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The Investment Dilemma – Go it Alone?

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SUMMARY: Deciding whether to work with an advisor or do it yourself when investing can be difficult. Going it alone, you must identify whether you will be a passive investor holding index funds, a more active investor hiring portfolio managers, or a fully active investor picking individual stocks and bonds yourself. All of these approaches require varying degrees of discipline, deep knowledge and time investments. They also raise the challenge of defying the human instinct to sell when markets drop and buy when they are rising. As such, an investor's first task is to honestly assess whether they have the time, dedication and wherewithal for their chosen strategy. If the answer is no, getting help may be the sounder approach. This paper offers the numerous considerations you need to weigh to make the right decision on how you will approach investing.

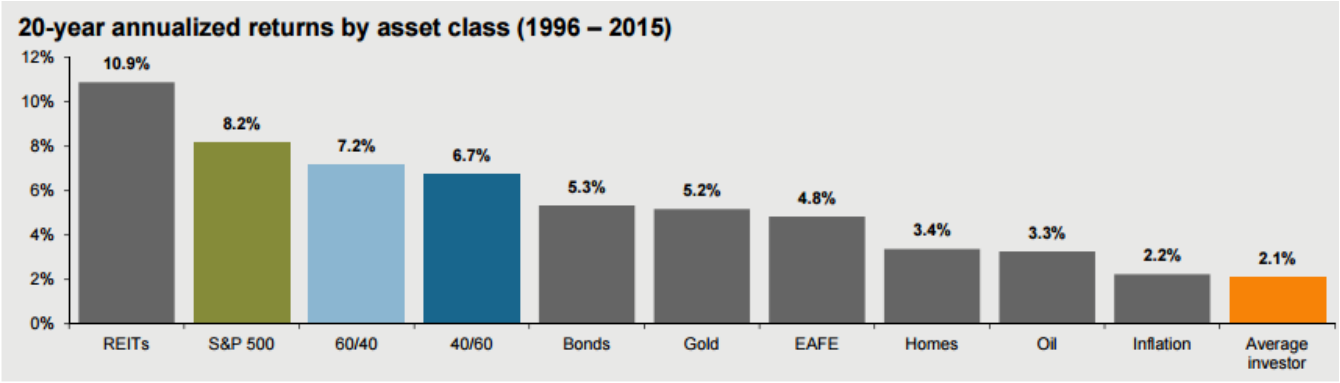
Investment Dilemma – Go it Alone?

Everyone who decides to invest must choose between going it alone or hiring someone to help them. This can be a difficult decision. While being a "do-it-youselfer" can often be the cheaper path and offers a greater level of control over your own destiny, it has an obvious drawback: investing is not your profession and most people do not have the time necessary to be successful. This paper offers the numerous considerations you need to weigh to make the right decision on how you will approach investing.

The Biggest Problem in Any Investment Strategy

The single biggest problem in all of investing is the mismatch between people's emotional timeframe and how long a given strategy is likely to underperform. Whether you choose to allocate your funds to a financial advisor, several fund managers or just several index funds, everything underperforms at some point. The problem arises as people jump horses mid-stream when a strategy has underperformed for a period of time. Yet, enough underperformance of any strategy can (and often does) mean the strategy's holdings are getting cheap and therefore should be bought, not sold. The quote, "it's often darkest right before the dawn," applies here.

Consider that even the legendary money managers have underperformance streaks of more than five years, and indexes routinely have negative performance streaks longer than a decade. How can an investor realize a strategy's long-term yield if they bail after two years? Academics have pinpointed performance chasing as the major reason why most investors underperform the very assets in which they are invested. The results for mutual fund investors looks like this:



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of July 31, 2016.

