

Spring 2011

"HELPING YOU MAKE SMART CHOICES ABOUT YOUR MONEY"

## YOU CAN IMPROVE YOUR INVESTING: JUST TRY MODIFYING YOUR BEHAVIOR

**A**re you unhappy with your investment returns? If so, here is one of the most important tips you will ever get: It is more likely that your own behavior—not the action in the markets— is getting you down.

Investment markets fluctuate constantly, but investors who stick with balanced portfolios over the years tend to do well. The problem for many investors, though, is being able to stick to a strategy when markets fluctuate wildly in the short term.

For years Dalbar Inc., a major investment research firm, has compared the average returns of stock mutual funds with the actual returns earned by investors in those funds. The long-term results aren't pretty.

### Behavioral issues

The most recent survey that included returns for the 20 years ended in 2009 showed that the average U.S. stock fund earned 8.2 percent per year. The average stock fund investor, however, earned about 3.2 percent a year.

Why is there such a gap? Investor behavior is to blame, Dalbar says. Investors don't plunk their money down into an indexed U.S. stock fund and leave it alone for 20 years. Instead, they buy and sell, often at the wrong times in the market's cycle.

Dalbar uses statistics on flows of money into and out of mutual funds to calculate the pitiful average investor returns.

### Resolve to change

The year is still young yet, and you have plenty of time to turn your portfolio management around by using several behavioral modification techniques.

First, look back at your own behavior with honesty. Did you get scared and sell out during the market downturns in 2008, 2002, or 1987? Did you throw money at the tech stock du jour when the market was going up in the late 1990s?



A new year should bring new thinking about your investment decisions. Resolve to change your behavior in 2011.

Second, admit that years of sound academic research are correct in concluding that there are no star money managers who will consistently beat the market. You won't find them if you look, so why bother? All you will uncover are those who have done well in the past, but that tells you nothing about the future.

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# INVESTORS WHO ARE SHUNNING STOCKS SIT ON A FIXED INCOME POWDER KEG

The trauma from huge stock market declines and financial crisis in 2008 continue to weigh on the portfolios of many individual investors today.

Statistics show that a lot of retirement savers yanked some or all of their money out of stocks and put it into government bonds or bank deposits. Many investors remain fearful of stocks, despite the climb in stock prices that began in March 2009.

However, even though bond investors have been rewarded with capital gains over the last two years as interest rates declined and bond demand held steady, they are now in a potentially bad position, say the principals of Tweedy, Browne & Co., a New York investment firm.

“It is quite ironic that in an effort to flee volatile equity markets, investors in high quality low coupon bonds today sit on a potentially significant risk, should we face inflation and rising interest rates,” they write in the company’s latest semi-annual mutual fund report.

### An inflation threat

Yes, stock market volatility can threaten a portfolio, but so can inflation, and too many investors may be discounting a return of inflation.

Tweedy, Browne notes that the Federal Reserve has said it wants to see more inflation. As *The Wall Street Journal* notes, “Central bankers who wish for more inflation usually get their wish, and the result is rarely benign.”

