

## IN THIS ISSUE

**P2** Is It Time to say “Good-bye” to Buy-and-Hold Investing?

**P3** The Mistakes We Make — and Why We Make Them

## Why is Money Important to You?

By Sheldon McFarland, Manager, Loring Ward Business Development Group

Security, status, freedom, philanthropy, a sense of accomplishment...there are many reasons people value money. But these reasons are sometimes forgotten amidst the hectic, day-to-day demands of life. When this happens — when we lose sight of our true goals and why we need money to accomplish them — we risk unnecessary worry and fear.

I recently met with a family friend I’ve known for many years. He was approaching retirement and was distraught about his financial future. He wanted reassurance that the recent financial calamity had not obliterated everything he had worked so hard to achieve.

I had long admired his frugality and knew he was a hard worker and savvy investor. I wondered what could have happened, what investments could he have purchased, that caused him to be so uncertain about his financial future.

At the time of our meeting, we had just passed through one of the worst financial declines since the Great Depression.

From October 2007 to early March 2009, stocks as measured by the S&P 500 Market Index, dropped approximately 60%, investor uncertainty skyrocketed, and trust and confidence were shattered. If you believed some headlines, the financial foundations of the world economy were collapsing.

I began by asking my friend about his goals: what did he want to do with his money? He is a down-to-earth guy and simply wanted the security of being able to retire in a couple of years and live a comfortable, not extravagant, lifestyle in retirement.


I probed a bit deeper and found that his investment portfolio of equities had declined by roughly 50%, not uncommon for many investors over this period. I also found he had several real estate investments, a few of which produced moderate cash flow, as well as a pension from his last employer.

After an hour or so of discussion and planning, we found that his equity portfolio, if invested in a properly-diversified portfolio, should be more than sufficient to meet his retirement goals. And this did not include the cash flow from his real estate investments or his pension.

Though my friend’s portfolio had more than enough assets to support his retirement goal — despite what was happening in the market — he had never clearly identified this goal and put specifics around it. And he did not have a documented plan on how he planned to achieve it. This lack of preparation and planning caused him to agonize unnecessarily.

The recent Great Recession was a stressful time, but in many cases, we were more worried than we needed to be. There are lots of lessons to be

learned from this experience, but I think one of the most important is the need to have a firm goal in place — a defined purpose — for our investments. And we need to work with our financial advisor to develop a written plan to reach that goal, a plan that is based on our time horizon, comfort with risk and other planning considerations, such as income needs.

With a long-term plan in place, it doesn’t particularly matter what the market is doing today. The focus becomes, instead, on if you are on track towards achieving your goals. 

---

The importance  
of money flows  
from it being a  
link between the  
present and  
the future.

---

— John Maynard Keynes

## Is It Time to say “Good-bye” to Buy-and-Hold Investing?

by Joni Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

The unpredictability of financial markets — exemplified by the steep declines of 2008 and early 2009 — can drive even the most seasoned investors to make abrupt changes in their portfolios.

Certainly, it has led some academics and market commentators to throw aside decades of established theory and declare the death of modern portfolio theory and its associated financial principles, such as strategic asset allocation, diversification and buy-and-hold investing.

One example of this view was an article published on the topic was a February 16 *Barron's* article “*Modern Portfolio Theory Ages Badly: The Death of Buy and Hold*” by Mike Hogan. Hogan asserts that “markets are likely to be too erratic in the future to rely only on nicely structured portfolios and economic growth...” He contends that investors today need to be more “tactical” in their moves — moving in and out of investments more quickly.

The claim is provocative. It can also be misleading.

If you don't believe buy-and-hold works, you are left with three main alternatives: market timing, tactical allocation and alternative asset classes.

Though these three alternatives have passionate advocates, most of the empirical data suggests they may be ineffective, even counterproductive investment strategies.

Here's why.

### Market Timing

Some buy-and-hold death notices take issue with *any* long-term strategy, implying that in today's world, market-timing is the only sensible approach.

