



INVESTING for SUCCESS

UNDERSTANDING THE FOUR KEY PRINCIPLES

OVERVIEW

SINCE THE DAWN OF THE MODERN DAY MARKET, INVESTORS HAVE BEEN TRYING TO BEAT THE ODDS.

There have been many studies, theorists and practitioners who have believed they have found the answer. The simple truth however, is that the market is such a complex and volatile system that no investor is capable of beating it entirely. However, there are a number of principles that have proven through time to be effective at guiding successful investment decisions. As with all investments, there is never a 100% guarantee of success, but investing is all about hedging your bets.

**THIS IS WHY WE HAVE COVERED THE FOUR KEYS TO INVESTING FOR SUCCESS;
TO HELP GUIDE YOU THROUGH THE VOLATILITY AND USE IT IN YOUR FAVOR.**



1 UNDERSTANDING YOUR INVESTMENT PHILOSOPHY

What lies at the heart of almost every investor's philosophy and strategy is the principle of diversification. This really took root in 1990 when Harry Markowitz and William Sharpe were awarded the Nobel Prize in Economics for their work on Modern Portfolio Theory (MPT). The main premise of MPT was the concept that diversification and how spreading one's risk in different directions would reduce the investor's variability of returns (referred to as volatility). This paper is not a critique of MPT per se, but a review of how we believe it has been used out of context. For example, many say be diversified to subdue risk... don't put all of your eggs in one basket. We say investors put their eggs in too many baskets, meaning they fall to the perils of over-diversification.

We've all heard industry experts expound on the benefits of diversification, and we agree with the general concept, as a stock portfolio must be diversified to some degree. After all, none of us wish to "put all our eggs in one basket" because if the basket falls to the ground the likelihood of all the eggs cracking is high. From an investment sense, if you own stocks in a single sector and that one sector suddenly drops in value, you can lose a substantial amount of your principal. **But can you go too far in spreading your risk? We believe that you indeed can.**

There are many studies demonstrating why diversification works. The concept is supported by the premise of combining assets with different properties that have low correlation to each other, and one ends-up reducing price volatility. That said, it's important to remember that no matter how diversified your portfolio is, your risk can never be eliminated. You can reduce risk (standard deviation or variation of returns) associated with individual stocks called unsystematic risk, but there are inherent market risks called systematic risks, that affect nearly every stock. **No amount of diversification can prevent this.**



"After all, none of us wish to "put all our eggs in one basket" because if the basket falls to the ground the likelihood of all the eggs cracking is high."

We believe to be a successful long-term investor, one must embrace systematic risk and volatility, and realize it is a beneficial component to investing, not a disadvantage.

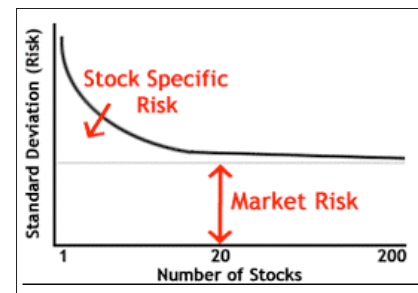
Volatility creates the opportunity for an investor to continue to invest in great companies at lower prices over time. However, our Philosophy is also based on the idea that many investors do not like volatility because they do not have the Flexibility needed to take advantage of volatility. Additionally, if investors do not understand what they presently own in their portfolio, they also lack the means to have the conviction that is also needed to continually invest in great companies.

So, how many stocks in a portfolio are needed for it to be considered truly “diversified?” In Edwin J. Elton and Martin J. Gruber’s book “Modern Portfolio Theory and Investment Analysis”, they concluded that the average standard deviation (risk) of a portfolio of one stock was 49.2%. Furthermore, they found that methodically increasing the number of stocks in the average well-balanced portfolio could in essence reduce the portfolio’s standard deviation to 19.2% (this number represents market risk). What was remarkable was the fact that they also found that with a portfolio of 20 stocks the risk was reduced to about 20%. Therefore, the additional stocks from 20 to 1,000 only reduced the portfolio’s risk by about 0.8%, while the first 20 stocks reduced the portfolio’s risk by 29.2% (49.2%-20%).¹

¹ From the book “Modern Portfolio Theory & Investment Analysis” by Edwin J. Elton and Gruber.

TRUE DIVERSIFICATION -

Many investors have the misguided view that risk is proportionately reduced with each additional stock in a portfolio, when in fact this couldn’t be further from the truth. There is strong evidence that you can only reduce your risk so much at which point there is no additional benefit from diversification. The study mentioned above isn’t suggesting that buying any 20 stocks equates with optimum diversification. True diversification is only garnered when one combines assets with unlike properties (low correlation) to achieve optimal efficiency. Thus, a 20-35 stock portfolio should be diversified amongst various sectors and industries to assure that variation in returns is being reduced.