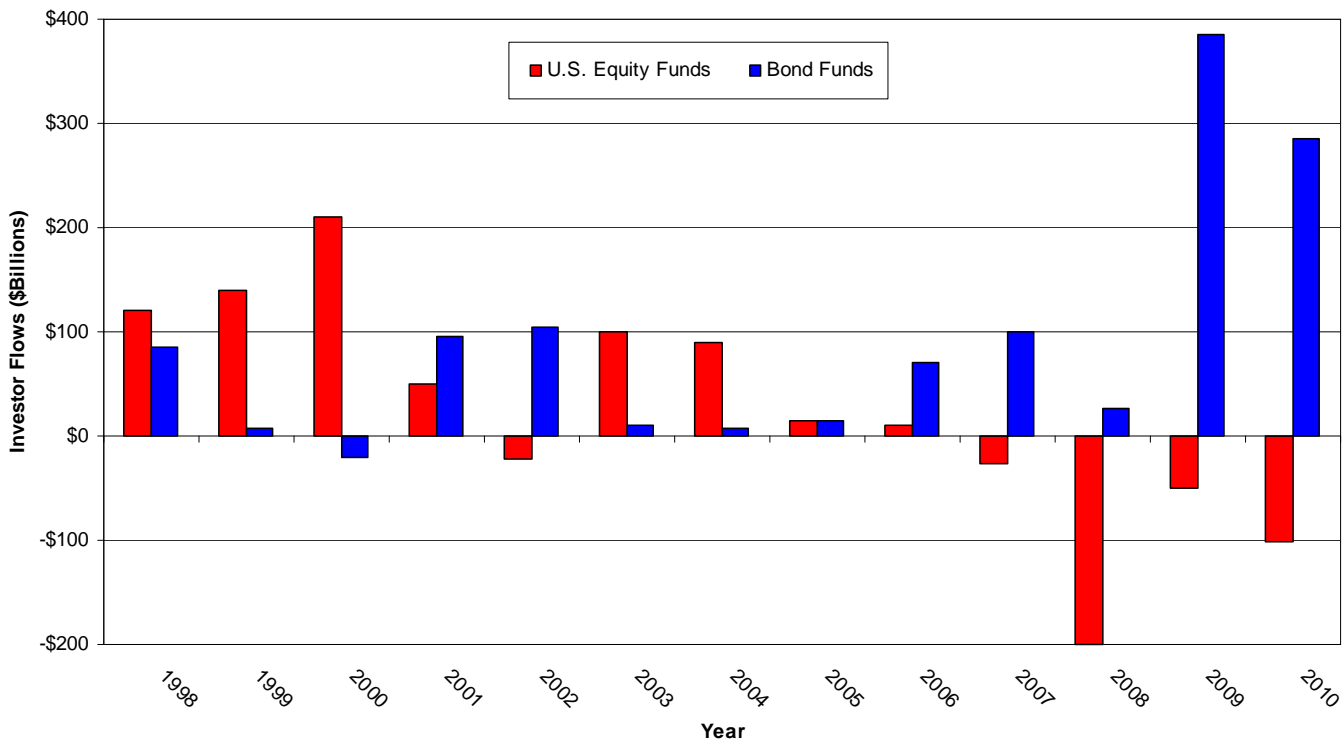
Even at today’s 2 percent inflation, money is under attack. A thousand dollars today will be worth just \$817.07 in 10 years. If inflation goes up to 4 percent, that \$1,000 will be reduced to \$664.83. At 6 percent inflation, it will go to \$538.62.

Tweedy, Browne’s principals say that low rate bonds will be big losers in an inflationary environment. They note that some investors call such bonds “certificates of confiscation.”

Stockholders, especially those who own dividend-paying stocks, have a much better chance of keeping ahead of inflation.

During the high-inflation 1970s, inflation and bond yields virtually matched each other, ranging from 7 percent in 1975 to 12.4 percent in 1980. Stocks, however, appreciated at an annualized rate of 17.6 percent from 1974 through 1980, about twice the rate of inflation.

## The Bond Fund Juggernaut: Annual Mutual Fund Flows



The above bar graph demonstrates the investment flows into and out of U.S. Equity Funds and Bond Funds. Note the huge inflows to Bond Funds in 2009 and 2010 despite the climb in stock prices that began in March.

Source: Credit Suisse—Portfolio Strategy, ICI

## STOCK ANALYSTS PROVE TO BE BAD GUIDES

When you see those ever-confident stock analysts on the financial cable shows talking about why a particular stock will do well, you might want to change the channel quickly.

Analysts seem to do a pretty poor job of predicting which stocks will shine and which will not, according to data compiled by Bloomberg, the big financial news service.

It said that since the U.S. stock market started to recover in March 2009, stocks that analysts didn't like have risen at more than twice the rate as stocks they adored.

### S&P winners

Bloomberg sorted the stocks in the Standard & Poor's 500 Index and found that stocks the analysts gave the fewest recommendations to increased by an average of 165 percent, while those the analysts loved rose by an average of 73 percent.

One investment advisor quoted by Bloomberg said he likes to invest in stocks the analysts don't like.

Stock analysts seem to recommend too many stocks after they have gone up, and fail to pick those that will become winners.

"You've got a stock that has 15 sells on it, you're set up there to have some strong outperformance," said Don Wordell of RidgeWorth Capital Management Inc. in Atlanta.

During 2010 stock analysts by and large picked health care and technology companies as the most likely to succeed. Instead, those sectors were among the lowest for the year, gaining less than 10 percent on average.

Analysts on average did not recommend banks and real estate firms, yet those industries rose by 19 percent and 28 percent during the year, Bloomberg said.

Bloomberg looked at each individual stock rating by each analyst and assigned a rating number from 1 for sell to 5 for buy. It then looked at the stocks with the most buy and sell ratings. In 2010 the stocks with the most buy ratings gained an average of about 9 percent, while those with the most sell ratings gained an average of 20 percent.

Bloomberg analysts favored health care stocks last year because they did not expect health care reform to pass Congress.

