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ASSETCLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

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There's Opportunity in Simplicity (Part 2)

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> *"The leader is one who, out of the clutter, brings simplicity …out of discord, harmony …and out of difficulty, opportunity." –Albert Einstein*

Last month I noted that a Wall Street firm's new ad campaign, "There's Opportunity in Complexity," offers a stark contrast between old-school traditional investing and new-school modern investing. As practitioners of the latter, we know there's opportunity in *simplicity*—not only in how one develops and executes a successful long-term investment strategy, but also how the features and benefits of such a strategy can be most effectively communicated to clients.

Below are 3 simple steps an investor can take to both simplify and supercharge an investment portfolio to meet long-term goals. This more modern and science-based approach increases the certainty of reaching long-term investment goals while significantly reducing anxiety along the way.

1. **Eliminate all "active" management from your portfolio.**
2. **Understand, accept, and manage compensated (systematic) risks.**
3. **Systematically rebalance your portfolio and stay disciplined.**

Why eliminate active management? Because it fails about 80% of the time. And it's expensive, it's less tax-efficient, it has limited shelf life ("winners" regress to the mean sooner than later), it's less diversified, it's old-school, it creates unnecessary anxiety, it's needlessly speculative…

Market, size, and price (value) risks have compensated investors very well over time. Starting with a market portfolio and tilting to small cap and value stocks is far superior to active management. And it's *less* expensive, it's *more* tax-efficient, it's *sustainable* over the long term (no inherently fallible gurus), it's *much more* diversified, it's *new*-school, it *reduces* anxiety, it *doesn't* rely on constant speculation…

Systematic rebalancing eliminates the destructive urge to engage in market timing. It maintains a constant and appropriate risk level for the portfolio in order to increase the certainty of an expected outcome.

The table below shows the returns for indexes representing short-, intermediate-, and long-term bonds and the three compensated stock risk factors for two periods: 1928-1994 and 1995-2015.

Index returns (annualized)	First 67 Years 1928-1994 Annual Return	Next 21 Years 1995-2015 Annual Return
U.S. Treasury Bills (1-month)	3.7%	2.5%
U.S. Treasury Notes (5-Yr.)	5.1%	5.5%
U.S. Treasury Bonds (Long-term)	4.7%	8.1%
Total U.S. Stock Market	9.7%	9.7%
U.S. Large Value Stocks	11.2%	10.7%
U.S. Small Value Stocks	13.2%	13.7%

How might an investor use this information to build a modern portfolio?

First, determine the appropriate stock/bond mix to meet your long-term goals. This must be considered in light of your risk tolerance. How much year-to-year volatility and downside risk can you accept while staying with your plan through thick and thin?

Second, decide how much risk you want to take in your bond investments. As you can see from the table, there is not a lot of incentive to prefer long-term bonds over 5-year bonds. Five-year Treasuries outperformed long-term Treasuries for 67 years before this recent bull market in bonds. Interest rates currently are at historical lows.

Third, decide on the most appropriate mix of total market, large value, and small value stocks. Although not shown, these same relative return relationships appear in the data for non-U.S. developed markets (which have the same expected return as the U.S.), so also decide on the best U.S./foreign mix for the stocks.

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The result should be a simple, high-performance modern portfolio—highly efficient with few moving parts. *If* you can remain confident and disciplined for the length of your investment time horizon, it will almost certainly get you where you want to go.

How to Mess Up a Good Thing

Complicating the bond side—Bonds should be the low-risk, low-volatility part of your portfolio. They should offer instant liquidity for distributions and allow for easy rebalancing to stocks after market drops (you know, the "buy low" thing). Increasing risk with maturities over 5 years, reducing quality and liquidity, or adding complexity through "laddering," esoteric products, etc., offers little in value at potentially high cost. Simply buy a short-term bond index mutual fund (or currency-hedged global 5-year fund like DFA's) and take your risk on the stock side. The potential payoff is much greater.

Fearing and/or mismanaging stock risk—At a recent dinner with advisor peers, I was challenged by one after I shared how much we recommend our clients tilt their portfolios toward small cap and value stocks, even to the extent of having all-value portfolios. He felt the need to remind me and the rest of the group of two things: 1) the actual return premiums for small cap and value stocks in the future are uncertain, and 2) there are periods when large beats small and growth beats value.

I answered that not only do *I* know those things, but our *clients* do as well. Just like they know the future return for stocks in general is uncertain and there have been long periods when bonds actually beat stocks.

We're in the risk business. Understanding risk, determining reasonable probabilities of outcomes, and helping our clients deal with uncertainty is *what we do*.

Clients of some advisors will realize lower portfolio returns over time because either the advisor is unwilling to understand and manage small cap and value stock risk or they do not effectively communicate that risk to clients. In fact, some advisory business models don't support the kind of personal up-front education and ongoing counseling that a multidimensional asset class portfolio strategy requires.

Allowing marketing to drive decisions—I know of other advisory firms that select asset class funds for client portfolios from several different fund families *simply because they are from different fund families*. How these funds are structured to capture the small cap and value premiums and their resulting performance is secondary to the *appearance* of independence.

Choosing "core and explore"—Other advisors include some actively managed mutual funds because the funds show a 3- or 5-year past performance advantage over an index fund. This "core and explore" approach *appears* to some investors to be more "sophisticated" or "open minded" and the inevitable switching among winners and losers gives the appearance of investing diligence. In the end, this approach simply costs investors to whatever degree it is implemented (20% committed to active management experiences the same high failure rate as 100%).

Settling for "kitchen sink" allocations—Still other advisors implement what I call "kitchen sink" asset allocation. Anything that resembles an asset class is thrown in the mix. They rationalize their decision as "more diversification" even though what *might* be gained in lower portfolio volatility is likely to cost clients dearly in lost compound annual return over a long period of time. Or they insist their more "sophisticated" clients *demand* hedge funds, commodities, or whatever. Smart rich people make dumb investing mistakes all the time. You don't need to help them make more.

The Bottom Line

Picture a very attractive car sold to consumers by Ford or General Motors and marketed aggressively as a high performance machine. In reality, the car is built on a Model T chassis with a 20-horsepower, 4-cylinder engine. That's what today's Wall Street offers investors. Very old technology and lousy performance, supported by marketing that elicits emotional responses and brand loyalty.

Now picture a brand new Tesla Model X with its super-efficient design and powertrain. State-of-the-art technology and high performance, supported by science-based research targeted at a buyer's *intellect*. That's modern asset class investing—Equius-style.

Simple. Yet powerful.

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* U.S. Treasury Bills (1-month), U.S. Treasury Notes (5-Yr.), and U.S. Treasury Bonds (Long-term) indexes are courtesy of Morningstar. The Total U.S. Stock Market, U.S. Large Value Stocks, and U.S. Small Value Stocks indexes are courtesy of Dimensional Fund Advisors. Please see other disclosures below.

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