

## Four Numbers You Need to Know

In investing, as in life, danger lies not so much in ignorance, but in what you “know” is true that actually is not true. We can see what most people think is true in investing from the coverage of the markets in the media. What will today’s economic statistic mean for the markets? What is the Federal Reserve going to do to interest rates at its next meeting? Is that biotech company’s drug about to get FDA approval? How much will earnings grow next year? How will the Australian elections affect the Asian markets? What do you think of the market? What stocks do you like?

But does any of this matter? The answer is no. Everyone is trying to be so smart about the minutiae involved in timing the markets or buying the “right” stocks that they miss the true path to investing success. The focus on the micro at the expense of the macro is so pervasive that it appears most investors would rather be “right” than achieve their objective. They may revel in being correct about the impact of the Fed’s moves, but they never assess whether their investment portfolio is meeting their financial goals.

Most people think the way to succeed in the stock market is to correctly predict the future. Predicting the future is hard, though, and nobody except the Psychic Friends Network claims to consistently succeed in doing so. (If your adviser contradicts this observation, maybe firing him in favor of Miss Cleo could save you money.) The real answer in investing is simple and does not involve fortune-telling. Asset allocation is the key to investment success, but you probably are not doing it. To find out, you need to know four numbers, two of which we will give you and two of which you will have to look up on your own.

## The First Number – 95 Percent

When we meet somebody new at a party and they find out we are in the investment business, we hear the same two questions – “What do you think of the market?” and “What stocks do you like?” In investing, most people concentrate on what these questions represent – market timing and security selection. But is that what is really important in investing? Academics have looked at the question of what explains the variability of future returns from an investment portfolio. Market timing and security selection explain only a small fraction. The dominant factor (explaining 95 percent of the variance in returns from quarter to quarter in the landmark study) is asset allocation, the basic decision of how much to invest in stocks as opposed to bonds and cash, before you reach the question of what stocks you are going to buy or when.

Asset allocation, as reflected in an investment policy, is like a road map. Without a map, you might be making great time, but also may be going in the wrong direction. While asset allocation is critical, it is boring – people are more excited about guessing where the market is going and what stocks will go up the most. Mention “asset allocation” to that person you just met at the party, and the next words you are likely to hear are “Excuse me, I’m going to get some more punch.”

*To see what is in front of one’s nose  
needs a constant struggle*

– George Orwell

Asset allocation is like eating broccoli, rotating your tires and flossing regularly. Most investors “know” asset allocation is important, most pay it lip service, but few effectively apply it. The enrollment packet you receive when you enroll in a 401(k) plan might briefly mention asset allocation and have a few graphs

showing different portfolio mixes, but the subject is quickly changed to anecdotes about how great the various managers are and how you can switch investments on a daily basis. Our minds are constantly drawn towards the exciting but away from the essential.

## The Second Number – 8.4 Percent per Year

So what does it mean to engage in “asset allocation” with respect to your investment portfolio? First, figure out what you are trying to achieve through your investments. Saving for retirement? Leaving a large estate for your heirs or favorite charity? Sending the kids to college? You do not know how you should invest until you know what you are trying to accomplish. Once you have the “roadmap,” however, you also have to follow it. That sounds easy and trivial, but it is not. Even if you start off knowing where you want to go in the investment world, there are temptations to get distracted and veer off course.

Our emotions are seemingly always tugged the wrong way in investing. The longer the stock market goes up (and consequently values decrease), the more sure we are that it will continue to rise. The longer the market goes down (and consequently values increase), the more depressed we get, convinced that investing in stocks is a bad idea. So it is natural to engage in market timing – investing the most when there is a cheery consensus that stocks can only rise, while retreating to cash when “everyone” knows the market will go down. It is also natural to try and find the perfect stock, infallible manager or can’t-lose market strategy. Neighbors and relatives always seem to have a stock tip or foolproof speculation method when investing enters the conversation. You buy an interesting new gadget or service and become convinced

that Internet retailing of paper clips is the wave of the future. In practice, recipients of stock tips are unlikely to be ahead of the crowd. The lure of finding the “next Microsoft” or jumping on board the recent hot manager or sector, however, is powerful.

How do investors fare in their attempts to time the market and buy the right stock, industry or manager? In the 17 years from 1984 through 2002, coinciding with the bulk of the biggest bull market in U.S. history, the average growth and income mutual fund had an average annual return of 11.1 percent, according to AdvisoryWorld.com. A study by Dalbar, Inc., a mutual fund research firm, estimates the return actually achieved by equity fund investors during that period to be 2.7 percent per year. In other words, there was an 8.4 percent annual performance headwind created by investor behavior.

