for when prices are excessively high, or a secular bear market is occurring. This is where active management can be particularly advantageous. First, the asset allocation may need to be changed, defensive investments increased (certain market segments and asset classes often stay healthy even when the broader stock market is declining). Second, certain investments have the ability to go to cash, and using these investments can help protect your principle. Finally, rebalancing the portfolio forces the taking of profits in order to reinvest proceeds into lower priced investments.

(vi) **Use Investments that Pay Dividends and Interest**

Dividends and Interest can play an important role in your investment success. First, if you need income, withdrawing dividends and interest enables you to avoid withdrawing your principle, thus your money can last longer. Second, if you don't need the income, the dividends and interest can be used to buy additional investments (a form of dollar-cost averaging). Finally, the payment of dividends and interest can help reduce volatility.

(vii) **Monitor Progress**

Are your investments on track to meet your goals as identified in item (i)? Have any of your goals changed? It is imperative to monitor progress against your goals, and make investment changes as necessary. The objective as stated earlier is to attain your financial goals with a little risk as necessary.

So how do we in the South Bay Group go about designing an investment portfolio for a client? Every client is unique, and there is no one investment or portfolio that is appropriate for everyone. Therefore we go through a discovery process for each client. The process looks at each client's specific goals and objectives, then identifies the gaps between where their finances are today and where they need to be to meet their goal(s). A client can easily have several financial goals with a separate portfolio designed for each one. See our ***Wealth Management*** series for more information on the discovery process.

Once we're finally in a position to design an investment portfolio, here is a simplified version of the steps we go through:

(i) What type of account, or combination of accounts, is appropriate for a client's specific goal(s)? A trust account, taxable account, retirement account, etc? The type of account will determine whether a client has to pay investment taxes every year, or whether profits are tax-deferred or tax-free, and this will impact the type of investments used. For example, in a taxable account we'd look for low turnover, tax-advantaged investments such as index funds, and use the strategic investment method to minimize the annual taxes. For a tax-deferred account we'd typically rebalance more often, and use the tactical method of investment.

(ii) How much income, if any, is required by the client from the portfolio? Ideally we'd aim to generate the income from dividends and interest seeking to minimize the need for a client to withdraw their principle from the account.

(iii) For how long will the money be invested? Some investments are liquid and appropriate for a short-term holding period, others are designed for multi-year holding periods.

(iv) What is the client's tolerance for risk? Not everyone wants to be 100% invested in the stock market.

(v) Is there a minimum return required in order for the client to reach their financial goal? If so, is the investment strategy required to meet the required return compatible with the client's tolerance for risk?

(vi) Are there other portfolios for other goals that we need to take into account in order to avoid duplication of investments?

(vii) Based on the above six steps, we would identify the investment method to be used:

- If we’re using the strategic method of investment, we would determine the appropriate asset allocation.
- If we’re using the tactical method of investing, we’d look at the relative valuations of each asset class, then incorporate that information to design the initial asset allocation. We would limit (or even eliminate) an expensive asset class until the price came down. We would increase the under-valued asset classes.

(viii) Now that we have the initial asset allocation, we pick the specific, low cost investment vehicles that we’ll use to fulfill that allocation.

(ix) On the appropriate schedule, we would re-balance investments to maintain the specified asset allocation. In a taxable account this would be done carefully to keep taxes to a prudent minimum.

(x) Finally, the whole process would be repeated on a regular schedule – have the goals changed, is there still a gap that needs to be addressed, is the account type still appropriate, how much income is required, etc.

Please note, I have written this article as a simplified explanation designed for clarity of understanding. It does not reflect the entire range of wealth management services available from the South Bay Group, nor are we limited to just those investments specifically mentioned in this article. Please refer to my “Wealth Management” articles for our entire wealth management process.

It is also important to note that, while our investment process is designed to be low cost and prudent, no investment strategy can completely eliminate risk, which is inherent in all investments.

Finally, please remember that you’re responsible for keeping your financial advisor current on any changes to your finances, family or life goals that could affect your investment objectives. Changes to your investment objectives could require a change to your investment portfolio.

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