

Vince Lombardi and The Seven Investment Fundamentals (PART II)

Our previous article addressed fundamentals 7, 6 and 5 of our Seven Investment FundamentalsSM. This article will address fundamentals 4, 3, and 2, leaving the final, and most important fundamental, to be discussed in Part III.

Here again are all seven in capsule summary:

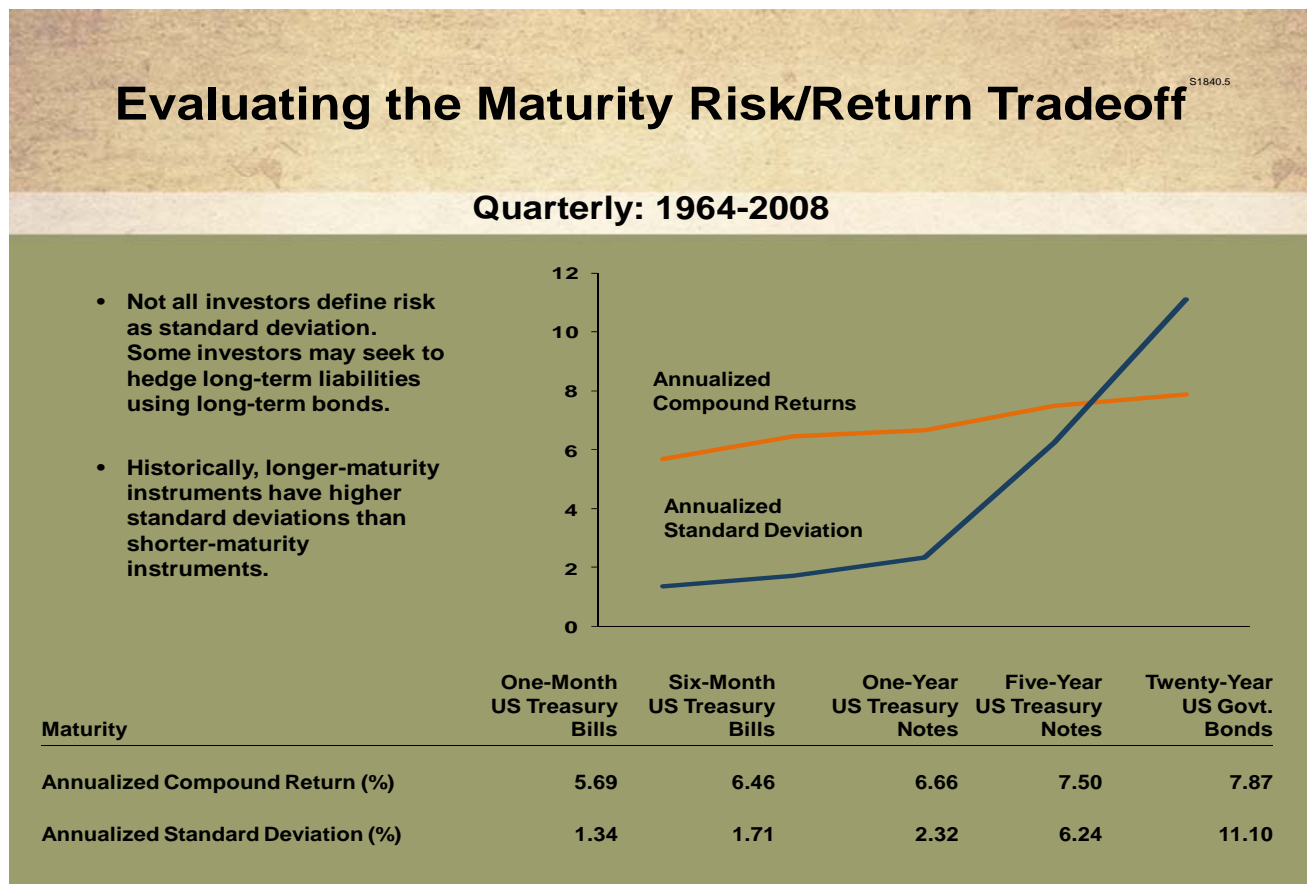
- 1. Have an Appropriate Allocation to Equities**
Your allocation to equities (stocks) is the single strongest determinant of returns over long periods of time.
- 2. Stay Fully Invested**
Market timing adds uncertainty, reduces efficiency and increases taxes and costs, all of which threaten your financial objectives.
- 3. Keep Costs Down**
Lower costs improve long-term results geometrically. 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.

