Common Portfolio Wisdom – "The Key to Safety is Diversification"

Pros –

Gains in one asset class may offset losses in another.

Diversification portfolio offers more stability than holding just one asset.

Cons –

There are periods when many asset classes may go down simultaneously.

Gains can be "watered" down and may limit potential.

Axiom – The key to safety is in harmony with long-term market trends.

Diversification has become like pixie dust in the financial world. People hear that word and think everything is good because they are diversified, but that is not always the case.

The thought is if your diversified than you will have a lower risk because you are not putting all your eggs in one basket as the saying goes, however, while diversification and asset allocation are important it does not guarantee lower risk.

Sometimes you can have a highly diversified portfolio among different stocks or funds, but they are all highly correlated meaning they go up and down about the same. It would be like putting all your eggs in different baskets but then putting all the baskets in the back of the same pick-up truck. When that truck hits a bump, all the baskets fly, and all the eggs break. That is highly correlated.

Bonds have typically been considered a good place for the conservative holdings in a portfolio and many firms still use bonds and bond funds for that portion. However, with the stock market at an all-time high and rising interest rates (when interest rates rise, bond values fall), we could be poised to see a bear bond market coming, maybe even at the same time as a bear stock market.

The average 60/40 portfolio, when stress tested has an average drawdown or loss potential of 30% or more. Is that lower risk?

So, while diversification is good, in and of itself does not mean you are low risk. How you are diversified, among what asset classes and how that is managed determines your risk.

If you want to know what your risk is, have a risk assessment done on your portfolio. This should be run by third-party investment research and analytics firm such as Morning Star. This report is more than a snapshot of your portfolio; it analyses the funds in your portfolio and can give you a probability of upside and downside return potential. Everyone, especially those in or nearing retirement should have an updated risk assessment done on a regular basis.

Common Portfolio Wisdom – "TIMING NOT THE KEY...TIME IN THE MARKET IS..."

Pros –

Buy and hold works well in long-term bull markets.

You cannot predict stock market action.

Cons –

Being in harmony with long- term trends is the key. Preserves capital to be used at better opportunities.

You can distinguish between normal market movement and true trend changes.

Axiom –

Market trends are intelligent, understandable, and recognizable.

There are two driving emotions in investing, fear, and greed. When investing emotionally, these to work against you which is why trying to time the market rarely works out. Even if you can take emotions out of the equation, trying to time the market means you are looking at one or two indicators (or computers are) and all your buy/sells are based on that alone.

A basic tactical approach to managing red money can feel like market timing. It looks at technical indicators, fundamental indicators and quantitative measures and manages the portfolio according whereas static model means the different asset classes chosen to make up the model don't change. With a tactical approach, if an indicator sends off a danger or sell signal, that asset is then sold and either invested where the signals are positive or placed in cash.

As we said last week, the market in cash is the best place to be. From 2000 to 2009, the market endured a major terrorist attack and a recession. S&P 500 reflected those tough times with an average annual return of -1% and a period of negative returns after that, leading the media to call it the "lost decade." A basic tactical approach that went to cash did very well in 2008 when the market took a big dive down volatility there were years during the lost decade of great ended where that approach ended up with a whipsaw effect. It would sell based on signals that would change rapidly usually causing you against and rarely trade cost as well as miss out on gains.

For that reason and others, the time in the market being key is the most accepted approach. They would say that if you missed just the 5 best days your overall returns would be greatly reduced. That is true, but the reverse is also true, if you missed the 5 worse days your returns would be drastically better.

The key is neither timing nor time in the market, but maybe a mix of the two. Market trends are intelligent, understandable, and recognizable so why not use that to your advantage? A skillful money manager will do just that. They will not be all in or all out, they don't try to time the market, but be in harmony with the market trends and invested accordingly.

Common Portfolio Wisdom – *"WE'RE IN A NEW ERA... OLD MARKET RULES DON'T APPLY"*

Pros –

Many new factors:

Internet, Baby Boomers, Global Markets, War on Terror

Cons –

Appearance that we are smarter.

Details abound; structure remains.

Factors change; results consistent.

Society may change, but human nature doesn't.

Axiom –

We are never in a new era. Market action is a reflection of human reaction. Human nature is the constant in the equation.

You also must overcome generational bias. That is, every generation thinks they are smarter than the last. When it comes to the market, we think that it will be different this time... that has been thought for years from the roaring 20s to the 90s tech boom to now… The market goes up and comes down, it will, and it must.

The truth is, we are heading into a normal market, but a normal market can be scary! A normal market has both bears and bulls, ups and downs. We have been on this upward climb for so long that sometimes we seem to forget that what goes up, must come down.

I just read an interesting article on why the market must go down, I feel this quote puts it in perspective.

The only reason stocks can go up is because they can also go down. It is this risk that keeps investors in check and that keeps people from paying an infinite amount of money for shares in a business. The reintroduction of risk, in the context of this summer's sell-off, is the best thing that could have possibly happened. When the possibility of loss goes away, so does the probability of gain.