Source: Investopedia

MUTUAL FUNDS - In our estimation most mutual funds do a pretty poor job of diversifying investor assets. What is ironic is that owning a mutual fund that invests in several hundred companies doesn’t necessarily mean that you are optimally diversified either. Many mutual fund holders suffer not from being under-diversified but rather over-diversified. Some funds, especially the larger ones, have so many assets that they literally have to hold hundreds of stocks and consequently, so are its investors. To add fuel to the fire, many investors in pursuit of perceived diversification will end up owning 10 or more stock funds that have 200+ holdings and thus have 2000+ holdings. This culminates in a portfolio that has a tremendous overlap of securities coupled with a minuscule percentage of ownership per security and thus equates to a severely inefficient portfolio. The investor gets the double-whammy of being over-diversified and ineffective at the same time. This is part in parcel why mutual fund investors tend to jump from one fund to another, and as the Dalbar Study concludes, earns substantially less than the market has to offer.

CONCLUSION - Diversification is like Chocolate: it’s good, but only in reasonable quantities. The common consensus is that a well-balanced portfolio with approximately 20 stocks diversifies away the maximum amount of market risk. Knowing what you own and why you own it can only be accomplished by a limited number of holdings, as owning additional stocks takes away the potential of big gainers significantly impacting your bottom line. It is the same case with large mutual funds investing in hundreds of stocks. According to Warren Buffett: “Wide diversification is only required when investors do not understand what they are doing”. **Bottom-line... Understand your Philosophy!**



EXECUTING YOUR INVESTMENT STRATEGY

Many investors may say their investment strategy is focused on attempting to lower volatility as much as possible. But, if risk is to be avoided, then volatility (which is defined as *risk* by MPT) should be avoided as well. **Truth be told, volatility is not risk and should not be feared.** Rather, it should be embraced as an ally. We declare this because the most proficient mechanism in investing today, Dollar-Cost-Averaging (DCA), requires volatility.

However, DCA can be taken an important step further. We call it, Strategic Cost Averaging™ (SCA). SCA not only requires volatility, it thrives in it. *Imagine that you're given the choice between:*

- Investing \$1,000 in an investment with a fixed 8% annual return each year for three years, or
- Investing \$1,000 in an investment that has averaged an 8% annual return over the same period, but has historically been volatile, earning a positive return in some years and a negative return in others.

Which would you choose? I'd imagine that most people would choose the one with a fixed return.

SCENARIO 1 - The following chart shows our zero-volatility example (investing \$1,000 per year with the investment earning exactly 8% per year.) As you can see, at the end of the period you would have invested \$3,000 and it would have turned into \$3,506.11.

	Year 1	Year 2	Year 3	Year 4
Shared Price	100.00	108.00	116.64	125.97
Invested	1,000.00	1,000.00	1,000.00	
Shares Purchased	10.00	9.26	8.57	
Total Shares Owned	10.00	19.26	27.88	27.83
Total Value	1,000.00	2,080.00	3,246.40	3,506.11

- Average return earned by the investment: 8%
- Volatility: None
- Amount of money at the end: \$3,505.74
- Return earned on your investment: 8%

SCENARIO 2 - The investment still averaged the exact same 8% annual return (i.e., started at a \$100 share price and three years later had a share price of \$125.97). However, the investment fluctuated in price from our 8% every-year scenario. This time, instead of the share price in Year 2 being \$108, it was \$88 (or \$20 lower). In Year 3, instead of \$116.64 it was \$136.64 (\$20 higher).

	Year 1	Year 2	Year 3	Year 4
Shared Price	100.00	88.00	136.64	125.97
Invested	1,000.00	1,000.00	1,000.00	
Shares Purchased	10.00	11.36	7.32	
Total Shares Owned	10.00	21.36	28.68	28.68
Total Value	1,000.00	1,880.00	3,919.13	3,613.09

- Average return earned by the investment: 8%
- Volatility: \$20 downward, followed by \$20 upward
- Amount of money at the end: \$3,613.09
- Return earned on your investment: 9.59%

The return earned on actual invested dollars were 19.87% higher in Scenario 2. The conclusion: using volatility through a disciplined process, such as Strategic Cost Averaging™, can potentially enhance returns over time even when your first year's return is negative. This is due to fact that you are automatically buying more shares when the market is low and fewer when the market is high. **Of course, there are no guarantees. However, when the investment process includes investing in quality companies, Strategic Cost Averaging™ can be a tremendous benefit to long-term investing.**