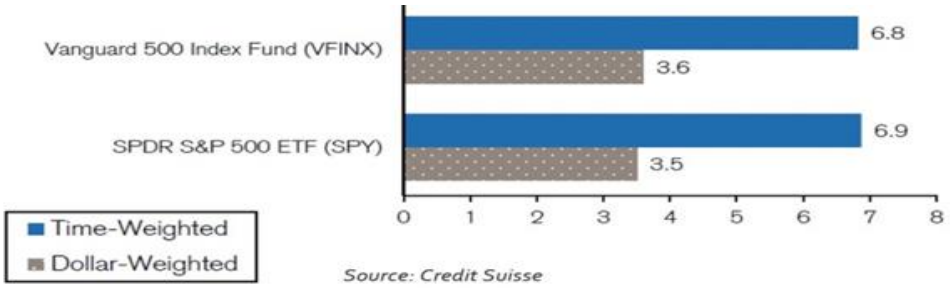
J.P.Morgan
Asset Management

Being a Passive Independent Investor

A "passive" investor buys a portfolio of index funds that is rebalanced periodically to some fixed number without placing any bets to over/underweight assets classes based on any market view. This is often the lowest cost option. The hard part of this strategy is the periodic negative performances of various indexes. Almost every developed country (including the United States) has had at least one 20-year period where an index failed to make a new high. Thus, an inordinate amount of patience and discipline is required to stick with indexing.

Even among indexes, there is usually a lot of performance chasing. Case in point: it's incredible how many portfolios I see today that own predominately U.S. equity index funds, which have outperformed almost all other indexes during the last 8 years. Never mind that as of this writing, the S&P 500 is at its second-highest valuation of all-time and by some measures has even exceeded the 2000 bubble. A non-performance chaser would keep their same allocation to non-U.S. stocks and bonds knowing that over the long-term, especially given their much higher prices, U.S stocks are likely to underperform at some point.

The graph below shows time-weighted returns (how the fund or ETF performed) versus dollar-weighted returns (an investor's actual returns, given the timing of their investments in those funds). As you would expect, there is a huge emotional drag from poor timing. While an index fund is cost effective, you're still experiencing more than **3% per year** of "emotional" headwind. I have nothing against indexing and routinely use indexes in my practice, but if you think indexing is going to make investing simple and easy, your expectations are too high for this strategy.



To be a successful passive investor, you need to decide that that is what you're going to do for life, hold a well-diversified global portfolio, rebalance like clockwork (which means selling what has "done well" to buy more of "what has done poorly"), and add to your portfolio in good years and bad. What you can't do—though many people do—is be a steadfast indexer until you lose money and then jump ship to an active manager who was cautious and now looks great during the trough of a bear market. If you have a mediocre return for a decade with your indexes, hold tight and wait it out. Either that or you need to get in the game of more active investing.

Active Investing Through Funds or a Financial Advisor

There are two ways you can be a more active investor and outsource a lot of the work. One is to pick several portfolio managers (as in an active mutual fund) and build a portfolio. The difficulty in this approach is that most active managers do not beat their benchmark. It is possible to successfully invest with active managers, but you need to have a disciplined process for picking managers, as I wrote about in "The Art of Manager Selection." More importantly, you must have realistic expectations. Every active fund is going to go through periods of underperformance, and if you don't understand why something is underperforming, you'll never know whether to stick with the manager.

I view hiring a portfolio manager like getting married. You know there will be some tough years, and you need compelling reasons to stick through the bad times to get to the good times. If your sole reason for buying a fund in the first place is past performance, you are likely to be tempted to sell at a low point when the fund is underperforming. This is why some fund managers, like Peter Lynch, who had an incredible run averaging 29% a year, had investors lose money on average due to their "emotional" timing of buying *after* he looked like a hero and selling *after* he looked like a zero.[1]

The other way to be a more active investor is to hire a financial advisor. As I explained in "How to Find a Financial Advisor," the process is similar to finding portfolio managers, although an advisor can do many things for your family besides investing your money. Your advisor should be able to articulate a clear strategy that you understand and stick with. And the "sticking with" behavior modification a good advisor can provide is the single greatest value an advisor brings to your investment discipline. Reducing or eliminating the emotional drag of more than 3% for index funds

[1] Fidelity Investments

and as much as 30% for some examples of active funds can make an incredible difference in your financial life.

Being a Fully Active Do-it-Youselfer

Fully active means you are picking individual stocks and/or bonds to earn a higher return than an appropriate index would. Let's review some big picture facts about active management. Because all existing securities are held by someone, somewhere, active management is a negative sum game. If you're taking an overweight position in something, then someone else must be underweight that same position. After fees and taxes, it's a losing proposition. Charles Ellis puts it succinctly:

> *"Watch a pro football game, and it's obvious the guys on the field are far faster, stronger, and more willing to bear and inflict pain than you are. Surely you would say, 'I don't want to play against those guys!' Well, 90% of the stock market volume is done by institutions, and half of that is done by the world's 50 largest investment firms, deeply committed, vastly well prepared – the smartest sons of bitches in the world working their tails off all day long. You know what? I don't want to play against those guys either."*

In independent active investing, you may get lucky and pick a few stocks that outperform for one year, or even a few years, not unlike how a casino gambler can "beat the house" over a short period. However, to have a long-term winning track record, you have to beat some of the most knowledgeable, most resourced professionals in the world.

