



## Advice to Invest By

When markets turn volatile and your distinct risk profile decisions are being put to the test, we all know how tempting it can be to second-guess even the best-laid strategy. Successful storytelling through realistic and engaging illustrations can reassure you that you are on track with your investment experiences. It can also help you share what you have learned with others who might benefit from similar advice.

Financial author Larry Swedroe is widely respected for his ability to explain in plain

English what our passive investing strategy is — and remains — all about. In a recent interview with IndexUniverse, Larry spoke about his newly published, anecdote-based book: **WISE INVESTING MADE SIMPLE**. With permission, we share the content of his interview with you. We believe it serves as an excellent timeless and timely reminder of our own investment advice. Larry's (and our own) conclusion: "The winning strategy is very simple. But it's not easy."

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### **"Straight From the Source" Interview: IndexUniverse Speaks with Larry Swedroe**

**IndexUniverse.com:** Tell us a little bit about **WISE INVESTING MADE SIMPLE**.

**Larry Swedroe (Swedroe):** The book tries to take a topic that a lot of people are scared of — money and investing — and bring it into the real world and make it simple and easy to understand by using stories ... stories about sports, about family, about the things that aren't scary. Most people remember stories more readily than a complicated chart.

**IndexUniverse.com:** Give me an example.

Swedroe: Well, I've found that the best way to teach people about investing is to tie it to the idea of betting on sports. Many people understand betting on sports, and not enough

people understand investing. So one of the stories I use in the book is this ...

Even someone who doesn't know much about college football would recognize the answer to this question: If the University of Texas, a national contender for the championship every year, played a school called San Angelo State, which team is likely to win? Easy, right? If they play 100 times, Texas would almost certainly win 100 of those games. The problem is, if you're trying to make money betting on Texas, you can't do it. To make money, you might have to give the other team a 40-point spread.

As it turns out, the point spread is an unbiased estimator of the outcome. Even though a bunch of amateurs set the point spread by their betting

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actions, the favorites tend to win by more than the point spread half the time, and less than the point spread half the time. So it's very difficult to make money betting on sports; the only people likely to make money are the bookies.

How does that tie to investing? Well, ask yourself the question: If you consider two companies, GE and Ford, you know that GE is the better company. But should you invest in GE just because it's a better company? No, you have to pay a much higher price for GE than you do for Ford ... the price-to-earnings ratio makes both of them equally good investments once you adjust for risk, the same way the point spread gives you an equal chance to win. In other words, GE is Texas and Ford is San Angelo State. Just as the point spread equalizes the risks of betting on either team, the difference in the P/E ratio makes both companies equal investments once we adjust for risk.

I use stories like that one to break down the myths about investing, to make it clear. Because stories are the easiest way to learn. If you tell somebody a fact, they'll learn. If you tell them a truth, they'll believe. If you tell them a story, it will live in their hearts forever.

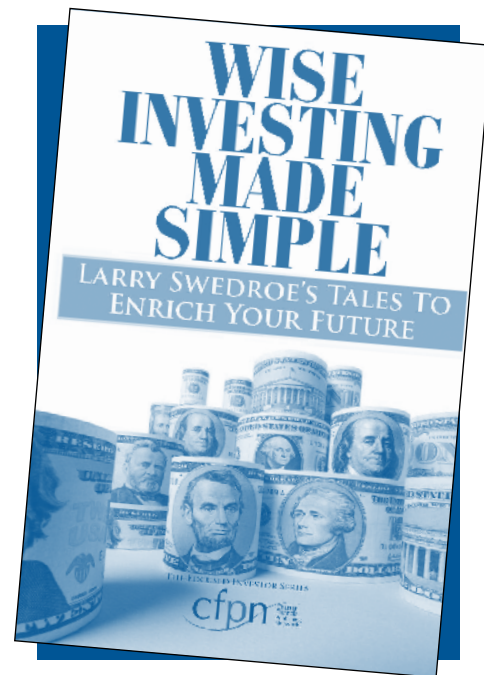
**IndexUniverse.com:** Do you think younger investors with a longer time horizon should hold more small-caps, more international and more value exposure than the broad market?

**Swedroe:** Let's begin by addressing this question: Why should anybody at all deviate from a market-cap-weighted strategy?

The answer begins by understanding that there isn't one factor that determines equity returns. That's what people used to believe — the more exposure to beta you had, the higher your expected returns and risk. But along came [professors] Eugene Fama and Kenneth French. They demonstrated that a three-factor model explains returns much better than the one-factor model. Beta explains about two-thirds of returns while the three-factor model explains about 95 percent of returns. And unfortunately, prior beta does not determine future beta.

They came up with three factors to explain returns:

1. **Beta:** exposure to stocks
2. **Value:** exposure to stocks with lower valuations
3. **Size:** exposure to small-caps



Financial author Larry Swedroe's  
WISE INVESTING MADE SIMPLE  
(September 2007)

Because small-caps and value stocks are more risky than large-caps and growth stocks, there should be a risk premium for holding those stocks, and, therefore, higher potential returns.