CONCLUSION - At the end of the day, increased volatility simply creates a situation in which the market lows are lower, thereby making the investment process more effective. Hence greater volatility can equate to greater returns. **Lastly, the volatility of the stock market isn't just something you have to put up with in order to earn superior returns; it's actually an essential factor that directly improves your returns.**

3 ALLOW YOUR MONEY MANAGER UNFETTERED FLEXIBILITY

IS YOUR MONEY MANAGER CONSTRAINED TO A CERTAIN BENCHMARK, PEER GROUP OR PROSPECTUS

OBJECTIVE? Research done by the University of Denver and ICON Advisors emphatically states that “style box” investing constrains a manager’s ability to manage money and by limiting their flexibility causes severe underperformance.² Current practice has most money managers being hired to represent a particular “style box” or peer group such as Small Cap Value or International. As the aforementioned research shows this system has absolutely no empirical basis, but simply evolved out of convenience. Unfortunately, along the way assumptions essential to its validity were made and believed to be true without any support whatsoever.

These academic studies have concluded that “boxing in” a portfolio can increase volatility and reduce returns. In fact, Morningstar, which introduced its nine-box grid in 1992, has said that the boxes were never intended to construct a portfolio. The system imposed by boxes seems rational, but it lacks flexibility which is contrary to the ultimate objective of investing. Flexibility is required both to pursue compelling opportunities and to minimize risk. Money management requires a sound philosophy and strategy, the ability to invest with unfettered flexibility and vision that extends beyond artificial boxes.

These studies make several points about investing by the box. Rigid adherence to “boxes” will force managers to work toward objectives that diverge from those of the investors. Further, efforts to fit into a box (and stay there) place constraints on investment managers that can lead to poor results. (Several of these studies also indicate that diversifying among boxes does not necessarily ensure risk reduction, the often cited benefit.) Finally, Morningstar has made it clear that they never intended for boxes to constrain investment managers or drive portfolio construction.

The investment process should be driven by its philosophy and strategy and not whether it fits in a style box or not. If the portfolio management is driven by a specific Investment Philosophy and Strategy, the Flexibility not only allows the investor to avoid “cookie-cutter” investing and the limitations set on portfolios, it also allows the power of SCA to not only potentially enhance portfolio performance, but, also allow for greater flexibility in tax efficient management (where applicable) in an investor’s portfolio.

2 Based on ICON Advisors research, “The Problematic Style Grid” by Charles Howard, July 2005.



“Rigid adherence to “boxes” will force managers to work toward objectives that diverge from those of the investors.”

CONCLUSION -

- Style boxes are now widely used to construct and monitor portfolios — they were designed to evaluate and monitor investments not to be a rigid framework for asset allocation.
- Research indicates that managers constrained by style boxes underperformed “unconstrained” or more flexible managers.
- Flexibility allows for tax efficient management of a portfolio where applicable.
- Managers that focus on philosophy and strategy-based investing rather than an arbitrary “style-box” have greater flexibility and provide higher returns with lower volatility over the long term.
- Stock selection should be based on a company’s ability to deliver long-term value to shareholders, not on staying in a style box.
- SCA can provide the flexibility allowing stock market volatility to be an investor’s friend.



HIRING A FIRM THAT PROVIDES TRANSPARENCY

DO YOU KNOW THE COMPANIES YOU OWN IN YOUR PORTFOLIO? As an investor in a company's stock you are an owner of that business. Yet, a majority of investors have no idea what they own in their portfolio; not even their top holding. We believe investors should know what they own and the reasons why they own it. With many of today's portfolios being constructed with mutual funds and ETFs, there are several hundred, if not thousand, companies in an average portfolio. Knowing enough about each of those companies to understand how to make investment decisions is a daunting, if not impossible, task.

For instance, when a company's stock price unexpectedly goes down, was it due to market forces or because of fundamental changes within the company? Is the situation one of a damaged stock or damaged company? Stocks are damaged by the stock market. Companies are damaged by the firm's management. If an investor is not familiar with the companies behind the stocks, they are not in a position to make rational decisions.

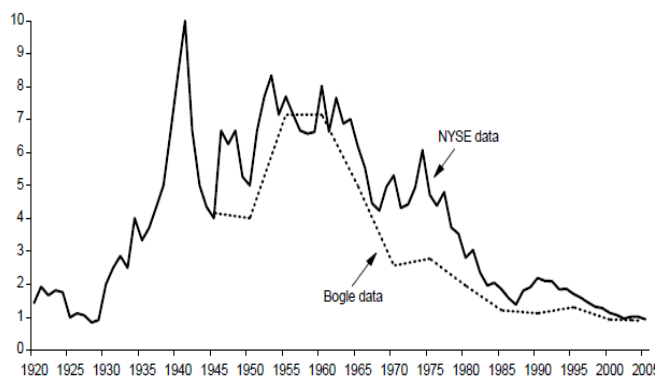
We believe today's investors are bedeviled by myopic time horizons. As society desires immediate gratification and short-term results, advisors, consultants and money managers are measuring performance on increasingly shorter time horizons. What causes this phenomenon? We contend that it comes from the premise that investors (and maybe some financial professionals) simply do not know what they own and why they own it.