Being an active investor requires an uncommon level of dedication. I have known a few investors who have outperformed in the long-term. There are powerful advantages small investors hold over big institutions. But every one of those "outperformers" was deeply dedicated and spent a significant amount of their waking hours thinking about and researching their investments. You need to have the time and desire to do this. This is an activity where you must be "all in" or you are doomed to fail.

Do or do not. There is no try. – Yoda

Minimum Knowledge Needed to Go It Alone

Because investing is a game of knowledge, if you are going to be an active investor, there is a minimum amount of knowledge you need to acquire before beginning.

Pick a Strategy: You're first task as an active investor is to pick a strategy you're going to follow. Arguably the most dependable and repeatable strategy is "value investing." There is probably no single school of investing that has created more successful investors than this one.

Know Your Mind (aka Behavioral Finance): Unfortunately, human beings are hardwired to be awful investors. Our brains are adapted to the natural world, and our fight or flight response makes us do the exact opposite of what we should be doing when investing. The objective is to buy low and sell high, but selling high means selling while the crowd is optimistic and buying when it's pessimistic. It is a lonely road. I often joke with my clients that they hire me to make them do the opposite of what they want to do—to make them "run into the burning building" in times of panic and to "let the hares outrun your turtle" in a time of exuberance. Having a grasp of how our minds derail and trick us is crucial to investing success. Only by knowing the tricks your mind plays can you start to mitigate their effect.

Study History: Because the markets are moved in the short-term by our psychology, there is arguably no industry where history rhymes as much as it does in finance. Many legendary investors' reading lists still include classics written 50 or even 100 years ago. As Edwin Lefevre wrote in 1923, "When you read contemporary accounts of booms or panics, the one thing that strikes you most forcibly is how little either stock speculation or stock speculators today differ from yesterday. The game does not change and neither does human nature." In other words, if you don't know history, you're flying unnecessarily blind.

Understand Accounting: There is math involved in investing. Accounting is the "language" of business, and if you're not fluent in this language, it will have the same effect as trying to race native speakers across a country where you don't even recognize the letters. It is the harsh reality. Trying to successfully invest without having a strong grasp of accounting is simply impossible.

Appreciate Risk and Probabilities: Everyone knows in any given year what their return has been. It's in black and white on your statement. However, risk is an opinion. Most value investors do not accept the view that "volatility" equates to risk. Buffett would tell you he would rather have a high probability of a lumpy (i.e., more volatile) 15% return versus a smoother and less probable 12%. The risk to value investors is the probability of permanent loss of capital. Having an understanding of risk and probabilities is absolutely critical to being a good investor.

In addition to these fundamental knowledge areas, you also need to have a strong understanding of individual companies before investing in their stock. Consider these basic questions. If you can't answer them intelligently, you should not buy the stock.

- Given all of the "obvious" facts about a firm that are priced into the stock, what are you seeing that the CFAs and Harvard MBAs are missing?
- What is the firm's competitive position relative to its peers? What advantages does this firm have, and how defensible are those advantages?
- What does the balance sheet look like? Is the firm employing a lot of leverage? Is there a risk that if sales slow the firm might be insolvent?
- How expensive is the stock relative to the firm's prospects? (Remember: No company is so great that at a certain price, it can't turn into a bad investment.)
- Is the management honest, capable and long-term oriented?

Realize that a stock's current price already embeds all of the well-known facts about the company. To "beat the market," you have to have a divergent view that is both correct and non-obvious.

The Real Value of an Advisor

Sometimes I receive questions from prospective clients that boil down to, "If I hire you, are you going to outperform the S&P 500?" This is a terrible way to evaluate an advisor. A diversified portfolio with any sort of safer, lower returning assets isn't designed to beat the S&P 500. The safer investments are meant to make the losses of a downturn tolerable enough that you can stick with your strategy. First, if you're diversified at all in some lower risk investments, you shouldn't outperform a 100% equity index over the long-term. Secondly, if your advisor invests you in a global portfolio (which most do), they will look like a genius when international markets are outperforming (through no skill) and look like an idiot when the international markets are underperforming (through no fault of their own).