But the decision to sell one stock or mutual fund in favor of another involves overcoming two distinct hurdles — knowing when to sell *and* when to buy.

For example, mutual fund investors invested more than \$300 billion into equity funds in the bull market of 2002 to 2007, and most of this money was invested when the market was near its highs. But in the bear market that followed, investors pulled out more than \$150 billion of assets — most of it after the market melted down in September 2008. The total cost of this poor market timing? For equity mutual fund investors, it was more than \$42 billion over the 12 months through May 2009.<sup>1</sup>

As a group, investors would have lost much less money had they simply held onto whatever funds they owned when the bear market began.

Even professional money managers have a problem timing the markets successfully. A 2008 study by Standard and Poor's looked at both the 2008 and the 2000 - 2002 bear markets. In both bear markets, the study found that majority of active funds underperformed their respective S&P Index for all U.S and international equity asset classes. In aggregate in 2008, actively managed funds underperformed S&P 500 Index an average of 1.67%.<sup>2</sup> Clearly, whatever these fund managers were doing, they weren't timing the markets well.

The lesson to draw from these results is to resist the temptation to time the market's short-term swings and, instead, invest for the long term.

### Tactical Asset Allocation

Tactical asset allocation may seem like a good idea in theory. After all, if you think this sector will outperform, shouldn't you allocate more of your portfolio there and away from sectors you think will underperform? But the reality may be much more difficult.

Morningstar tracks the performance of the hundreds of mutual funds that aim to add value primarily through tactical asset allocation. Morningstar classifies these funds as “asset allocation” funds, which are further broken down into three groups based on risk preference: Conservative, Moderate and Aggressive.

According to Morningstar, managers of asset allocation funds, “use a flexible combination of stocks, bonds and cash; some shift assets frequently based on analysis of business-cycle trends.”<sup>3</sup>

Morningstar found that the average conservative asset allocation fund, for example, lost 16% in 2008. An investor who chose instead an index mix consisting of 35% Total US Stock Market and 65% Barclays Capital Aggregate Bond, lost “only” 10%. Of the 39 conservative allocation funds, only 4 beat the passive index benchmark — the other 90% failed to do so.

Balanced asset allocation funds fared no better than their conservative peers in 2008. Of the 57 moderate allocation funds, 51 failed to keep pace with the index alternative.

Aggressive allocation funds offered a glimmer of hope in 2008, with a little more than half — 55% — of funds beating their benchmark.

All told, 75% of the nearly 150 unique asset allocation funds failed to match an equivalent index mix.<sup>4</sup> And this does not factor in the greater expenses and taxes associated with an active approach.

While a sensible buy-and-hold approach in 2008 certainly tested the resolve of even the steeliest of investors, it certainly beat the tactical alternative three-quarters of the time.

### Alternative Investments

Some investors are adopting even less-conventional approaches in an attempt to offset the risks of investing in stocks — such as absolute-return or market-neutral hedge funds; or managed futures, which seek to profit from gains and losses in commodities; or financial futures, which include a range of currencies, government securities and equity indexes.

But it important to note that even commodities and hedge funds performed poorly during 2008. The only major asset class that did reasonably well, was the very-unalternative 5-Year Government bonds, which returned 13.11% in 2008.

You should also be wary of selecting alternative strategies that may be harmful to long-term financial security. Alternative products often come with high fees and complex strategies, including the use of leverage which increases the risks of investing.

Buy-and-hold is not a perfect invest strategy — it can certainly be emotionally challenging in volatile markets. But everything we know about investment theory and practice suggests that staying the course may remain an effective approach long after those proclaiming the death of buy-and-hold have been flummoxed by the inextricable problems of market timing, strategic asset allocation and alternative investments.