**IndexUniverse.com:** So a younger investor should tilt toward small-cap and value [stocks] to achieve higher returns?

**Swedroe:** There are good reasons why one might want to take on more risk in a portfolio. One reason is that, as you get bigger risk premiums, you have higher expected returns. A young person may have a longer investment horizon than an older person, and therefore more ability to wait out a bear market. Thus, the younger person might be willing to have a higher equity allocation. They won't always have better returns, but the longer their time horizon, the more likely it is they will benefit from a higher equity allocation.

The same is true for small and value stocks — they don't always outperform, but the longer your horizon, the more likely you'll get the benefit of the small/value premium.

There is a second factor in people's ability to take risk: the correlation of your earned income to the economic cycle risks that drive stock returns. Someone whose earned income is highly correlated with economic risks — a construction worker, a small-business owner, etc., might want to underweight small/value to the market and also have a smaller equity allocation. On the other hand, people with very low correlations — doctors, lawyers, tenured professors — have more ability to take risk. And that means they can increase both their equity allocations and their size/value exposure.

**IndexUniverse.com:** Will small and value always outperform? Or have those premiums been priced out of the market?

**Swedroe:** The answer is the same as if you asked me if stocks will always outperform bonds. We know that they will not. If they did, there would be no risk. But we must always expect that they will over any time period. The reason is simple. They are riskier. And thus investors price them for higher expected returns.

Well, value and small stocks are riskier and they too must be priced for higher expected returns. At least if markets are acting rationally. But investors must also keep the following in mind: If you own more than the market share of small-caps and value stocks, your portfolio will perform differently than the market. You are taking on what is called the risk of tracking error.

Having the discipline to stay with whatever strategy you choose is far more important than the specifics of your asset allocation. If you choose a strategy that you will, in all likelihood, abandon when things get tough, you'll likely do far worse than if you chose a different strategy and stuck to it.

**IndexUniverse.com:** Is there a place for commodities, currency, real estate and other alternative investments in most people's asset allocations?

**Swedroe:** I believe the answer to that is yes and no. I divide alternative assets into four categories: the good, the bad, the flawed and the ugly.

There are about 20 of these alternative investments altogether. Of the ones you mentioned, real estate and commodities have a place [in many] portfolios.

**IndexUniverse.com:** What else is in the good category?

**Swedroe:** I have other assets in the good category. [For example,] international equities, which I consider alternatives because most investors underweight them. Note that the greatest diversification benefits come from international small-cap and emerging markets stocks. People tend to stick to international large caps, which are a good diversifier, but the correlations are much higher.

**IndexUniverse.com:** Briefly, what is in the flawed, the bad and the ugly categories?

**Swedroe:** In flawed, there are a lot of things people invest in that I wouldn't recommend: junk bonds, venture capital, covered call writing strategies, socially responsible investments, precious metals equities, preferred stock, convertible bonds and emerging market bonds, and private equity. They are flawed in the sense that they might have some positive characteristics (e.g., low correlation), but their negative characteristics more than offset the positives. In other words, there are more effective ways to achieve the same objective.

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The bad? Hedge funds, leveraged buyouts and variable annuities. These are all products that are sold, not bought. [That is, they seem to be structured more to favor the broker making the sale than the investor purchasing the fund.] Once you adjust for the biases in the data and the risks involved, for instance, the data show that hedge fund returns barely compete with Treasury bills. Variable annuities are way too expensive.

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The ugly? Equity-indexed annuities. These may be the worst investment known to man. I've looked at many of them, and I've never found one that looks attractive. Another ugly is leveraged funds. And finally, I would add the broad category of structured investment products put out by Wall Street. The best advice I can give regarding products created by Wall Street is this: The more complex a product, the faster you should run away from it. It is far more likely that the complexity benefits the seller/issuer than the buyer.

**IndexUniverse.com:** If you had just five minutes to talk to a 25-year-old who knows nothing about investing, what would you tell them?

**Swedroe:** The sad truth is that outside of your family and your health, there's nothing more important than money — not the money itself, but what it can do for you. Yet our education system has failed to educate the public about investing — unless you happen to get an MBA in finance. So my suggestion would be to get educated. First, read James Surowiecki's book, *THE WISDOM OF CROWDS*. Then read *YOUR MONEY AND YOUR BRAIN* by Jason Zweig. And then I would tell him to read my books. And if our investor did that, he or she would know how to avoid all the mistakes most people make. One of my favorite lines is this: If you think education is expensive, try ignorance.



The best news is: The winning strategy is very simple. But it's not easy. We're human beings subject to our emotions, and we make mistakes. And that's where a good advisor can help people. A good advisor develops not only an investment plan, but then integrates that plan into an estate, tax and risk management (insurance) plan.

## Our Basic Tenets

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

- Fee-based investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An investment approach based on research by Nobel Prize-winning economists
- 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**



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