Mark Twain is quoted as saying, “History doesn’t repeat itself, but it does rhyme.” Is this tongue-in-cheek assessment accurate? In the investment world we believe that it is. Let’s look at the evidence.

Use Only Short-Term Bonds

We believe in using strictly short-term bonds. In addition to short term, we adhere to using only high-quality bonds. Academic research has shown that by abiding by this philosophy, we can structure a modified portfolio with 70% stocks and 30% short-term bonds and do so with less risk than a traditional 60% stock and 40% long-term bond portfolio. The 70/30 portfolio has a higher expected return but less expected risk. While this relationship may not hold over short periods of time, it continues to hold over extended periods - even after recent market declines.

Consider the chart below. Over the last 45 years, extending bond maturities increased your risk (as measured by standard deviation). The Five-Year US Treasury Note exhibited three times the volatility of the One-Year US Treasury Note (6.24% vs. 2.32%.) The Twenty-Year US Government Bond was four times more volatile (11.10% vs. 2.32%) relative to the One-Year US Treasury Note, while the relative return increase is marginal.



This chart illustrates only the maturity aspect of fixed income's potential volatility. Unfortunately, we don't have to go back far in time to illustrate the importance of high quality in fixed income investing. Consider the mortgage meltdown in 2008 and 2009. Or reflect on the adjustable rate municipal bond market that froze entirely where no market at all existed for several months. As a result of these events, the American Funds Bond Fund of America - one of the largest US bond funds - declined in value by 12.33% in 2008. The fund uses a fairly standard fixed income approach to investing. Although this approach has served it relatively well over time, in periods of instability (like 2008), the investment strategy failed shareholders.

In comparison, a short-term, high-quality approach actually *gained* a small amount in 2008. In that environment, where return of capital was more important than return on capital, it looks pretty attractive.

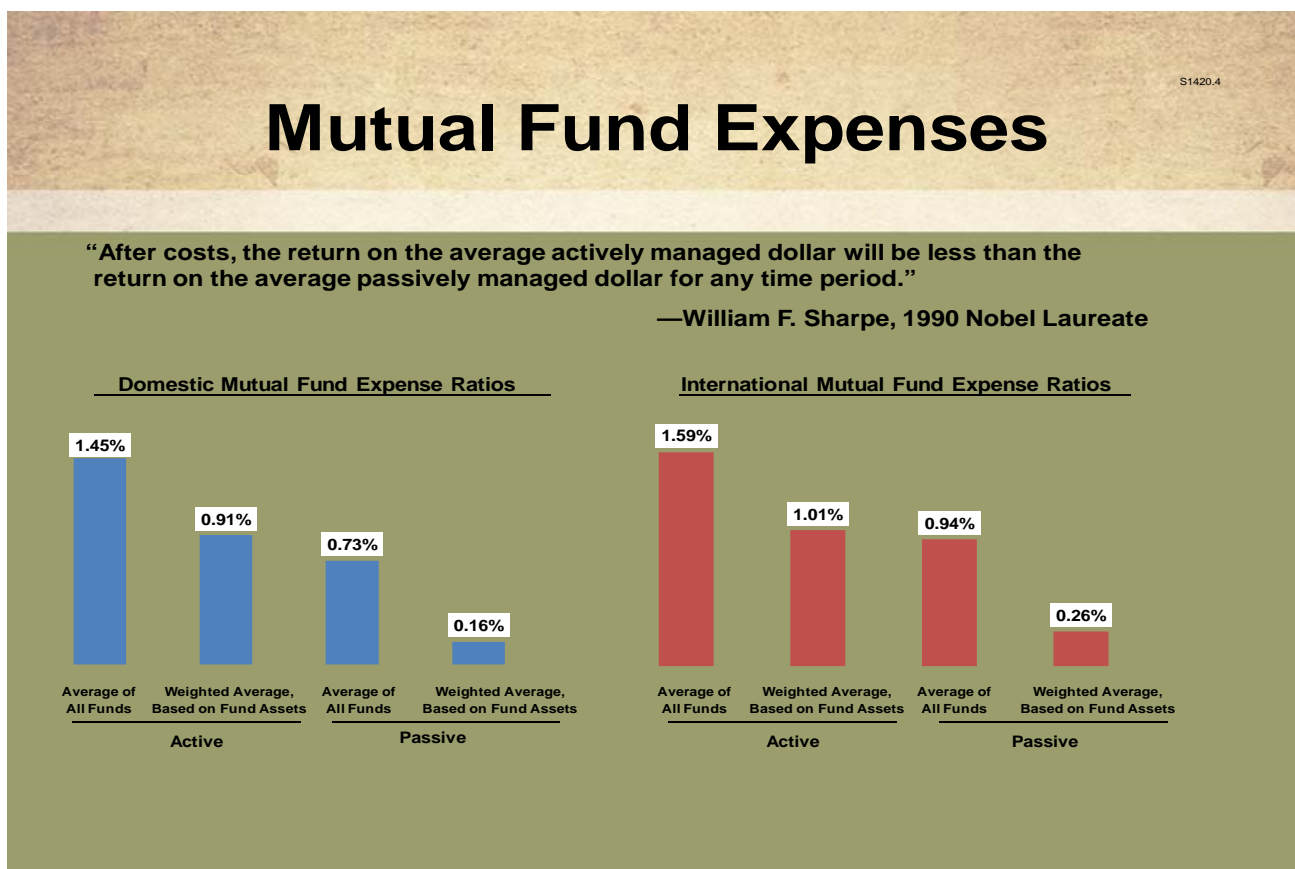
We have no idea when interest rates will go up. But when they do, as an investor you are better served in shorter maturity instruments.

