



## ACHIEVING INVESTMENT SUCCESS

It is hard to sell “winning” positions and buy “losing” positions, but it is precisely this discipline that can help prevent serious mistakes.

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In the latest DALBAR study, Quantitative Analysis of Investor Behavior<sup>1</sup>, it was revealed that for the 20-year period ending in 2009, stock fund investors experienced average returns of 3.17%. Amazingly, investors on average would have been better off simply buying and holding the S&P 500 Index, which averaged 8.2% over the same period. This same pattern of significant underperformance relative to the benchmark also held true for the average bond fund investor. Worse yet, the average stock fund investor barely outpaced the rate of inflation by 0.37%, while the average bond investor didn't even come close to inflation. So why then, with the vast resources dedicated by every financial company, magazine and cable television network to “educate” investors on the latest trends and hot tips, do most investors fall well short of achieving basic market returns? The answer most likely lies in two parts. The first is investors' behavior and their tendency to invest where they are currently comfortable. For example, in the markets leading up to 2008, investors began to develop a high comfort level with stocks of all kinds, causing most to increase this exposure in their portfolios. When markets began to collapse in 2008 investors' emotions caused the opposite reaction leading them to reduce their stock exposure or, in the most extreme case, abandon stocks altogether. The second reason investors fall short in their quest for returns is a lack of discipline in the investment process.

No one can reliably and consistently pick the best stocks (or asset classes) and time the market. Instead of searching for a financial fortune teller, investment success may be achieved through the design of a well-conceived financial plan, adopting a principled and proven investment philosophy, and applying discipline to that approach. This is the foundation for having a successful

investment experience. However, it doesn't come easy and proper coaching along the way can be invaluable. In this newsletter, I will revisit our approach to investment management and highlight some of our core beliefs.

### Start With a Plan

Developing a financial plan that factors in your unique circumstances and objectives for risk and return should have a major influence on how your assets are invested. A well-conceived financial plan will help you identify and prioritize your short and long-term goals. It will also illuminate factors that have critical investment implications such as your investment time horizon, risk tolerance, income and cash needs, and income tax situation. All of these considerations should become the basis for formulating your personal Investment Policy Statement.

There are many benefits of establishing an Investment Policy Statement (IPS). For starters, having an IPS helps enforce a longer-term view of investing. This recognizes that long-term economic performance is far more important to wealth creation than short-term crisis events and newspaper headlines. The IPS should inform future investment decisions and guide the decision making process to ensure your risk and return objectives are being adhered to. This benefit can prove to be invaluable as it helps you avoid making emotional (and often irrational) decisions that can result in significant long-term consequences.

In addition to capturing your investment objectives and constraints, the IPS should outline details of your long-term asset allocation and diversification. It should also describe how the investment allocation will be rebalanced and managed over time.

## Asset Allocation

Simply put, asset allocation (the mix between major asset classes such as cash, bonds, and stocks within your portfolio) is the most critical decision you will make as an investor. This decision will be the primary determinant of the level of risk and volatility you may experience. It will also help you balance your need for investment returns with your concern for portfolio preservation. Setting (and sticking to) this long-term strategic allocation will help prevent you from making costly mistakes such as chasing and missing the returns of investments that have already gone up in value.

Looking back on the recent recession there are many cases where investors strayed from their plan, or worse, had no plan to begin with. Leading up to the recession, seduced by outsized returns, many investors were lulled into owning much higher percentages of stocks than they would normally be comfortable with. This often resulted in losses that were more severe than they would otherwise have been when the markets fell. Discouraged and frustrated by their experience, those same investors compounded their problems further by selling stocks at severely depressed prices and even avoiding stocks altogether. From the market low point in March 2009, many have missed the opportunity to participate in the rebound in stocks.

An asset allocation that factors in your objectives and preferences for risk and return may greatly influence the amount of market volatility you will experience over time and your potential wealth. How you allocate among cash, bonds, and stocks also plays a direct role in your ability to achieve higher compound returns. After all, ending wealth is determined by *compound* returns, not *average* returns.

Consider this hypothetical example of a \$100,000 portfolio under two different investment allocations and return scenarios: Higher Risk and Lower Risk.