Mutual funds are designed to not be transparent; if they were transparent, it could exacerbate front-running. The Investment Act of 1940 structured mutual funds in a way that leaves the investor uncertain as to when and why a money manager bought or sold a position. Research irrefutably states that people will by nature succumb to extreme emotions such as fear and greed when presented with the unknown or intense situations. This lack of transparency has led to extremely dramatic changes in the way people approach investing. Without knowing what they own and why they own it, their emotions take over their state of discipline and produce highly irrational outcomes such as an inordinate amount of trading and a seemingly uncanny ability to "buy high and sell low!"

Research done by Dr. KW Macro and Bogle Research in 2005 showed that as the investment world has moved to an industry consumed with "packaged products" (and thus a lack of transparency) that stock ownership based over time has dramatically been reduced. As the adjacent chart shows, in 1960 before the giant move to mutual funds, the average holding period of NYSE listed stocks was 8 years. Today it stands at 11 months.

Simply put, investors as shareholders have left the confines of being an owner in a business to a speculator using fear and greed (because they do not know what they own and why they own it) to drive their investment decision-making process.

The average holding period of NYSE listed stocks (years)³



³ Drescher Kleinwort Wasserstein "Seven Deadly Sins of Money Managers" and developed by Dr. KW Macro and Bogle, 2005.

CONCLUSION - No one said it better than John Maynard Keynes when he opined that, "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only." **Keynes made this quote in 1936...wow...what do you think he would have to say about today?**

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CONCLUSION

At the end of each day, as the closing bell rings, every money manager, Registered Investment Advisor and investor should reflect on their decisions. Was there a regular pattern, reason, or logic to the decisions made? If not, you should really reconsider your strategy, or lack thereof. This is why we have outlined our four keys to Investing for Success.

These keys are simple enough to understand, but all too easy to neglect:

- **A back-to-basics philosophy centered on clarity that has the validation of long-term success**
- **An investment strategy that utilizes market volatility, Strategic Cost Averaging™, and long-term investments in quality companies found in a select few sectors;**
- **The flexibility needed to allow for tax efficient management of a portfolio as well as turning market volatility into an ally and providing higher returns over the long run;**
- **A level of transparency that will guide your investment decisions by helping you understand what you own and why you own it.**

Take the time to re-evaluate your investment decisions and ensure that you are Investing for Success.

CONCLUSION (continued)

We can sum-up the four keys to Investing for Success in the following manner:

1. Make sure you know what you own and why you own it. Strive not to be overly-diversified and remember as Buffet said; "Wide diversification is only required when investors do not understand what they are doing".

Bottom-line... Understand your Philosophy!

2. Contrary to Modern Portfolio Theory we would argue that volatility (i.e. risk) is not your enemy but your friend. Simply put, the volatility of the stock market isn't just something you have to put up with in order to earn superior returns; it's actually an essential factor that directly improves your return.

Bottom-line... Work your Strategy and make sure your Strategy works for you!

3. View yourself as a business owner vs. a speculator in the so-called "markets." Hiring a money manager that is unabashedly transparent is paramount in the investing process. Remember the wisdom of John Maynard Keynes nearly 80 years ago when he said; "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils."

Bottom-line... Demand that the money manager you hire is vigilant about being Transparent at all times!

4. Don't get caught up in the style-box trap. Make duly sure that your money managers have complete flexibility and are equipped with every tool possible to execute the strategy for which you hired them. Peer group comparisons, benchmarking and style box "handcuffing" are used as crutches for a weak investment philosophy. The current system imposed by said constraints seem rational and intuitive, but at the end of the day lacks flexibility which is contrary to the ultimate objective of investing. Flexibility is required both to pursue compelling opportunities and to minimize risk.

Bottom-line... Seek out a money manager who welcomes the ability to invest with unfettered Flexibility and vision that extend beyond artificial peer group comparisons, style boxes and benchmarking!

We believe that the proper investment Philosophy, Strategy, Flexibility, and Transparency are the keys to Investing for Success... it's an idea that allows us to Invest With Clarity™.



**Listen to Mark Pearson
share his insights on how
to Invest With Clarity™.**

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