We often tell clients that the concept of “income” is not relevant; total portfolio return and sustainable withdrawal rates are. Bonds should not be viewed as a performance enhancer, but as a volatility dampener. The recent meltdown showed this fundamental continues to hold true.

Keep Costs Down

It is perfectly clear that, all things being equal, the less you pay, the more you keep. Costs come in many forms, from management expense, to tax dilution, to ancillary frictional costs associated with frequent trading activities. While it's difficult to quantify the costs associated with the latter two issues, it's easy to quantify the primary expense - management fees. Morningstar® (an independent mutual fund research firm) has determined that the universe of domestic equity funds has a weighted average expense ratio of 0.91%. For international equity funds the average is 1.01%. Alternatively, the average cost for comparable passive strategies is 0.16% and 0.26%, respectively. Therefore, the cost differential whether domestic or international is 0.75% per annum.

While this may not seem like a lot of money, the difference in terminal wealth of a million dollar portfolio over a twenty year period is \$829,550 (terminal wealth is \$6,475,238 for the passively managed portfolio and \$5,645,688 for the actively managed portfolio). That should be enough to get any investor's attention. While this is an overly simplistic analysis that ignores both taxes and relative performance



(historical evidence supports that both measures are improved through passive management), the point remains the same - pay less and keep more.¹

