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Adding Balance to Wealth℠

ASSET CLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

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There's Opportunity in Simplicity (Part 1)

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We know the research behind asset class investing (Modern Portfolio Theory, The Efficient Market Hypothesis, and the Fama & French Three-Factor Model) can be a bit daunting for some investors. But this knowledge has transformed long-term investing in so many positive ways that we believe it's imperative our clients understand it on a higher level than most investors do.

The challenge is to convey the benefits of our approach in ways that establish realistic expectations and increase our clients' confidence in a long-term strategy. Since risk is *the* essential component in all of this and is often misrepresented or even ignored in too many advisor-client relationships, we need to be more creative and effective in how we talk about this basic source of return in an era of efficient markets.

To this end, Equius is holding a series of client events in June centered on simple, yet very powerful investment images we've created to represent the essence of asset class investing principles.

Too many numbers

When we started talking about the benefits of our strategy in the early 1990s, it seemed necessary, since so much financial science is behind the approach, to talk about standard deviations, variance, correlation coefficients, multiple regression analysis, and systematic and unsystematic risk, among other things. Numbers, numbers, and more numbers.

In hindsight, I think we were delusional to think that much of what we were conveying was actually making sense in the way we wanted it to. In fact, I think the number that stuck in most clients' minds was 80%—the widely quoted failure rate of old-school active management—because it confirmed what these clients had intuitively learned from years of broken promises and misguided expectations with respect to stock picking and market timing.

But the realization that active management is a perpetually cruel joke foisted on serious investors is not enough to carry you through volatile markets. For too many investors over the last 15 years, stocks in general became the bad joke—no matter how much science, reason, experience, or logic was brought to bear on the subject.

Active management is just one of many kinds of *uncompensated* risk that investors should avoid. We still have to deal with *compensated* risks and how to put these risks into a perspective that is realistic, truthful, and ultimately beneficial to clients seeking to reach certain goals over 15-, 20-, 30-, or even 50-year periods.

Triggering the "aha!" moment

Several years ago, Equius decided to meet this challenge by creating a series of posters and handouts that illustrate historical asset class risk and return using unique visual techniques. We transform numbers into colors and images, represented in ways that are true and accurate but far less intimidating and confusing. "Aha!" is a common reaction to these presentations, even among clients we've served for many years.

Our goal is to transform investors from easily deceived dependents of Wall Street "wizards" to confident drivers of their own financial destiny. We *partner* with our clients in knowledge, confidence, and discipline rather than being intimidating men and women who hide behind curtains of complexity—pulling levers, evoking strong emotion, and ultimately just expelling a lot of smoke and hot air.

I'm reminded of this difference whenever State Street Global Advisors' new advertisement annoyingly pops up on my iPad. Their tagline is "There's Opportunity in Complexity." I actually laughed out loud when I first saw it. *Of course there's opportunity in complexity*—for State Street!

In four simple words (irony alert), they summed up nicely what I and so many other enlightened and evolved investors have learned over the last three decades about Wall Street and its legion of old-school stockbrokers, investment managers, and financial advisors.

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Simple, but not easy

The fact is, *there's opportunity in simplicity*—for investors. Millions have recognized this over the past decade by shifting a massive amount of wealth from active management to index funds.

But what investors should realize is that while the basic principles of long-term investing are relatively simple, appropriate implementation and consistent maintenance of an optimal strategy is certainly not easy.

Simply shifting from active management to indexing, for example, is not enough. The benefits of indexing can be, and too often are, wiped out by a lack of appreciation for the other challenges of long-term investing.

Too many investors buy high and sell low.

We know this by observing actual money flows in and out of stock mutual funds during various market cycles. Investors succumb to their emotions and habitually buy high and sell low—destroying wealth that can be regained only by taking inappropriate levels of additional risk.

Too many investors constantly tweak portfolios.

We know this by observing mutual fund cash flows into "alternative" investments and pseudo asset classes like precious metals, commodities, technology, oil and gas, hedge funds, REITs, emerging markets, master limited partnerships, mortgage securities, and others at various times in the market cycles. Picture a cat chasing its tail.

Too many investors misunderstand risk.

We know this by talking to prospective clients about their perception of stock market risk and their past behavior during volatile periods. These investors are too concerned with daily, monthly, and yearly return volatility despite having significantly longer investment time horizons. Not only does this create anxiety that leads to destructive market timing decisions, but it's also reflected in much lower portfolio stock allocations than what is needed to meet important financial goals far into the future.

Too many investors overemphasize fund expenses at the expense of long-term net returns.

We know this by the fact that too many investors settle for traditional index funds that fail to more fully capture the long-term risk premiums offered by U.S. and foreign small cap and value stocks. These investors leave substantial expected returns on the table by focusing exclusively on fund expense ratios rather than considering more critically the *net* benefits of more optimally structured "asset class" funds and portfolios.

All of this knowledge is confirmed and highlighted by the fact that experienced, educated, and seemingly sophisticated *financial advisors* make these very same mistakes, and more, costing their clients dearly over time.

Our answer to these challenges

Our infographic titled "The Evolution of Modern Value Investing" helps investors understand the evolution of markets, technology, and financial science since the Securities Act of 1933 was passed 83 years ago and offers clear support for a more modern asset class approach to long-term investing.

Our "Stocks Reward Patience" illustrations present an 88-year history of the U.S. stock market and, for contrast, U.S. small value stocks in a way that investors have never experienced before. These tools are very effective in shifting investor focus from short-term volatility to a more appropriate long-term view. This change in perception, along with focused and consistent counseling by our advisors during difficult periods, has produced much better outcomes (higher growth in wealth, less anxiety, greater confidence, and so on) for our clients over time.

Our "Yearly Returns Are Random" graphics are clear illustrations of the insanity of market timing as well as the lack of value created (or, more often, value destroyed) by expanding beyond a handful of core asset classes in a well-structured portfolio.

Our "Investing Metamorphosis" illustration completes the loop by highlighting how so many in our industry have failed to transform beyond the caterpillar stage of 1930's-era security analysis—despite all the advances in technology, financial and behavioral science, the dominance of institutional trading in the markets, and other significant developments of the past eight decades.

Next month I'll outline steps investors can take to simplify their investment strategies and also discuss how so many investment advisors perceive *insecurity* rather than *opportunity* in simplicity.

Note: We make a few of these illustrations available as wall posters and handouts to other advisors and investors at assetclassinvesting.com.

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