

THE EDUCATED INVESTOR

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Investor Identification

As individuals, we each bear a distinct thumbprint. We also can be identified by characteristics such as our earlobe shape, dental records or DNA. When it comes to investing, unique identifications become more difficult. While we each have distinct investment objectives, we tend to fall into two general groups for the core of our portfolios — either we adopt an **actively managed** or **passively managed** investment approach. Why do we strongly recommend the passive approach for all of our clients?

An Efficient Debate

A long-standing debate about the stock markets has been whether or not they are “efficient.” The Efficient Market Hypothesis (EMH) is the basis for the body of academic work known as Modern Portfolio Theory, upon which the American Law Institute built its prudent investing guidelines for trust fiduciaries. EMH states that markets quickly and accurately reflect available information, and are setting “fair” prices for buyer and seller. Inefficient markets, in contrast, would enable a savvy investor to exploit security prices that do not accurately reflect all available information or do not respond quickly to new information.



Few would argue either extreme — that markets are purely efficient or inefficient. But those who espouse an active investment approach believe that markets are at least inefficient enough to make it worth the treasure hunt. They will pay the costs involved in attempting to find mispriced stocks, bonds, sectors or markets to buy and sell.

As investment advisors advocating a passive strategy, we heed the academic evidence indicating that markets are too efficient to accept the costs involved in identifying mispriced securities. We instead recommend that investors allocate their investments according to equity risk factors, which can be expected to compensate investors with real, after-expense premiums. Portfolios are designed to meet each investor’s unique ability, willingness and need to take risk (and its commensurate expected reward).

The Best-Laid Plans

EMH, Modern Portfolio Theory and the American Law Institute aside, many still find it tempting to pursue that undiscovered stock-picking method or broker who can successfully pick the winners and avoid the losers. Behavioral economists have studied this tendency toward overconfidence in one’s active investment talents, and found it to have a significant negative impact on a portfolio’s long-term outcome.¹

Consider the following example (among many) that indicates such a belief is likely overly optimistic. A critical question about efficient markets is not whether security prices are correct, but whether an active investment approach can persistently exploit any mispricings, after costs. Surely if anyone could do so, it would be those best, brightest and well-paid portfolio managers for large corporate pension plans. The consulting firm FutureMetrics studied the performance of 213 major US corporate pension plans for the 15-year period 1987-2001.² How did they compare to a comparable passive benchmark portfolio?

Estimating that the average pension plan had an allocation of 60 percent equities and 40 percent fixed income, the study compared the realized returns of the plans to a benchmark portfolio of 60 percent S&P 500 Index and 40 percent Lehman Intermediate Government/Corporate Bond Index. Out of the 213 pension plans attempting to outperform the market using active management techniques, 9 percent of them succeeded. More than 90 percent failed. It would be logical to assume that individual investors, with far fewer resources available to them, would likely fare even worse.

In short, investors who look in the mirror and see someone who has superior stock-picking or market-timing skills may want to take a closer look. They’re likely falling victim to mistaken identity.

¹ Terrance Odean and Brad M. Barber, *Journal of Finance*, April 2000.

² FutureMetrics, LLC.

An “Active” Approach to “Passive” Investing

The body of academic evidence supports the belief that markets are highly efficient, and the best way to capture expected premiums is via a passive management approach. However, “passive” management should not be interpreted as lack of action, nor should it suggest only a “buy and hold” strategy.

Quite the contrary, a passive approach involves ongoing action that is focused on disciplined, prudent steps toward achieving a long-term investment plan. This differs markedly from wasted efforts to chase the latest hot investment trends. Following is a description of some of the actions you and your investment advisor can take to manage your passive approach.

Preventing Style Drift

Even a perfectly constructed investment portfolio will eventually drift off course as market movements affect your planned asset allocation. For example, imagine you created a portfolio in 1990 comprising 80 percent S&P 500 Index equities and 20 percent bonds. You then simply held that portfolio through 1999. By the end of the decade, the portfolio’s asset allocation would have shifted from 80 percent equities to more than 90 percent equities — a much riskier portfolio than you had intended.

To control such movements, it is important to not just buy and hold, but to buy, hold *and* rebalance. In our example, to rebalance back to an 80/20 portfolio would have required selling some of the “winning” S&P 500 equities that had been moving full-steam ahead and replacing them with bonds.

The “Active” Side of Passive Investing

In the second half of the 1990s, stocks (as a whole) dramatically outperformed fixed income. Further, the large-cap growth stock asset class dramatically outperformed other equity asset classes and domestic outperformed international. Investors should have considered rebalancing appropriately to maintain their intended risk profile.

1998 provided opportunities to tax-loss harvest in several equity asset classes, including value, small-cap, real estate, international and emerging markets.

2000-2001 provided additional opportunities to rebalance as the value and small-cap asset classes outperformed large-cap growth, and domestic stocks outperformed international by a wide margin.

2002 provided many opportunities to tax-loss harvest equity holdings.

1995

1996

1997

1998

1999

2000

2001

2002

2003

In essence, this means buying low and selling high — exactly what all investors would like to achieve — yet it also involves buying when things seem darkest and selling when they look brightest. Thus, while rebalancing is the correct strategy, it can be difficult to execute, as it goes against our basic human instincts to keep the “winners.” Having the discipline to rebalance often requires the guidance of an objective investment advisor, who can remind you of its critical role in achieving your investment objectives. Your advisor can also assist you in deciding when and how often it makes sense to make such adjustments.