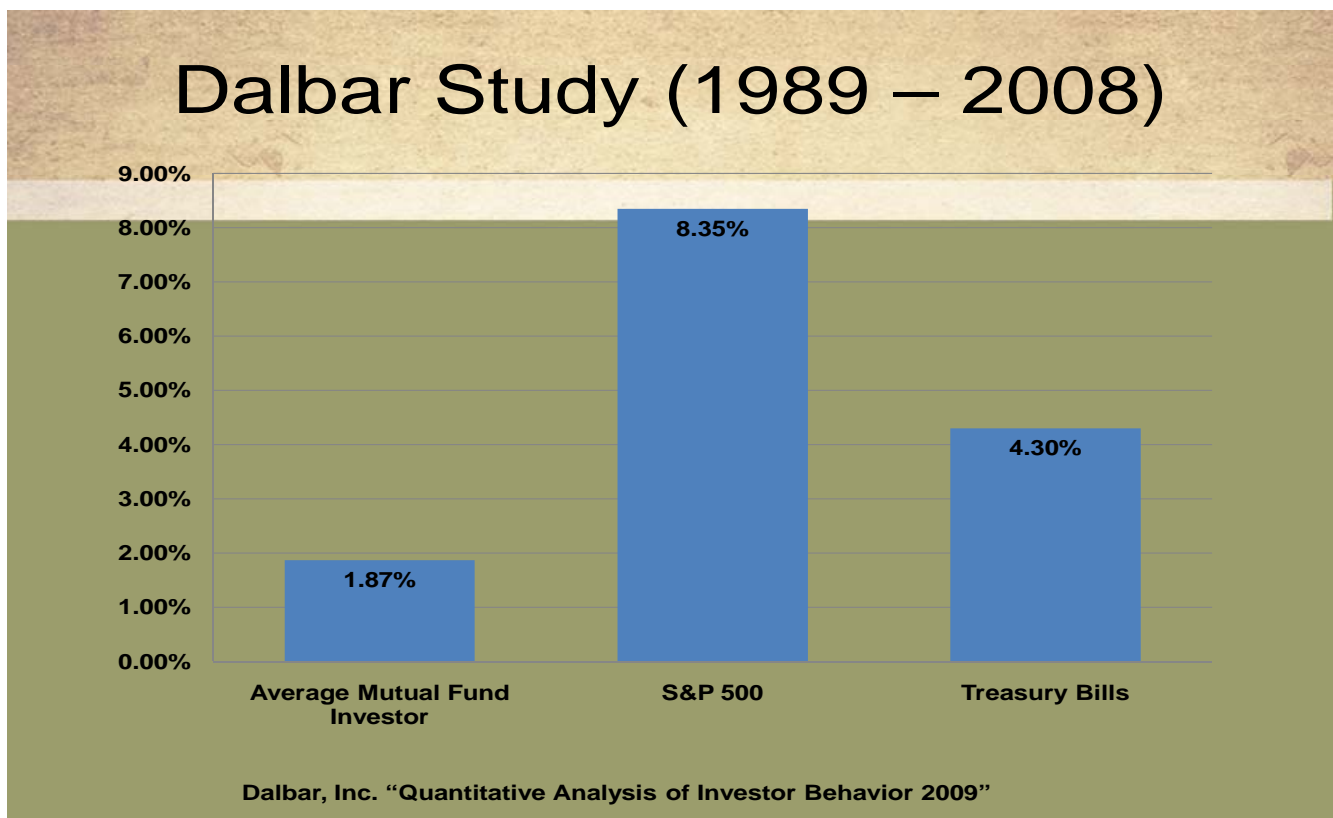
¹Assuming that gross performance is identical between the two disciplines (let's say 10%) and for simplicity we'll assume 50% of the portfolio is invested in domestic stock and 50% is invested in international stock.

Stay Fully Invested

While keeping costs down is intuitively appealing to most investors, staying fully invested may not be. There are numerous behavioral tendencies that we as humans have developed that seek to deprive us of capturing market returns. These tendencies include greed, overconfidence, hindsight bias, familiarity bias, regret avoidance, self attribution bias and extrapolation. These tendencies have historically adversely affected our decision making ability. A new branch of economics has originated, termed Behavioral Economics. In fact, one of the founders of this discipline won the Nobel Prize in Economics for his work on the subject.

The media feeds off these behavioral tendencies. It's difficult to remain committed to a well thought out investment program when the sensationalism in the financial media is designed to evoke an emotional response and increase the viewership/circulation. In an address given to The Anderson School of Business at UCLA in 2003, Steve Forbes, President and CEO of Forbes, Inc. said, "You make more money selling advice than following it. It's one of the things we count on in the magazine business – along with the short memory of our readers." Consider recently that on March 9, 2009, the point of maximum opportunity to own stocks coincided with the point of maximum fear stoked by the financial media. If you recall, the general consensus in the media was that the world financial markets were imploding and any news that contradicted this assessment was generally ignored. However, from that date through the writing of this article, the S&P 500 has advanced by roughly 64%.

To illustrate behavioral tendencies further, Dalbar, an independent research firm, has concluded that over the previous 20 years (through 12/31/08), the average equity investor generated a return of 1.87% annually. Alternatively an investor that simply purchased the S&P 500 and forgot about it would have generated a return of 8.35% (RCG-style fully diversified portfolios over this same time period averaged roughly 8.85%).



The story doesn't get any better in volatile markets. Dalbar found that in calendar year 2008 (the 2nd worst stock market in U.S. history), the average equity investor lost 41.63%, while the S&P 500 declined 37.72%. If that is true of 2008, it is a virtual certainty that market timers as a whole will fail to outperform a buy-and-hold strategy again in 2009. What investor would have had the intestinal fortitude to invest in March, at the height of market instability, after lacking the will to remain committed to their original plan? If history is any indication, likely very few.

In conclusion, we will continue to revisit these principles, but until the financial markets prove otherwise, we remain committed to these sound investment fundamentals. We continue to believe that if followed, they allow investors the highest possible probability of success. Our friend, Mr. Twain, said it best when he surmised, "There are two times in a man's life when he should not speculate: when he can't afford it, and when he can." We couldn't have said it better.

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and investment management firm in Florida.*



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