

# Adam Smith Advisors

A Cherry Tree Affiliate

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## ADAM SMITH INSIGHTS:

Published by Keith Tuft, President of Adam Smith Advisors, LLC, with insights on investing and wealth management.

### INVESTING QUOTE OF THE MONTH:

“Stop trying to predict the direction of the stock market, the economy or the elections.” — Warren Buffett (great investor)



## FOUR PRINCIPLES FOR INVESTING SUCCESS

Vanguard (a large investment firm) just published a white paper on “Principles for Investment Success.” It is excellent, and right in line with our own investment philosophy and strategy. Vanguard stresses four main principles for investment success: financial goals, portfolio balance, low cost, and discipline. Below are highlights of this Vanguard report, as well as some of our thoughts on the topic.

### GOALS

Create clear, appropriate, and realistic financial goals. The goals should not depend on optimistic return assumptions, or unrealistic savings amounts per year. People who do not have goals tend to chase favorable returns, build a portfolio based on transitory things such as fund ratings, and can end up buying high and selling low. They often end up “fund collecting” by purchasing individual funds or stocks based on their own merits, without considering how they might fit into an overall portfolio. They build their portfolio piecemeal from the bottom up, rather than strategically from the top down. As a result their portfolio often ends up with too many funds, inappropriate risk, and/or concentrated too heavily in one type of fund or market sector.



Many investors tend to purchase actively managed funds that are highly rated by firms such as Morningstar, in spite of the fact that studies show that funds with the highest (five-star) ratings on average tend to underperform over the subsequent three years (after achieving their high fund rating). Buying and selling funds based on Morningstar fund ratings often results in excessive trading and buying high and selling low. Research has shown that hoping for outsized market returns, or relying on finding some hot investment that will outperform the market to reach your financial goals is not the most likely road to success.

You might have multiple financial goals such as paying for your children’s college costs, and becoming financially independent by age 60. Your financial goals and roadmap should spell out the constraints you have such as income taxes, time horizon, risk tolerance, liquidity requirements, and other factors. We outline these financial goals and constraints for our clients with an Investment Policy Statement (IPS), and use that as a guide and roadmap to help them reach their long-term goals with confidence. We also have a “one-page financial plan” that helps update our clients each year on their progress towards reaching their goals.

### BALANCE

Investors should use diversified investment funds and multiple asset classes to avoid exposure to unnecessary risks. The asset allocation of your portfolio determines 90% of your investment returns and portfolio risk over time, according to studies by Brinson (1986) and Scott (2016). Stock picking and market timing are only responsible for 10% of returns historically. Investors should diversify their portfolios to both mitigate losses and to participate in gains. Attempting to avoid volatility and near-term losses by reducing stock market risk can expose investors to other types of risk, such as the risk of lagging behind inflation and the risk of falling short of your financial goals. If your portfolio is too conservative, the lower expected returns of that portfolio may require a level of savings to reach your financial goals that is unrealistic. Likewise, if your excessively conservative portfolio does not allow your portfolio to keep up or exceed inflation, you will lose purchasing power over time. Over a 30 year time horizon, an average inflation rate of 3% per year would reduce a portfolio’s purchasing power by more than 50%. That may be more risky than suffering a temporary 20% setback/correction in the value of your stock investment portfolio. Stocks are risky, but so is avoiding them.

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Owning large positions in individual stocks is taking an unnecessary risk, since that individual stock performance risk can be diversified away by owning a portfolio full of index-based funds that own hundreds of securities each. We invest in diversified funds across a wide variety of asset classes, to minimize unnecessary risk and to keep our investment portfolios right on target in terms of the customized risk/return objectives of each client.

### MINIMIZE COST

Markets are unpredictable, but costs and taxes are more under your control. Lower cost funds have tended to outperform higher cost funds over time. Be sure to ask what the expense ratio (or cost) is on all of your investments. Unlike many other products and services, with investing you don't necessarily get more if you pay more. In fact, in most cases, it is likely just the opposite. The more you pay for an investment fund, the more of the return gets paid to the fund company and the less there is left for you. Using index-based mutual funds and exchange traded funds (ETFs) is a great way to control and minimize investment costs and taxes. The vast majority of more expensive actively managed mutual funds do not outperform index funds over time, and you cannot predict ahead of time which active funds are likely to outperform going forward. It is not likely to be the same funds that outperformed over the past five years. The lower turnover of index funds (resulting in fewer capital gains), the special tax status of ETFs, and using smart tax location are several ways to minimize investment related taxes. We use very low cost and tax-efficient index-based mutual funds and ETFs for our client portfolios.

*"It is critically important to stick with your investment strategy through thick and thin."*

### DISCIPLINE

It is critically important to stick with your investment strategy through thick and thin. Often the worst long-term results occur when investors change their investment strategy and holdings based on what has performed best over the most recent 1-5 years. That is called performance chasing, and it is a very common investor mistake. For psychological and emotional reasons it is very difficult to stick with an investment strategy, and not to chase what is working the best right now. The right thing to do is to periodically rebalance your portfolio back to your asset allocation (stock/bond) targets. Many people find this counterintuitive, since it means trimming back on what has been performing best recently and adding to your worst performing investments. Spontaneous departures from your target asset allocation, chasing winners, and attempting to outguess or time the market rarely pay off and typically result in worse returns than simply holding the course. Numerous studies have shown that even the best professional money managers are not able to accurately and consistently time the market. Opportunities to time the market that look clear and obvious in retrospect are rarely visible or predictable looking forward. Past great performance of certain money managers does not have any predictive value in terms of future good relative performance. Stick with the plan.

### CONCLUSION

Future market returns are unknowable and not controllable. Instead, investors should focus on the factors in their control such as having clear goals, having a diversified portfolio, using the right asset allocation for them, using low cost and tax efficient investments, having appropriate risk, having a strong savings rate, and having the discipline to stick with the strategy over the long term. By using this approach you will be more likely to successfully reach all your financial goals.

Source: Vanguard's Principles for Investing Success, May 2017.

*Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of ASA) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at <http://www.cherrytree.com>.*

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