SERVŌ WEALTH MANAGEMENT
Simplify Complexity

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Factors In Focus

The Simplest Principles Are The Most Profitable

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In an article on his website *A Wealth of Common Sense*, blogger and portfolio manager Ben Carlson makes the case that you should be able to explain your investment philosophy in a 60-second conversation.[1] I couldn't agree more. Here are seven basic principles that I think everyone should follow:

1. Your wealth should be invested according to the long-term financial goals you have for your life and beyond. The short term is often irrelevant.

2. There is no credible evidence that trying to pick stocks and bonds or time the market works better than buying and holding a diversified portfolio that matches your goals through the ups and downs. So don't bother.

3. Your asset allocation should be a function of three primary considerations: how much to have in stocks versus bonds, small company versus large company stocks, and value versus growth stocks. In each case, the former category is riskier but has a higher expected return.

4. You should diversify broadly amongst the stocks and bonds you hold, both in terms of the number of securities (think thousands, not hundreds or dozens) as well as geographic location (don't invest all your stocks or bonds in just one country).

5. The choice of investment vehicles should be based on their diversification, total costs (expenses, trading and cash drag), and how well they target the desired segment of the stock and bond markets you want to own.

6. You cannot control what the investment markets do, but you can take proactive steps to minimize the taxes you pay on your returns and the amount of those returns that you lose to poor decision making (buying high/selling low, performance chasing, etc.).

7. Partnering with a financial advisor who will understand your goals, develop and manage an investment portfolio that is appropriate for your circumstances, and keep you well informed and disciplined—especially in difficult times—could be the single best investment decision you make.

A Contrast In Philosophies

How have these simple beliefs fared when compared to more complex and opaque investment approaches?

College endowments often manage hundreds of millions to billions of dollars. Their portfolios are spread across dozens if not hundreds of managers and strategies in the public and private equity and fixed income markets as well as "alternatives" like commodities and real estate.

Unfortunately, their results don't reflect the amount of work involved in constructing and maintaining such elaborate plans:

Endowment Category	7/2004 to 6/2014 % Returns	7/2008 to 6/2009 % Returns
> $1B in assets	+8.2%	-20.5%
$501M to $1B in assets	+7.3%	-19.8%
$101M to $500M in assets	+7.1%	-19.7%
$51M to $100M in assets	+6.5%	-18.6%
< $50M in assets	+6.5%	-17.7%
Average Endowment Fund	+7.1%	-18.7%
75/25 Asset Class Mix	+8.2%	-18.8%

source of endowment data: nacubo.org; 6/2014 is latest data available

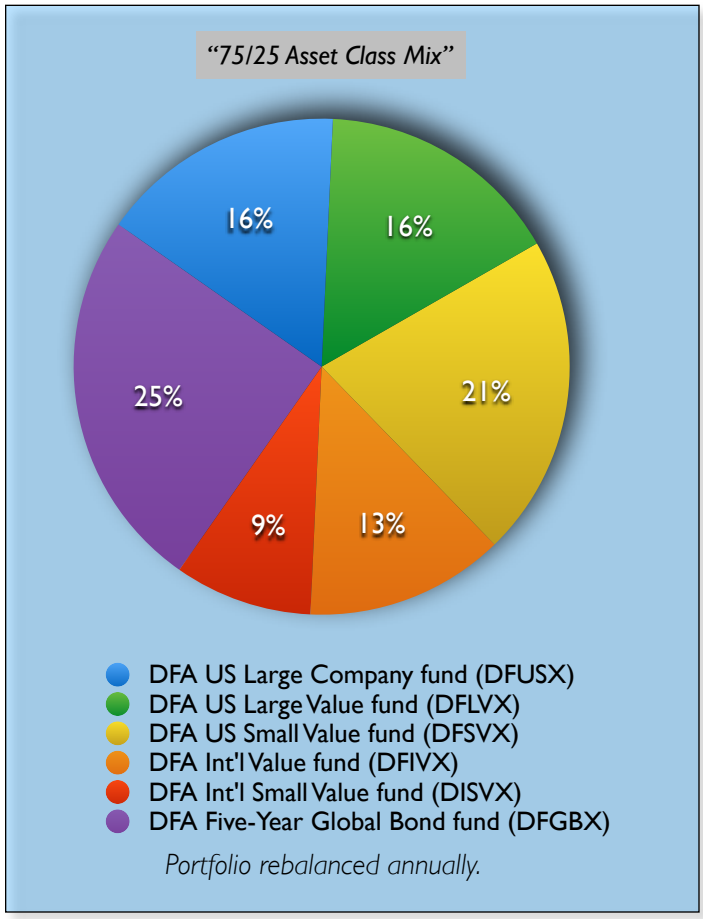
A quick look at the chart on the previous page reveals that over the last decade, no segment of the endowment fund industry has done better than a basic "asset class" portfolio consisting of stock and bond mutual funds that is diversified globally across financial markets.

Billion dollar endowments, with the buying power and negotiating strength to invest in any conceivable strategy with almost no costs were only able to match the +8.2% annualized return of the asset class strategy. In 2008/2009 when markets plummeted, they actually lost 2% *more*.

Endowments with less than a billion dollars performed much worse. Their returns ranged from +6.5% to +7.3%—1.7% to 0.9% per year *less* than the asset class mix. In each case, results in the worst 12 months (2008/2009) were no better than the buy, hold and rebalance asset class strategy.

Sophisticated Results From Simple Design

What is in this asset class mix that has held up so well compared to some of the biggest investors in the world? Is it the perfect blend of holdings that only could have been known with perfect hindsight? Hardly. It's a basic group of six Dimensional Fund Advisors (DFA) mutual funds that should look familiar to all Servō clients and *Factors* readers.



Here is a summary of the portfolio's simple design characteristics:

- It holds thousands of US and non-US stocks (70/30), a balance of large and small companies (60/40) with an emphasis on low-priced value stocks.
- The fixed income component is restricted to government and corporate bonds maturing in five years or less ("short term") with credit ratings in the upper tier (AA/AAA) of the market in the developed countries of North America, Europe and Asia.
- Finally, no market timing or rotation took place; the mix was simply rebalanced annually back to its original target whether previous year returns were up or down.

Don't Follow The Herd…Off A Cliff

Unfortunately for America's colleges and universities, you won't see these principles or this portfolio showing up in their annual reports any time soon.

It doesn't take dozens of analysts and CFAs to research and manage this mix (or something like it), or periodically report its progress to trustees. If Servō is any guide, just one will probably do. Also, it's unlikely that any group or board would sign off on such elegant simplicity anyway.

As an individual investor you don't have to make the same mistakes. You have the ability to look at your wealth through a long-term lens, focus on just a few primary investment decisions, strive for simplicity and stick with your plan even when others are abandoning theirs. These are timeless principles that anyone can embrace.

With the assistance of a skilled financial advisor who can help you master all of these principles you should have a greater amount of free time to spend on more rewarding pursuits: friends, family, work, passions and leisure. For you, there's no reason why the simplest financial principles cannot also be the most profitable.

Source of asset class return data: DFA Returns 2.0

1 http://awealthofcommonsense.com/whats-your-philosophy/

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