However, that doesn't mean you should just be ok with losses. Warren Buffett once said it this way, "Invest in such a way that whether the markets go up, down or sideways you are ok." He also put it this way, "You know who is swimming naked when the tide goes out."

Everything looks great when the market is on a bull run, when the tide is in, but when the bear comes and the tide goes out, is when you find out if your protected (clothed) or swimming naked.

Remember the 2008 stories where people went back to work or delayed retirement because of the losses they suffered? History will repeat itself. Don't let that be you, don't be caught swimming naked with advisors and managers swimming naked with your telling you in it for the long haul.

Common Portfolio Wisdom – "*PROFESSIONAL MANAGEMENT = BETTER RETURNS"*

Pros –

Better potential long-term results if properly tactically managed in today's market.

Cons –

Styles such as asset allocation and modern portfolio theory, systems, methods, and experience are still subservient to market trends.

Axiom – Opinions don't count; market trends do.

Cheaper doesn't always mean better. Just in the same way, more expensive doesn't always mean best quality. It's getting value for what you're paying for.

A lot of times, we see people paying these high investment fees to advisors or money managers and yet, they don't know anything that that advisor or money manager is doing for this fee. They're not getting valuable service for it.

It reminds me of paying a teenager to mow my yard this summer. We set a price and overview of what is expected, but when I came home, and he had botched the yard. It took me longer to clean up all the grass because he cut it so low, than it did for him to mow. That's not a valuable service. Why would we want to pay for somebody to do something that they really didn't do or they're not doing well?

When it comes to costs, we want to make sure the costs are reasonable and that we're not paying for things that we don't need, but we also want to make sure we're getting value for what we're paying for. If you don't know what you're paying for, it's something that you need to be able to ask and receive an answer of what all the fees cover.

You also want to know how they are managing your portfolio. This should not require you to have a degree in finance to understand the answer, it needs to be in terms you can understand. Basically, you want to know if, when and how they would make changes. Paying for someone to put together a portfolio and then never do anything else or paying someone to make changes when they do not take market trends into account and can adjust their plan accordingly means you are not really receiving value for your fee. Would you pay a football coach that never changed personal or adjusted his game plan for each opponent? Would he ever win if he didn't do those things? It wouldn't matter what he did in the past, if he wasn't doing anything going forward.

If you're not getting an honest answer or one an answer that you understand, that should be a red flag. If you can't get a clear answer on how much a fee is and what all that fee is covering along with how your portfolio is being managed, do you really feel like you're getting the valuable service for that?

Common Portfolio Wisdom – "PORTFOLIO DECLINES ARE JUST A PAPER LOSS IF NOT LIQUIDATED"

Pros –

True on a tax basis.

Emotional selling is rarely good.

Cons –

When the market recovers after a long-term decline, the investor has to make a larger % gain than the loss to get back to even (as opposed to growing capital from pre-decline levels).

Axiom – Guarding against large long-term loss is the most important component for growing wealth.

This Wall Street saying actually comes from a reality in the world of taxes. If you bought a stock for $10 a share, and four years later it is worth $20 a share you have good news. You made money. If you sell the asset at this point you will have a gain to report on your taxes of $10 a share. You have "realized" your gain. You also have some bad news, a tax due on the gain. This is called a "capital gains tax," which is a tax on the gain in the asset. You are only taxed if you sell the asset, thus you "realize" the gain only by selling the asset."

If, however, the share price went down to $5 a share, you have lost money in your investment, and if you sell, you will "realize" a loss. You can use that loss on your tax return to wipe out certain gains. You would not be able to use this to your advantage on your tax returns unless you sold. In reality, you haven't lost until you sell, is only true when it comes to taxes. It is not true when it comes to investing."

If you have $100 and lose 10%, what do you have? Right, $90, now say you make 10% on $90, that do you have? Right, $99, you have to make a greater gain to offset losses. This is only magnified by the percent of loss. For example, if you lose 30%, which is the average market loss during bear markets, you have to gain 43% just to get back to even.

There are no paper losses when it comes to investing. There is only lost money. Investors cannot afford to be unrealistic in our outlook and most of all in our beliefs about money.

The truth is the market goes up and down. Your accounts may very well recover to their old levels, but until then, "you have what you have" is a better catch phrase to use. Reality is always a better place to begin when evaluating how to move forward. You can even say that you have lost money in your investments and if you keep them, they may one day regain their value, or they may not. Even if they do, you still experienced an opportunity loss.

Common Portfolio Wisdom - *“INFORMATION = POWER AND SOPHISTICATION”*

Pros –

Accurate information is important.

Investors have access to more information now due to the Internet.

Cons –

Power through information is weakened since everybody has access to the Internet.

Too much information. Emotions tend to rule over facts.

Axiom –

Information is no longer power. Power now comes from the correct interpretation of the proper information.

We live in a world where there is so much information available to us that is pure noise. It can be hard to figure out where to turn to find the right answers to life’s questions and financial questions are no exception.