An advisor's real task in guiding investments is to lay out a fundamentally sound plan and then provide you with the data, arguments and reasoning you need to stick with that plan during the "performance winters," which every strategy encounters. An advisor should be a "behavior modifier" who helps you avoid the common mistakes independent investors often make.

Investing is tough. As Charlie Munger said, "Anybody who finds it easy is stupid." Should you try to invest without taking the time to attain a minimum amount of knowledge in this field, you'll find yourself on the losing side of the game. Below is an essential reading list covering important topics in investing. If you don't have the appetite to plow through such a list (or similar ones by great investors), it's a good sign you shouldn't be an active investor.

A final thought: I believe that the most common mistake smart people make is thinking they are smarter than they are. Buffett and Munger are the best investment team in history in part because they constantly probe for the limits of their knowledge. Buffett states, "You have to stick within what I call your circle of competence. You have to know what you understand and what you don't understand. It's not terribly important how big the circle is. But it's terribly important that you know where the perimeter is."

Let that inspire the strategy you choose. Appreciate how far your investing knowledge reaches, and be honest with yourself. If you recognize that you do not have the time and dedication to invest independently, enlisting the help of a financial advisor may be the better approach.

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A Short Reading List

Value Investing:

- The Essays of Warren Buffett – Lawrence Cunningham
- The Intelligent Investor – Benjamin Graham
- Margin of Safety - Seth Klarman
- The Most Important Thing Illuminated – Howards Marks
- Security Analysis – Ben Graham & David Dodd (More of a textbook but informs critical fluency in analysis of individual securities)

Risk:

Nassim Taleb's books are a must:

- Fooled by Randomness
- The Black Swan
- Antifragile

Psychology:

- Thinking, Fast and Slow – Daniel Kahneman

Economic History:

- Devil Take the Hindmost – Edward Chancellor
- Triumph of Optimists – Elroy Dimson, Paul Marsh and Mike Stanton
- The Big Short – Michael Lewis
- This Time it's Different – Carmen Reinhart & Ken Rogoff
- The House of Morgan – Ron Chernow
- Lords of Finance – Liaquat Ahamed
- The Rise and Fall of Nations – Daron Acemoglu & James Robinson
- When Globalization Fails: The Rise and Fall of Pax Americana – James Macdonald
- An Empire of Wealth: The Epic History of American Economic Power – John Steele Gordon

Accounting:

- Quality of Earnings – Thornton O'Glove
- Financial Shenanigans – Howard Schilit

Sources:

1. Charlie Munger, "American Businessman, Lawyer, Investor, and Philanthropist"
2. Warren Buffett, "American Business Magnate, Investor and Philanthropist"
3. Edwin Lefèvre, "American Journalist, Writer, and Diplomat most noted for his writings on Wall Street business"
4. Charles "Charley" D. Ellis, "American Investment Consultant"
5. Credit Suisse Group, "Swiss multinational financial services holding company"
6. The Art of Manager Selection, "Loic LeMener, Founder and President of Opus Wealth Management
7. How to Find a Financial Advisor, "Loic LeMener, Founder and President of Opus Wealth Management
8. J. P. Morgan Asset Management, Guide to the Markets, July 2016
9. Fidelity Investments, "Multinational Financial Services corporation based in Boston, Massachusetts"

About the Author

Loic LeMener is the founder and President of Opus Wealth Management in Dallas, Texas, a boutique wealth management firm that specializes in personalized client solutions. Loic and his team provide their clients with a targeted needs evaluation to answer important questions that provide a better, more personalized experience. The team focuses on integrity and believes in the following "golden rule" – they won't do anything for you that they would not do for themselves or their loved ones.

Loic received his Masters in Business Administration from Southern Methodist University, studying Finance, Accounting and Portfolio Management. He also earned the Certified Financial Planner™ certification and the prestigious Chartered Financial Analyst® designation. In addition, he has been quoted in national publications such as Barron's.

In his free time, Loic is a devout reader, with his favorite topic being "value investing." His favorite investors are Warren Buffett, Ben Graham, Charlie Munger, Seth Klarman, Howard Marks, and Jeremy Grantham.