## WHY DO MUTUAL FUND INVESTORS KEEP CHASING ACTIVE FUNDS?

Objective mutual fund performance studies have shown time and time again that passive, indexed mutual funds beat their more expensive actively-managed cousins. If that is true, why do investors still overwhelmingly buy active funds rather than passive funds?

Only about 10 percent of the assets invested in mutual funds has gone into passive, indexed funds, says the industry's trade group, the Investment Company Institute, in its 2010 annual report.

The vast majority of individual investors' money has gone into funds that actively pick and choose which investments to buy based on the fund manager's outlook for the economy, the markets, and individual industries and companies.

### A poor value

"Given the limited value that these funds seem to offer to their shareholders and the size of the fees they charge, current academic wisdom suggests implementing a simple passive investment strategy based on well-diversified, low-cost fund alternatives," say Sebastian Müller and Martin Weber, two German university professors who researched this question.

They studied 3,000 mutual fund investors to see if there was any relation between their financial literacy and their purchases of passive or active mutual funds.

### Just overconfident

They expected that investors who had lower financial literacy would be influenced by salespeople and advertising to buy active funds.



Sales of actively-managed mutual funds continue to dominate the industry.

They were surprised to find, however, that although financially literate investors were more aware that passive indexed funds were a better deal, the majority continued to plunk their money into active funds.

"One possible explanation for this result lies in the overconfidence phenomenon," they write. "Investors might overestimate their ability to identify outperforming funds."

They said they found a positive relation between the investors' belief in their own ability to identify superior investments and the likelihood that they would buy actively-managed funds.

But since active funds do not tend to do better than passive funds, these sophisticated investors in essence outsmarted themselves by being overconfident.

# SMALL STOCKS BEAT BONDS, BABY BOOMERS AND MORE

## Small stocks beat bonds

A lot of attention has been paid to how bond returns beat large stock returns over the last decade.

But stock investors should not mope: stocks of small companies prospered over the past 10 years. The Center For Research in Securities Prices says small stocks earned 11.5 percent annually over the 10 years ended last Nov. 30, compared to a 6 percent annualized return on U.S. Treasury Notes.

## Baby Boomers

About half of baby boomers have no plan in place in case they live longer than expected, a study by the Society of Actuaries has found.

“With the challenges in the housing and financial markets over the past few years, coupled with the fact that people are living longer, many baby boomers are finding themselves unprepared to maintain their lifestyle in retirement,” said a spokeswoman.

The majority of boomers surveyed for the study planned to take Social Security before age 70, although the Society encourages retirees to wait as long as possible to let the benefit increase.



## Hindenburg flames out

Yet another silly market indicator has crashed and burned. This time it was the Hindenburg Omen, a technical indicator that tries to predict instability based on the number of new highs and lows on the New York Stock Exchange.

Last summer the indicator predicted a pending market crash. Since then the S&P 500 Stocks Index has risen by more than 20 percent.

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Third, treat the financial news as entertainment. That’s really all it is. The networks, the news shows, the magazines and newspapers all are trying to catch your attention in order to get you to look at the advertisements that keep them alive.

A story that says you should diversify and hold your investments is boring and you will find barely a mention of it in the mass media. Instead they will throw contradictory investment recommendations and economic forecasts at you. Letting any of that influence your investment decisions can easily derail your portfolio.

Fourth, you should resolve to rebalance your portfolio annually. That will mean selling portions of your recent

winners and reinvesting the money into the laggards. This will force you to sell high and buy low and will help control your risk.

### Get help

Finally, you may want to get realistic and admit to yourself that it is the rare person who can go it alone.

Work with an advisor who can put your longings and fears about your portfolio and the markets into perspective and help you sort out the reasons for or against taking precipitous action with your portfolio. Above all, avoid making snap decisions on your own—sit on them for awhile and seek advice.

## Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors’ returns within their tolerance for risk. Here is what sets us apart:

- ◆ Fee-only investment management
- ◆ A disciplined investment strategy
- ◆ Access to institutional no-load passive asset class funds
- ◆ An academic Nobel Prize-winning investment approach

- ◆ Continued access to academic research
- ◆ A tax-efficient focus with valuable tax- and estate-planning ideas
- ◆ Risk tolerance assessment
- ◆ Periodic portfolio rebalancing
- ◆ Regular communications and state-of-the-art reporting
- ◆ No front-end loads, no back-end loads, no surrender fees, not locked in
- ◆ **MOST IMPORTANT ...  
A TRUSTED ADVISOR RELATIONSHIP**

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