Managing the Impact of Taxes

In addition to initial portfolio construction with an eye toward tax efficiency, your advisor can help you seek what are known as tax-loss harvesting opportunities. Because the US tax code allows us to deduct realized losses (with some limitations), unrealized portfolio losses can be harvested year-round, whenever the cost of doing so is expected to be significantly less than the tax benefit gained. Using this technique, bear markets like the one experienced in 2002 can provide wonderful opportunities to improve your after-tax returns. However,

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implementing tax-loss harvesting appropriately also requires close familiarity with the regulations involved as well as monitoring any tax code changes that might affect one’s investment activities. As such, we can expand our passive “buy and hold” strategy to a “buy, hold, rebalance and tax manage” strategy.

Implementing Personal Assumption Changes

Proper selection of your portfolio’s asset allocation involves careful analysis of your unique ability, willingness and need to take risk. The analysis is based upon factors such as your investment horizon, ability to remain calm during bear markets, earned income level and stability, financial objective and marginal utility of wealth.

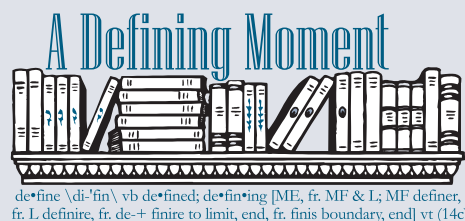
Such analysis leads to the construction of your individual investment policy. Just as your portfolio can drift out of balance, so too can your investment policy if any of the underlying assumptions radically change. Life-altering events — such as a death or birth in the family, divorce or marriage, receipt of a large inheritance, gain or loss of job — can dramatically impact the long-term objectives upon which you have based your asset allocation decisions. Thus it is critical that you and your advisor periodically review your investment policy (especially when major personal events have occurred), and make appropriate adjustments to your policy and your portfolio.

Monitoring Market Impact

Outside market movements also can lead to a change in the assumptions behind

your investment policy and resulting asset allocation. This is not to be confused with the active management approach of attempting to predict where the market will be heading next, but rather whether past market activities have brought you nearer or farther than you planned from your disciplined investment objectives.

In short, ever-changing market conditions and your own significant life events require vigilance and action in maintaining your investment portfolio. But the action should be focused on skill-based implementation of your “passive” fundamental investment assumptions rather than on luck-based “active” market forecasts.



Active management — The attempt to uncover securities the market has either under- or overvalued. It is also the attempt to time investment decisions to be more heavily invested when the market is rising and less so when the market is falling.

Passive management — Specifically contrary to active management, passive management is the practice of constructing a portfolio by using funds that are proxies for specific asset classes or markets, based on the theory that it is so difficult to persistently outperform the market that it is cheaper and less risky to just buy the market. Characteristics of the passive management approach include lower portfolio turnover, operating expenses and transaction costs; greater tax efficiency; a long-term perspective; broader diversification and risk reduction; periodic style-drift correction; and incorporation of the separate dimensions of worldwide returns.

Asset class — A group of assets with similar risk and reward characteristics. Cash, debt instruments, real estate and equities are examples of asset classes. Within a general asset class, such as equities, there are more specific classes such as large and small companies, distressed (value) and glamour (growth) companies, and domestic and international companies.

Asset Allocation Wins Again

The 1986 landmark study *Determinants of Portfolio Performance* is widely recognized as among the earliest of many studies demonstrating that asset allocation is by far the most important determinant of return variation for diversified portfolios.¹ In other words, decisions about how much equity versus fixed income to hold — and how much of various types of equity asset classes you hold within your equity portion — impact return variation more than which specific stocks or sectors you select.

The Vanguard Group published a corroborating study, *Sources of Portfolio Performance: The Enduring Importance of Asset Allocation*.² Its conclusions were no surprise. Vanguard studied 420 domestic balanced mutual funds that existed at any time between 1962-2001 (provided the fund had at least five years of performance history and significant allocations to both bonds and equities). It analyzed how significantly asset allocation, marketing timing and security selection contributed to return variation through time and absolute return level.

The study first determined each fund's policy allocation (the allocation among stocks, bonds and cash), and concluded that, on average, 77 percent of a fund's

monthly return variation was explained by its policy allocation. Security selection and market timing, collectively, explained the remaining 23 percent.

The 77 percent figure was lower than that reached by the original 1986 study, which concluded 94 percent for the same factor. Vanguard's authors cited some study approach differences that might explain the discrepancy. In any case, the general conclusion was the same. To a high degree, asset allocation remained the primary contributor to return variation.

The study also compared the absolute return of the policy allocation relative to the actual return for a fund. It found that *more than 100 percent* of the achieved return could be attributed to asset allocation. How can a contributing factor be more than 100 percent? This means that the costs

associated with market timing and security selection actually *reduced* the realized return below what would have been achieved if no such efforts were made.

In summary, the Vanguard study reaffirms the results of prior studies on the importance of asset allocation's impact on portfolio returns and return variation relative to the contribution from market timing and security selection. Our conclusion is that investors who spend much of their precious time and hard-earned dollars focusing on market timing and security selection issues are highly likely to find the efforts unproductive or even counterproductive.

¹ G.P. Brinson, L.R. Hood and G.L. Beebower. *Financial Analysts Journal*, July/August 1986.

² The Vanguard Group, July 2003.

A Book to Invest In: The Successful Investor Today

Want to learn more about passive investing, asset allocation, the Efficient Market Hypothesis and other key ingredients to a successful investment experience? The latest on these subjects and more can be found in Larry Swedroe's newly published book, *The Successful Investor Today: 14 Simple Truths You Must Know When You Invest* (Copyright 2003, Truman Talley Books, St. Martin's Press).



Our Basic Tenets

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

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...**
A TRUSTED ADVISOR RELATIONSHIP