

This is the third and final article in a series that we started in the fall of 2009. The premise: To go “back to basics” and review each of the seven investment fundamentals that we first published in 1999 to determine what, if anything, should be changed in light of the global financial crisis and securities market meltdown from late 2007 through early 2009.

Following are all seven fundamentals in capsule summary. .

- 1. Have an Appropriate Allocation to Equities**
Your allocation to equities (stocks) is the single strongest determinant of returns over long periods of time.
- 2. Stay Fully Invested**
Market timing adds uncertainty, reduces efficiency and increases taxes and costs – all of which threaten your financial objectives.
- 3. Keep Costs Down**
Lower costs geometrically improve long-term results. We believe the total annual portfolio costs should be no more than one percent.
- 4. Use Only Short-Term Bonds**
Short-term bonds offer less risk than intermediate-term or long-term bonds. The risk exposure from long-term bonds is disproportionate to the small increase in return.
- 5. Include Small-Cap Stocks**
On average, small-cap stocks produce higher returns than large-cap stocks over time.
- 6. Include Value Stocks**
On average, value stocks produce higher returns than growth stocks over time.
- 7. Have Broad Diversification**
No single investment strategy works all the time. Increase returns and reduce risk through broad diversification applied consistently over long periods of time.

There is a reason that we published this series in reverse order. Fundamental number one is, without a doubt, the most important of all and the one where RCG learned the most over the past two years.

The key word in fundamental number one is APPROPRIATE. Study after study has shown that the primary determinant of a portfolio’s performance is the asset allocation, or the percentage of the portfolio allocated to stocks versus bonds. In the long-term, the higher the allocation to stocks, the better the portfolio performs. Of course, the inevitable catch is that the higher the allocation to stocks, the greater the volatility (i.e., the short-term ups and downs of the value of the portfolio.)

Some financial advisors say the only way to determine your allocation to equities is to base that decision on your age. They pigeon-hole investors by saying, “If you’re 65, you automatically get our moderate growth portfolio.” Or, “If you’re 40, you should be in an aggressive growth portfolio.” They might also use questionable (at best) rules, like subtracting your current age from 100 (or 110), which determines the percentage that you should have allocated to equities.

Other advisors might tell you that your allocation to equities should be based on the rate of return required to accomplish your financial objectives. Using historical data about rates of return and calculating long-term financial projections, they then back into the allocation needed to generate the rate of return that’s needed in order for your plan to work. While this may be a legitimate approach for investors who have a very favorable relationship between their financial assets and their standard of living, it could be a poor approach for those who are lagging behind in their savings goals. If a 10% average annual investment return is the only thing that will make the investor’s plan “work,” the resulting allocation to equities would be 100%, and that is a portfolio that not many investors have the stomach for, especially after the experience of the last two years.

Another method in determining an investor’s asset allocation involves answering a risk tolerance questionnaire. Such feedback ranges from just a handful of questions to multiple ways of asking the same question in order to assess the investor’s true tolerance for risk.

By contrast, RCG’s approach has always been to take each client through the decision-making process by reviewing history, as well as zeroing in on some particularly volatile periods in the equity markets to gauge their reaction. To put it another way, could they have stayed the course during such a time? Of course, it is easy to intellectually say yes, but an accurate tolerance for risk doesn’t become apparent until you actually live through a tumultuous period and know how it feels in your gut.

For many of our clients, risk is a preference, not a requirement. Using an extreme example, let’s take Bill Gates, one of the wealthiest people in the world. What should his asset allocation be? On one end of the spectrum, you could say that he has so much money that he doesn’t need to take any risk at all, and he should have all of his money in U.S. Treasury Bills. On the other end, you could say he has so much money that he should have it all in stocks, because that’s where the return is likely to be the greatest in the long run. That, in turn, would increase the chances that the Bill and Melinda Gates Foundation (where the vast majority of his wealth will end up) will be able to accomplish the goal of wiping out certain diseases in the world. Plus, Gates has so much money that even a 1.8% dividend yield on his all-stock portfolio would produce more than enough income to support his lifestyle.

Now back to the reality that our clients face: Which risk am I most comfortable with? Or the corollary: Which risk causes me the most anxiety? Am I most bothered by the wild gyrations in the stock market? Or is it the fear of inflation that keeps me awake at night? How about ups and downs in interest rates, with the resulting impact on bond prices? For most people, the answer is “all of the above.”

Translation: A balanced portfolio that provides some degree of protection against all these risks is the most appropriate. One thing is for certain – “no risk” is not an option.

There’s an old saying on Wall Street: Only two emotions interfere with successful investing – fear and greed. And the latter has clearly been front-and-center over the past two years. Not since the Great Depression have Americans seen such economic and financial despair. Human nature demands that we take action to salvage what we can.

What we learned during this time period in our economy is that some of our clients did not have the risk tolerance they thought they had when we helped them establish their investment policy. Which begs the question: What would we do differently today? For those who are currently making withdrawals from their portfolio for living expenses, or will be doing so shortly, we suggest that their allocation to bonds be x years of planned withdrawals. For some clients, this could be as short as five years and for others, it could be as long as ten years. The point is to be able to live off the stable portion of the portfolio for that time period so that equities don't have to be liquidated during extreme bear markets.

In other scenarios, we are systematically moving to a lower equity allocation over an agreed-upon time period. For example, some clients who previously had a 100% allocation to equities are moving to 80% equity; others who had a 70% allocation to equities are moving to 50/50. In all cases, we are taking that action because of what the client now knows about his or her risk tolerance, not because of some prediction on our part about how markets will do in the future.

Some clients are staying put with their allocation, having seen the dramatic recovery in the equity markets since March of 2009 and being thankful that they had the discipline to stick with the plan, even when it was very scary to do so. Yet another group has found it helpful to "compartmentalize" their investment assets by holding equities in an account that will not likely ever be needed for their own spending needs and instead passing it on to future generations or charitable organizations.

The bottom line: We still firmly believe that each investor should have an APPROPRIATE allocation to equities. What works for you may not work for someone who has roughly the same financial profile. It depends on risk tolerance or other personal circumstances. At RCG, we stand ready to assist you in determining what is APPROPRIATE for you.

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and investment management firm in Florida.*



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