Remember: buy-and-hold investing requires strategy and patience. Its goal isn't to aim for the highest possible returns, but rather to generate returns necessary to meet your long-term objectives at an acceptable risk level. 🌟

*A buy-and-hold strategy does not assure a profit and does not protect against a loss.*

<sup>1</sup>Mark Hulbert, *New York Times* July 12, 2009

<sup>2</sup>Standard and Poor's Investment Service, 2009.

<sup>3</sup>Morningstar Principia. 2009

<sup>4</sup>Ibid.

# THE WALL STREET JOURNAL

This thought provoking article by Professor Meir Statman — a long-time member of Loring Ward's Investment Committee and the Glenn Klimek Professor of Finance at Santa Clara University — appeared in the August 24 edition of the Wall Street Journal. It is reprinted here by permission of the Wall Street Journal.



## The Mistakes We Make — and Why We Make Them

How investors think often gets in the way of their results. Meir Statman looks into our heads and tells us what we're doing wrong.

What was I *thinking*?

If there's one question that investors have asked themselves over the past year and a half, it's that one. If only I had acted differently, they say. If only, if only, if only.

Yet here's the problem: While we know that we made investment mistakes, and vow not to repeat them, most people have only the vaguest sense of what those mistakes were, or, more important, *why* they made them. Why did we think and feel and behave as we did? Why did we act in a way that today, in hindsight, seems so obviously stupid? Only by understanding the answer to these questions can we begin to improve our financial future.

This is where behavioral finance comes in. Most investors are intelligent people, neither irrational nor insane. But behavioral finance tells us we are also normal, with brains that are often full and emotions that are often overflowing. And that means we are normal smart at times, and normal stupid at others.

The trick, therefore, is to learn to increase our ratio of smart behavior to stupid. And since we cannot (thank goodness) turn ourselves into computer-like people, we need to find tools to help us act smart even when our thinking and feelings tempt us to be stupid.

Let me give you one example. Investors tend to think about each stock we purchase in a vacuum, distinct from other stocks in our portfolio. We are happy to realize "paper" gains in each stock quickly, but procrastinate when it comes to realizing losses. Why? Because while regret over a paper loss stings, we can console ourselves in the hope that, in time, the stock will roar back into a gain. By contrast, all hope would be extinguished if we sold the stock and realized our loss. We would feel the searing pain of regret. So we do pretty much anything to avoid that pain — including holding on to the stock long after we should have sold it. Indeed, I've recently encountered an investor who procrastinated in realizing his losses on WorldCom stock until a letter from his broker informed him that the stock was worthless.

Successful professional traders are subject to the same emotions as the rest of us. But they counter it in two ways. First, they know their weakness, placing them on guard against it. Second, they establish "sell disciplines" that force them to realize losses even when they know that the pain of regret is sure to follow.

So in what other ways do our misguided thoughts and feelings get in the way of successful investing — not to mention increasing our stress levels? And what are the lessons we should learn, once we recognize those cognitive and emotional errors? Here are eight of them.

### No. 1 Goldman Sachs is faster than you.

There is an old story about two hikers who encounter a tiger. One says:

There is no point in running because the tiger is faster than either of us. The other says: It is not about whether the tiger is faster than either of us. It is about whether I'm faster than you. And with that he runs away. The speed of the Goldman Sachs of the world has been boosted most recently by computerized high-frequency trading. Can you really outrun them?

It is normal for us, the individual investors, to frame the market race as a race against the market. We hope to win by buying and selling investments at the right time. That doesn't seem so hard. But we are much too slow in our race with the Goldman Sachs.

So what does this mean in practical terms? The most obvious lesson is that individual investors should never enter a race against faster runners by trading frequently on every little bit of news (or rumors).

Instead, simply buy and hold a diversified portfolio. Banal? Yes. Obvious? Yes. Typically followed? Sadly, no. Too often cognitive errors and emotions get in our way.