RISK LEVEL	YEAR 1 RETURN	YEAR 2 RETURN	AVERAGE RETURN	COMPOUND RETURN	ENDING VALUE
Higher Risk	50%	-50%	0%	-13.4%	\$75,000
Lower Risk	10%	-10%	0%	-0.5%	\$99,000

In the Higher Risk scenario, despite the large gain in Year 1 you can see how devastating a loss of the same percentage in Year 2 impacts ending portfolio value. In fact, one would have to earn double the amount lost in the subsequent period just to get back to even. Although the average return over the two years

is 0% under both scenarios, the compound return and ending value is greater for the allocation that controlled volatility.

In many cases, rules of thumb or conventional wisdom are inadequate in determining how you should be allocated to stocks and bonds. Rules of thumb tend to ignore both your *willingness* and your *ability* to take investment risk, where willingness deals with the emotional or qualitative aspects of risk taking and ability deals with the quantitative aspects that can be calculated or simulated in your financial plan. A major drawback of using conventional wisdom is that it ignores how the order of returns can impact a portfolio. For example, experiencing negative returns earlier in your time horizon may be more detrimental than if those same negative returns were to happen in later periods. This is called sequence risk. By following a simple rule of thumb or conventional wisdom approach, you may end up with a portfolio more heavily weighted to stocks and therefore taking greater risk than you actually need relative to your objectives.

You cannot control the market, but you can control how you are allocated to it. Sticking to your allocation based on a well-conceived plan is a great way to help protect yourself from the next recession...and there will be another one. Maintaining your asset allocation through good and bad times will also result in improving your investment experience.

## The Right Diversification

Once the broader asset allocation is determined, the focus becomes how to properly diversify within stocks and bonds. The essence of diversification is properly assembling asset classes that behave differently in different market environments, not simply owning more "stuff". When done properly, these asset classes are designed to work together to help reduce portfolio volatility and, thus, potentially improve expected returns. One absolute in investing is that returns are directly related to risk. At the most basic level, the broader mix between stocks and bonds is diversification, where a higher risk and higher expected return asset class (stocks) is combined with a lower risk and lower expected return asset class (bonds) in an effort to reduce volatility. Both stocks and bonds will behave differently in a given market and economic environment but diversification doesn't end here.

There have been decades of academic research devoted to determining what factors are responsible for explaining stock returns over time. The factors that are most pervasive are that of value stocks versus growth stocks, small companies versus

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large companies, and stocks that display positive momentum relative to their peers. The first factor, value stocks versus growth stocks, recognizes the greater return potential of value stocks relative to growth stocks. Although this seems counterintuitive given the namesake of “growth” stocks, over long periods value has dominated growth in both large-cap stocks and small-cap stocks and across domestic and international markets.<sup>2</sup> The reason for the outperformance of value stocks can be directly attributable to their risk characteristics. The second factor identifies that over long periods, small-cap stocks have outperformed large-cap stocks.<sup>2</sup> This again is due to the higher risk of small-cap stocks relative to large-cap stocks.

The third factor that explains stock returns is a concept called momentum. The premise behind momentum is that a stock’s recent performance has the tendency to continue or persist over short periods. In other words, stocks that have outperformed recently may continue to outperform, but usually for no longer than three to twelve months.<sup>3</sup> There are many possible reasons for why performance can persist, most of which are related to investor behavior. A likely explanation is known as herding mentality and describes investors’ tendency to chase yesterday’s winners or flee from yesterday’s losers. While exposure to positive momentum can increase expected returns, it can also enhance diversification when combined with value stocks since both tend not to move in the same direction at the same time (i.e., returns from momentum and value are negatively correlated).

It’s important to point out that there may be periods of time when value, small, and momentum stocks underperform. For this reason, having the right diversification means also having sufficient large-cap stocks and diversifying across domestic and international stocks including emerging markets. It also helps to have a longer-term view of investing and an understanding that disciplined exposure to these factors can pay off eventually. In summary, having value, small, and momentum factors in your stock allocation will help you diversify equity risk and may improve returns.