*“I see the better way, and approve it; I follow the worse”*

*~Ovid, Metamorphoses*

How did investors give up three-quarters of the returns of the stock funds they invested in? By getting too excited and investing after the market had gone up, and getting too fearful and selling after the market had gone down. By rushing to invest in the sector or asset class that had gone up the most in the previous period, and then selling when the performance does not repeat. This behavioral effect dwarfs the performance differences between funds, the numbers to which people pay the most attention. Of the mutual funds in existence for the entire period of the Dalbar study, we estimate that a manager in the bottom 15 percent of trailing peer performance would have an average return only about two percent per year less than the average manager. Sticking with this admittedly terrible manager would produce results more than six percent *per year* better than the average stock fund investor.

The Dalbar numbers are not secret – they have been widely discussed in the media. Vanguard’s John Bogle commented on them on the editorial page of The Wall Street Journal. But the conventional 401(k) plan, for example, is still structured with a view to the performance and variety of investment choices. Few plan sponsors calculate how the participants are actually doing. Brokerage firms still focus their recommendations based primarily on stock selection and market timing.

The abysmal performance of the average fund investor tells us that people are not succeeding in their investment programs. They do not have a road map of where they are going. They are pulled towards the latest trends and fashions. Human nature takes them towards the exciting and away from the essential, away from what will allow them to succeed. This is amplified by the efforts of a predatory financial services industry that strives to generate products that can easily be sold, regardless of the effect on the wealth of their customers.

So we know now that asset allocation is critical and that investment programs divorced its principles are unlikely to succeed. How do you know if your portfolio has been applying the correct allocation theory? Is there an easy way to know how you have been doing?

## The Third and Fourth Numbers – The Percentage of Your Portfolio in Equities at March 31, 2000 and March 31, 2003

This brings us to another word likely to send your listener in search of more punch– “rebalancing.” Once you have an asset allocation target, you need to monitor your portfolio to make sure the market is not taking you too far away from your target. Trifling as this sounds, think about what it means in practice. You have to sell at least a portion of whatever has gone up the most, whatever you are happiest with, to reinvest elsewhere. Whatever has gone down the most, whatever you are disgusted with, you buy. This is severely counterintuitive behavior, and most people cannot do it. Do you? Think about your investment portfolio on two dates. March 31, 2000 was the approximate top of the long bull market that began in 1982. March 31, 2003 was about the bottom of the three-year bear market. Did you have about as much in stocks as a percentage of your portfolio on the first date as on the second?

*Asset allocation is not a theory that has been tried and found wanting; it has been found demanding and not tried*

In the bull market of the late 1990s, the equity percentage of a portfolio holding both stocks and bonds went up, since the rise in stocks increased their value. Most investors, excited by the rise, held on, hoping for further gains. Money flow statistics show

that many investors were selling other assets to add new money to their stock market holdings. This is in sharp contrast to an investor who rebalanced, selling stocks to bring the equity percentage down to their target level. In the bear market from 2000 through 2002, stocks fell sharply, decreasing the equity percentage of the typical balanced portfolio. Most investors, depressed by the decline, were afraid to bring the equity percentage of their portfolio back up to the target allocation. Money flow statistics show many investors sold stock holdings to flee the bear market. When the cyclical bull market began in 2003, their portfolio equity percentage was too low to make back what they had lost. Once again, the typical investor chased performance, with the paradoxical result that performance was destroyed.

It is easy to learn the rules of asset allocation, but they are difficult to follow. They run counter to human nature. This is as it must be – human nature, after all, is what creates market tops and bottoms. Following the appropriate principles would have you selling technology stocks just at the time your tiresome neighbor and ne’er-do-well brother-in-law were babbling about how they were getting rich by holding them. Following the appropriate principles would have you buying stocks during the worst bear market since the Great Depression. But you pay a high price for a consensus. By the time an action feels “right,” the major part of the price move is over.

So like eating broccoli, rotating your tires and flossing, asset allocation remains a largely unpracticed theory. People pay it lip service, but they cannot bring themselves actually to do it – there is always a more winsome new theory, a hot concept or a fledgling stock. For most investors, following a rational investment program has not been tried and found wanting, it has been found demanding and not tried. If you would like help developing a sensible, coherent investment approach from people experienced in combating human nature and bad habits, give us a call at (503) 419-3938. If you do, we will promise to talk about something more interesting the next time we run into you at a party.