**April 2010**

# Talking and Walking

Rotating your tires, exercising vigorously, flossing, drinking eight glasses of water, *not* drinking eight glasses of wine.... There are many things experts urge us to do, that, when asked, we say we do, but, in reality, we do not – or at least, not with the consistency that we would have others believe. In the investment world, rebalancing and asset allocation rank just below "buy low, sell high" in this category.

Nobody argues against rebalancing and asset allocation, just as you are unlikely to hear an impassioned argument against moderate exercise and a sensible diet – but do investors actually do it? We believe not, just as we suspect teeth remain unflossed, and we *know* our tires still need rotating. Many people are talking the talk, but not walking the walk.

Rather than us repeating the standard lecture on the importance of rebalancing and asset allocation, imagine two investors each divide $1,000 evenly between a stock and cash that earns no interest (a good assumption, these days). Let us further assume that the stock either doubles or halves in value in each year. Investor #1 is a buy-and-hold investor who never rebalances. After two years, if there is one up year and one down year, he winds up with the same $1,000 he started with. It does not matter if the first year is a loss and the second year is a gain, or vice versa.

Investor #2 rebalances her portfolio. At the end of each year, she puts half of her portfolio value in the stock and keeps the rest in cash, selling some stock if it has gone up and buying more if the stock went down. If the first year is a loser for the stock, she has only $750 left (having lost half the $500 starting value of the stock) and rebalances to have $375 in stock and the same in cash. At the end of the two years, Investor #2 has a $1,125 portfolio, again, regardless of the sequence of winning and losing years. Both investors own the same assets, and the stock they own goes nowhere during the two years, but Investor #2 winds up with 12.5 percent more, all because she actually walks the walk of rebalancing rather than merely talking the talk. If they continued for six additional years, three up and three down, Investor #2 would have 60 percent more than Investor #1, despite both the stock and the cash being at the same values as at the start.

In the real world, we cannot be sure that there will be as many winning periods as losing periods, and the person who rebalances will be worse off in a sustained downturn without any up years, for example, because she keeps putting more money in the losing asset. The example demonstrates, however, the power of having sufficient money invested in an asset when it appreciates. Investor #2 does not *know* anything more than Investor #1 about the market and its future movement. In our imagined investment world, each year the stock doubles, stock investors will have high self esteem, believing they are brilliant analysts. Each year the stock halves, stock investors will have low self esteem, perhaps believing those crooks on Wall Street have stolen their money. However, all that is going on between their ears, not in reality. Investor #2 wins our game not because of what she believes or knows, but because of what she does.

Now let us do a play-at-home version of our game. All you need are your account statements from two dates – June 30, 2007, and June 30, 2009. Do not worry about individual holdings – just figure out the percent of your portfolio value that was invested in stocks (it does not matter which stocks or with which managers) on each of the two dates.

***"They say that exercise and proper diet are the keys to a longer life. Oh, well."*** ~ Drew Carey

The first date, in 2007, was an easy time to own stocks. Despite the first signs of the coming financial crisis, the U.S. market was hitting all-time highs, volatility was low, and risk-taking was the order of the day. The second date, in 2009, was different -- the financial markets were in the early stages of recovery from the worst financial crisis since the Great Depression. The total return from the U.S. stock market in 2008 was the worst since 1931. On the first date, greed was the prevailing emotion among investors; on the second, fear dominated. If your equity percentage was lower on the second date than on the first, you may want to review your asset allocation/rebalancing methods.

How does the typical investor react to such market volatility, more like Investor #1 or Investor #2? Sorry – it is a trick question. The typical investor winds up underperforming both. After a winning run, the typical investor likely is putting more money in the risky investment; after a losing streak, the typical investor is likely to give up and take all the money out of the now-cheap stock. The "natural" thing to do was to throw money at the stock market in 2007 and flee from the market in 2008 and early 2009. This is why investing is so hard for so many people – the natural thing to do, the thing that most people actually do, is the wrong thing to do.

People tend to see investing as a game where you are trying to buy the perfect stock or mutual fund to make money, but the real secret is behavioral, within us. When we experience volatility of the sort that we have seen for the past couple of years, it is hard to fight the waves of greed when the market seems to be giving us easy money, or the waves of fear when the market seems like a monster destroying our retirement fund. Investor emotions harm investment returns. Asset allocation and rebalancing are counterintuitive. Why diversify when it seems like what you want is to put all your money in the one best asset? Why take money away from your winners and give it to the losers?

Successful investing is a matter of discipline, of training yourself to do the right thing, not the natural or easy thing. With respect to asset allocation and rebalancing in your portfolio, there is only one question: What is moving – your lips or your feet?