Within bond allocations, structure also drives performance, but it is the role bonds play within a balanced portfolio that is most critical. The primary purpose of bonds is to reduce overall portfolio

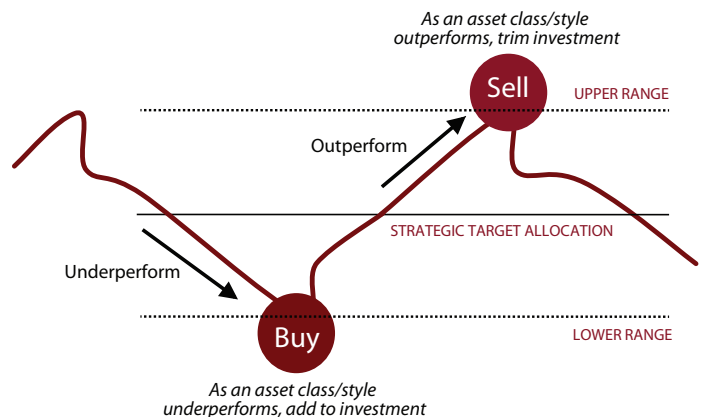
volatility and provide reliable income. Focusing on high credit quality and relatively short-term maturities through the use of individual bonds can be an effective way to attain this objective.

Over time returns are determined primarily by asset allocation and how certain asset classes and exposures are assembled. Understanding this principle changes many aspects of investing. Rather than focusing on individual stock or bond selection and trying to time the market, investors can focus on achieving diversified and controlled exposure to the risk factors that drive expected returns. This can avoid a lot of disappointment and frustration and certainly beats hoping to someday find that one person who has a crystal ball or magic formula.

### Rebalancing Discipline

After designing a portfolio allocation consistent with your objectives and achieving the appropriate diversification, there should be a process in place to maintain your allocation. The market is ever-changing. Because we assemble dynamic portfolios with asset classes that behave differently, we can exploit their natural differences and fluctuations by periodically returning them back to their original target allocations. This is the discipline of rebalancing. By setting reasonable price targets both above and below original purchase prices (i.e., setting ranges) and monitoring changes daily, we can identify when asset classes become relatively too large or too small, and thus have changed the portfolio’s risk characteristics from what was originally intended.

Rebalancing is often difficult for individual investors because emotion creeps into the process. It is perceived by many as counterintuitive and uncomfortable. For instance, it is hard to sell “winning” positions and buy “losing” positions, but it is



precisely this discipline that can help prevent serious mistakes. Having the discipline to reduce asset classes that have grown too big (selling high) and adding to asset classes that have become too small (buying low) will add return and may provide significant value to your investment experience.

Among the benefits of rebalancing and perhaps its greatest attribute is its function to control portfolio volatility. Once you have identified a portfolio that is consistent with your objectives, having a rebalancing discipline will help you maintain your desired level of risk and return. Having discipline in the investment process removes the natural tendency to make irrational decisions that can result in costly mistakes.

## Conclusion

Investing is not easy if left to our own devices and emotions. This explains why the average investors' performance so significantly lags the benchmarks. By recognizing our innate behavioral tendencies and removing emotion from the investment process, investors have reached the first step in achieving a successful investment experience. Developing a plan, adopting a principled and proven investment philosophy, and applying discipline are the final ingredients necessary for success. This is the truth that most financial companies, magazines and cable television networks don't want you to know. After all, they are in business of selling news and entertainment — not advice.



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### Footnotes:

<sup>1</sup> Average stock and bond performances were used from a DALBAR study, Quantitative Analysis of Investor Behavior (QAIB), 03/2010. QAIB calculates investor returns as the change in assets after sales, redemptions, and exchanges. This method captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns, two percentages are calculated: total investor return for the period and annualized investor return. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will be successful in the future.

<sup>2</sup> Fama, E.F. and French, K.R. "The cross-section of expected stock returns." *Journal of Finance* 47 (1992).

<sup>3</sup> Jegadeesh, N. and Titman, S. "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency." *Journal of Finance* 48 (1993); and Asness, C.S. "Variables that Explain Stock Returns." Ph.D. Dissertation, University of Chicago (1994).

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