### No. 2 The future is not the past, and hindsight is not foresight.

Wasn't it obvious in 2007 that financial institutions and financial markets were about to collapse? Well, it was not obvious to me, and it was probably not obvious to you, either. Hindsight error leads us to think that we could have seen in foresight what we see only in hindsight. And it makes us overconfident in our certainty about what's going to happen.

Want to check the quality of your foresight? Write down in permanent ink your forecast of tomorrow's stock prices. Do that each day for a year and check the accuracy of your predictions. You are likely to find that your foresight is not nearly as good as your hindsight.

Some prognosticators say that we are now in a new bull market and others say that this is only a bull bounce in a bear market. We will know in hindsight which prognostication was right, but we don't know it in foresight.

When I hear in my mind's ear a voice that says that the stock market is sure to zoom or plunge, I activate my "noise-canceling" device rather than go online and trade. You might wish to install this device in your mind as well.

### No. 3 Take the pain of regret today and feel the joy of pride tomorrow.

Emotions are useful, even when they sting. The pain of regret over stupid comments teaches presidents and the rest of us to calibrate our words more carefully. But sometimes emotions mislead us into stupid behavior. We feel the pain of regret when we find, in hindsight, that our portfolios would have been overflowing if only we had sold all the stocks in 2007. The pain of regret is especially searing when we bear responsibility for the decision not to sell our stocks in 2007. We are tempted to alleviate our pain by shifting responsibility to our financial advisers. "I am not stupid," we say. "My financial adviser is stupid." Financial advisers are sorely tempted to reciprocate, as the adviser in the cartoon who says: "If we're being honest, it was your decision to follow my recommendation that cost you money."

**See The Mistakes We Make — and Why We Make Them on Page 4**

## The Mistakes We Make — and Why We Make Them *continued from Page 3*

In truth, responsibility belongs to bad luck. Follow your mother's good advice, "Don't cry over spilled milk."

Where am I leading you? Stop focusing on blame and regret and yesterday and start thinking about today and tomorrow. Don't let regret lead you to hold on to stocks you should be selling. Instead, consider getting rid of your 2007 losing stocks and using the money immediately to buy similar stocks. You'll feel the pain of regret today. But you'll feel the joy of pride next April when the realized losses turn into tax deductions.

### **No. 4 Investment success stories are as misleading as lottery success stories.**

Have you ever seen a lottery commercial showing a man muttering "lost again" as he tears his ticket in disgust? Of course not. What you see instead are smiling winners holding giant checks.

Lottery promoters tilt the scales by making the handful of winners available to our memory while obscuring the many millions of losers. Then, once we have settled on a belief, such as "I'm going to win the lottery," we tend to look for evidence that confirms our belief rather than evidence that might refute it. So we figure our favorite lottery number is due for a win because it has not won in years. Or we try to divine — through dreams, horoscopes, fortune cookies — the next winning numbers. But we neglect to note evidence that hardly anybody ever wins the lottery, and that lottery numbers can go for decades without winning. This is the work of the "confirmation" error.

What is true for lottery tickets is true for investments as well...confirmation error misleads us into focusing on investments that have done well in 2008.

Don't chase last year's investment winners. A diversified portfolio of many investments might make you a loser during a year or even a decade, but a concentrated portfolio of few investments might ruin you forever.

### **No. 5 Neither fear nor exuberance are good investment guides.**

A Gallup Poll asked: "Do you think that now is a good time to invest in the financial markets?" February 2000 was a time of exuberance, and 78% of investors agreed that "now is a good time to invest." It turned out to be a bad time to invest. March 2003 was a time of fear, and only 41% agreed that "now is a good time to invest." It turned out to be a good time to invest. I would guess that few investors thought that March 2009, another time of great fear, was a good time to invest. So far, so wrong. It is good to learn the lesson of fear and exuberance, and use reason to resist their pull.

