Ruminations on Investment Philosophy

This is an attempt to describe our investment philosophy and the investment experience our clients should expect. Our approach is driven by academic (as opposed to Wall Street) research and therefore is grounded in what is believed to be optimal and prudent rather than oriented toward the fads and fashions of the moment or what will sell well to the public. Remember, when Wall Street builds a better mousetrap, investors are generally the mouse. Our approach is long-term, strategic, and based on well-established financial theory, empirical data, experience, and judgment. Specifically:

- With a few caveats (see next two points), we accept that markets are efficient. This means that individual securities are generally priced correctly *ex ante* and incurring additional costs in the hopes of finding a mispricing is generally futile though of course apparent mispricings will seem obvious *ex post*. In short, active management does not consistently add value through security selection or market timing thus **we will invest almost exclusively through index funds and other passively managed vehicles**.
- Notwithstanding the overall validity of market efficiency described above, there are a few anomalies that appear to be both pervasive (they exist in most markets) and persistent (they exist most of the time). The most significant of these anomalies are value and momentum, but there is some evidence of others as well. **We will tilt portfolios toward factors such as value and momentum** that appear to reward investors over time.
- It also appears that while stocks of smaller companies don't outperform (after adjusting for risk) larger companies, it does appear that factor tilts such as value and momentum may be larger in smaller companies. Thus, **we will tilt portfolios toward smaller companies.**
- The aforementioned tilts to various factors can, and almost certainly will, give rise to tracking error or "frame of reference risk." What this means is that **your portfolio will not exactly track vanilla indexes such as the S&P 500.** Over time we expect the performance of your portfolio to exceed widely followed benchmarks, but of course it is not guaranteed, and it can sometimes take a while for this to happen.
- Both diversification and cost control are crucial. Thus, **we will use mutual funds or exchange traded funds** (ETFs) to gain exposure to various asset classes due to their broad holdings, low costs, and low turnover (which also reduces costs).
- From peak to trough, U.S. stocks declined in nominal dollars by between 45 and 55 percent in 1973-1974, 2000-2002, and 2007-2008. Therefore, **during poor markets, investors should *expect* the risky portion of their portfolios to decline by approximately half.** The "risky portion" is everything that is not investment grade bonds or cash. For example, an investor with a $1,000,000 portfolio that is 60% stocks and 40% investment-grade bonds *should* experience a decline to $700,000 periodically. This is the necessary pain to achieve the higher returns that are expected from risky assets. This is not a "worst-case" scenario, it is the periodic *expected* case. If stocks did not occasionally experience losses, they would cease to be priced attractively enough to earn superior returns. It is our job to make sure client portfolios are positioned at an appropriate level of risk and that our clients do not increase their risk-taking when things look rosy (e.g. 2006) and do not decrease their risk exposure when the outlook is frightening (e.g. 2008).
- Foreign investments will be used for additional diversification. Thus, **for international exposure we will over-weight smaller companies and/or emerging markets companies** since they offer greater diversification benefit to an investor who already owns large U.S. companies.

- Diversification between risky asset classes (domestic stocks and foreign stocks for example) is beneficial in prosperous times to ensure exposure to whatever area is currently doing well. During market turmoil however the benefit of diversification between these risky asset classes largely vanishes as they all decline together. Diversification still works however, but it is the diversification of also holding safe assets (investment grade bonds) in a portfolio. **If everything in your portfolio is going up, you probably aren't properly diversified.**
- For additional diversification, **a portion of the portfolio may be invested in "alternative" investments** such as, but not limited to, REITs (Real Estate Investment Trusts), high yield bonds (aka junk bonds), MLPs (Master Limited Partnerships), and hedge fund like investments (though with much lower cost, greater transparency, and greater liquidity). While it would be imprudent to place a large percentage of a portfolio in these types of investments, in smaller proportions they may improve the risk/return profile. "The dose makes the poison." (Paracelsus, c. 1500)
- Depending on the specific inflation exposure of each client outside of their portfolio, **some or all of the bond allocation may be to TIPS** (Treasury Inflation Protected Securities).
- While we review portfolios and the market environment frequently, we make changes very infrequently. Turnover has costs and generally doesn't add value (though it does make everyone feel better to "do something" rather than simply stay the course). As Warren Buffett has said, "Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell." He also stated, "Lethargy, bordering on sloth, should remain the cornerstone of an investment style." Once a client's portfolio is invested appropriately, **we will not do much trading** aside from opportunistic tax loss harvesting. This is a sign of prudence and patience, not inattention. We do not trade simply to appear busy.
- If we manage multiple household accounts for you, we will manage them as part of one portfolio to increase trading efficiency, tax efficiency, etc. Thus, when **viewed in isolation, individual accounts may have what appears to be an "odd" investment allocation**, but it is appropriate when viewed in the context of your overall portfolio and life circumstances.

Notes:

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