There is a myth out there that you should be able to be good at planning your financial life on your own. People often feel embarrassed when they do not understand everything related to financial planning. I think that myth is partly due to the vast amounts of information available today. We think we can google or YouTube anything and find the answer.

Let’s think about this, the power is not in the information but the application of information. A medical student could be the head of the class academically, but that doesn’t mean they will be the greatest surgeon, it all depends on how they apply the information and develop a skill.

If you google anything, you find varying opinions. Take milk for example, half the searches will say how important milk is and the other half say you should not drink milk. So, where does all that information get you? Stuck in trying to interpret what is best for you. That is the key, what is best for you, your lifestyle, your goals.

Same is true with anything financial, you will always have different “experts” with varying opinions, so information often leads to inaction, not knowing what to do.

Again, you are the key all of this. It is not that you need to be educated, to get more information so you can decide. No, you need someone who cares about you, the most important piece and can correct interpret what is best for you.

How do you know who that is? For starters, when you meet to, they just try to fill you with information about their product? Do they use their information to seem sophisticated and powerful using terms you do not understand? Or do they spend their time listening to you, finding out what you want, what’s important to you?

Common Portfolio Wisdom – "*A GOOD FUND = 5-STAR RATING"*

Pros –

Rates management quality and consistency.

Can demonstrate how that fund could perform in a certain market.

Cons –

If the market trend changes, the fund's style and holdings may not perform well.

Axiom –

When referring to styles and holdings, past results are rarely good indicators of future results, as market trends tend to continually change.

For us football fans, July marks the start of training camps, the beginning of football season. If you are an avid fan, you have been paying attention to free agency, the draft, and trades all spring. (for those that are not football fans, stick with me anyway).

Have you ever been excited to acquire a new player in a trade or free agency that seems to be on the top of his game, unstoppable? You think he is just what you need to go all the way. Then, as the season progresses, your new star player looks nothing like he did for his past team. He is slower, always a step behind and hasn't made the impact you expected.

This happened with Jimmy Graham; he was amazing when he played in New Orleans and then only average with Seattle and Green Bay. His "star" ranking was high, but that did not indicate future success.

The same is true when it comes to picking funds, the highest ranked funds mean they have had great results in the past, but it does not tell you how they will perform in the future.

This is an especially important truth now, the past few years have been good, maybe the top of a bull market. So, the funds ranking and performance over the past 3,5 even 10yrs tells you how that fund performs in a bull market, but not how it will perform in a different market just like a player's history at one team doesn't guarantee success at another.

You have probably seen or heard the disclosure, "Past performance is no guarantee of future results." So, why do we choose how we will invest for the future based on past performance?

There is a better way called forward-looking due diligence. This is more than just looking at how a fund performed but why it performed that way, in that market and how will it be managed going forward in different market conditions. Does the fund adapt and adjust to be successful as a player for a new team, or will it only perform well in certain markets like a player only being effective in one system?

Doing this on your own in all honesty is probably not possible. You need access to the managers; you need to have the knowledge and understanding of what to ask and what you want. The next time you talk to your advisor or they show you something new, ask how they run due diligence. If their answer is centered only around past results, then you may end up with your star fund being a bust.

Common Portfolio Wisdom – "CASH IS TRASH"

Pros –

During times of great market opportunity cash instruments usually won't outperform inflation and taxes.

Cons –

Cash is a great tool to protect portfolios from large long-term loss during market downturns.

Preserves capital to be used at better opportunities.

Axiom –

There are three main goals we have when investing money, safety, liquidity, and growth. No magic investment meets all those goals completely. Yellow money (Cash) is safe and liquid but provides very little growth. Red money is liquid (most of the time) and provides growth, but there is no safety. Green money sits in the middle with safety (principal protection), but it has limited liquidity at least early on and limited growth potential (but also not subject to market loses). We describe this more in our book, Creating Your Dream Retirement.

Everyone should have some in yellow money for emergencies and a buffer fund. Yellow money is easily accessible where both Green and Red money can take a few extra days to make a withdrawal and considerations such as taxes need to be part of the picture when drawing from other accounts.

Cash also has its place when it comes to your Red Money portfolio. When the market is extremely volatile or headed down, it could be advantageous to go to cash, but it needs to be done in the right way, not emotionally.

A tactical approach to managing red money looks at technical indicators, fundamental indicators and quantitative measures and manages the portfolio according whereas static model means the different asset classes chosen to make up the model don't change. With a tactical approach, if an indicator sends off a danger or sell signal, that asset is then sold and either invested where the signals are positive or placed in cash.

As we said last week, there are times being in cash is the best place to be. From 2000 to 2009, the market endured a major terrorist attack and a recession. S&P 500 reflected those tough times with an average annual return of -1% and a period of negative returns after that, leading the media to call it the "lost decade." Cash was king during this period. This isn't to say that you should have been in cash the entire time, however it is true the yellow money accounts outperformed stocks during this period, but using cash at the right time and using other investments accordingly in your red money portfolio led to much better performance than either just yellow or just red.

Stay tuned for more on tactical investing vs time in or timing the market.