### **No. 6 Wealth makes us happy, but wealth increases make us even happier.**

John found out today that his wealth fell from \$5 million to \$3 million. Jane found out that her wealth increased from \$1 million to \$2 million. John has more wealth than Jane, but Jane is likely to be happier. This simple insight underlies Prospect Theory, developed by Daniel Kahneman and Amos Tversky. Happiness from wealth comes from gains of wealth more than it comes from levels of wealth. While gains of wealth bring happiness, losses of wealth bring misery. This is misery we feel today, whether our wealth declined from \$5 million to \$3 million or from \$50,000 to \$30,000.

We'll have to wait a while before we recoup our recent investment losses, but we can recoup our loss of happiness much faster, simply by framing things differently. John thinks he's a loser now that he has only \$3 million of his original \$5 million. But John is likely a winner if he compares his \$3 million to the mountain of debt he had when he left college. And he is a winner if he compares himself to his poor neighbor, the one with only \$2 million.

In other words, it's all relative, and it doesn't hurt to keep that in mind,

for the sake of your mental well-being. Standing next to people who have lost more than you and counting your blessings would not add a penny to your portfolio, but it would remind you that you are not a loser.

### **No. 7 I've only lost my children's inheritance.**

Another lesson here in happiness. Mental accounting — the adding and subtracting you do in your head about your gains and losses — is a cognitive operation that regularly misleads us. But you can also use your mental accounting in a way that steers you right.

Say your portfolio is down 30% from its 2007 high, even after the recent stock-market bounce. You feel like a loser. But money is worth nothing when it is not attached to a goal, whether buying a new TV, funding retirement, or leaving an inheritance to your children or favorite charity.

A stock-market crash is akin to an automobile crash. We check ourselves. Is anyone bleeding? Can we drive the car to a garage, or do we need a tow truck? We must check ourselves after a market crash as well. Suppose that you divide your portfolio into mental accounts: one for your retirement income, one for college education of your grandchildren, and one for bequests to your children. Now you can see that the terrible market has wrecked your bequest mental account and dented your education mental account, but left your retirement mental account without a scratch. You still have all the money you need for food and shelter, and you even have the money for a trip around the country in a new RV. You might want to affix to it a new version of the old bumper sticker: "I've only lost my children's inheritance."

So here's my advice: Ask yourself whether the market damaged your retirement prospects or only deflated your ego. If the market has damaged your retirement prospects, then you'll have to save more, spend less or retire later. But don't worry about your ego. In time it will inflate to its former size.

### **No. 8 Dollar-cost averaging is not rational, but it is pretty smart.**

Suppose that you were wise or lucky enough to sell all your stocks at the top of the market in October 2007. Now what? Today it seems so clear that you should not have missed the opportunity to get back into the market in mid-March, but you missed that opportunity. Hindsight messes with your mind and regret adds its sting. Perhaps you should get back in. But what if the market falls below its March lows as soon as you get back in? Won't the sting of regret be even more painful?

Dollar-cost averaging is a good way to reduce regret — and make your head clearer for smart investing. Say you have \$100,000 that you want to put back into stocks. Divide it into 10 pieces of \$10,000 each and invest each on the first Monday of each of the next 10 months. You'll minimize regret. If the stock market declined as soon as you have invested the first \$10,000 you'll take comfort in the \$90,000 you have not invested yet. If the market increases you'll take comfort in the \$10,000 you have invested. Moreover, the strict "first Monday" rule removes responsibility, mitigating further the pain of regret. You did not make the decision to invest \$10,000 in the sixth month, just before the big crash. You only followed a rule. The money is lost, but your mind is almost intact.

Things could be a lot worse. 🌀

*Dollar-cost averaging does not assure a profit or protect against loss in declining markets.*

*Reprinted by permission of the Wall Street Journal. Copyright © 2009. Dow Jones & Company, Inc. All Rights Reserved Worldwide. License number 2260480255977. Dow Jones & Company's permission to reproduce this article does not constitute or imply that Dow Jones sponsors or endorses any product, service, company, organization, security or specific investment.*

*Photo courtesy Santa Clara University.*