the EDUCATED INVESTOR

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Read Any Good Books Lately?

An entertaining book that speaks volumes about investing in less than 250 pages can be an invaluable addition to anyone's library. *The Only Guide to a Winning Investment Strategy You'll Ever Need,* by Larry Swedroe, is just such a book.

When *The Only Guide* was released in 1998, it was hailed for its approachable presentation of passive asset class investing. In January 2005, a revised and expanded version was published, retaining the engaging readability of the original, with new data and reflections on more recent market events. The insights from 1998 have remained every bit as applicable today, demonstrating the strength of the approach we recommend for new and seasoned investors alike.

This special edition of *The Educated Investor* includes some of our favorite excerpts from this book.[1] Its new 2005 edition is available at major bookstores and on Web sites such as Amazon.com.

If you would like to learn more, please contact us to discuss how we can help you adopt or further your "winning investment strategy."

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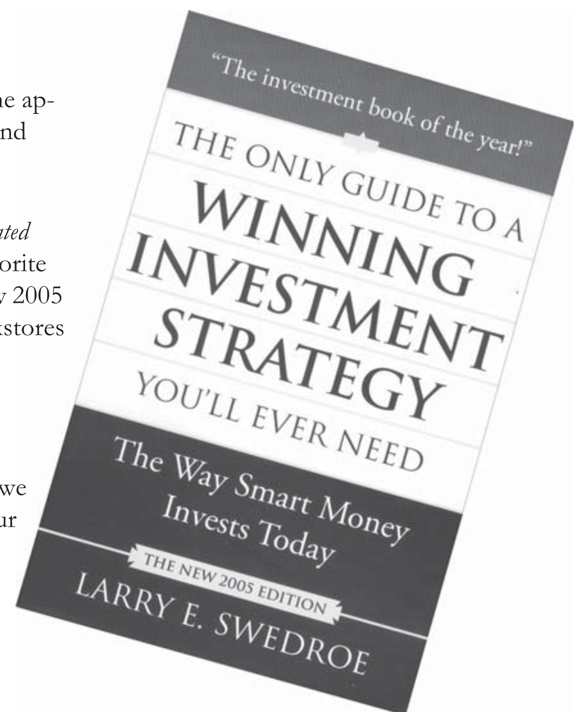

Excerpt #1

How Do You Invest to Win? Don't Play the Game!

Introduction, pages xviii-xix — At a tennis clinic I learned something that not only dramatically improved my tennis game but also provided me with an insight about games in general. After making what I thought was a great shot, a forehand that landed right in the backhand corner of my opponent, my teaching pro said, "That shot will be your worst enemy." While it was an exceptional shot, he explained, it was not a high-percentage shot for a good "weekend player." Remembering how good that shot felt, I would try to repeat it. Unfortunately, I would be successful on a very infrequent basis. The pro asked me if I wanted to make great shots or would I rather win matches? (I thought that one was the cause of the other.)

What does tennis have to do with investing? Simply this: Like any game, consistently successful investing requires a successful strategy. The vast majority of individual investors (and unfortunately even most professionals) try to beat the market. They do so by attempting to uncover individual securities they believe the rest of the market has somehow mispriced (the price is too high or too low). They also try to time their investment decisions so that they are buying when the market is "undervalued" and selling when it is "overvalued." Such a strategy is known as active portfolio management. Occasionally, with the same infrequent timing of my great tennis shots, these active portfolio managers will make the proverbial killing. On the other hand, over the long run, the great likelihood is that they will lose more often than they will win.

Playing the "Loser's Game"?

In the introduction to his book, Larry Swedroe describes how an active approach to investing — attempting to uncover individual mispriced securities or predict market movements — is akin to playing a "loser's game" of tennis. The odds against winning are simply too high, especially compared to the expenses involved in playing. The following excerpts explore this concept further.

Excerpt #2

The Market Plays for Keeps

Chapter Two, Page 45 — Academics would say that "experts" are highly unlikely to beat the market because it is "efficient." A less technical way of saying the same thing is that there are so many bright, hard-working individuals trying to beat the market that the competition is awfully tough. Remember that because all stocks must be owned by someone, outperforming the market must be a zero-sum game — if one investor outperforms, another must underperform.

Today, institutional investors account for as much as 80 to 90 percent of all trading. Charles Ellis noted: "Half of all trading on the NYSE is done by the fifty most active institutional investors, all of which are fully staffed by the very best people available. Every investor in the market is competing with these giants all the time."[1] In order to win this game you have to believe that others are making mistakes in how they price securities. In other words, the market is wrong, and you are right.

[1] Editor Peter Bernstein, *The Portable MBA in Investment*.

Excerpt #3

Patient Persistence Pays Off

Chapter Three, Pages 71-72 — Trying to time investment decisions just doesn't work because most of the action occurs over such brief, and unexpected, periods of time. Despite that, there are "professional" Wall Street market timers who claim they can pick the best 1 percent of all trading days and who will spend much of their time, and your money, on this futile endeavor. "These professionals would do well to learn from deer hunters and fishermen who know the importance of 'being there' and using patient persistence — so they are there when opportunity knocks."[1]

A study of one hundred large pension funds and their experience with market timing found that while they all had engaged in at least some market timing, *not one* had improved its rate of return as a result. In fact, eighty-nine of the one hundred lost as a result of their efforts, and their losses averaged an incredible 4.5 percent over the five-year period.[2]

[1] Editor Peter Bernstein, *The Portable MBA in Investment*.
[2] Charles Ellis, *Investment Policy*.

Excerpt #4

Gambling With Stock Selection

Chapter One, Page 9 — Americans love lotteries, Las Vegas, wagering on sporting events, and so on. That is why you hear the term "play the market." Serious investors never play the market; they invest in the market. Serious investors do not care that a passive strategy (buy and hold the market) is boring. They do not look for markets to provide them with excitement. Instead, they look for markets to produce returns commensurate with the amount of risk taken. Serious investors follow the advice of Girolamo Cardano, a sixteenth-century physician, mathematician, and quintessential Renaissance man, who said: "The greatest advantage from gambling comes from not playing at all."[1]

[1] Peter Bernstein, *Against the Gods*.

Quotable Thought

Chapter Six, Page 141

There are two times in a man's life when he should not speculate: when he can't afford it, and when he can.

— Mark Twain

Adopt a Winning Investment Strategy!

Rather than attempting to play the active management game, the prudent approach to long-term investing is to build — and have the discipline to maintain — a globally diversified, passively managed portfolio that is tailored to your unique goals, including your own willingness, ability and need to accept risk (and its commensurate expected rewards). Read on for more insight.

Excerpt #5

Saving Versus Investing

Chapter Four, Page 109 — The differentiation between savings and investments is a very important concept to understand. Savings, because of low risk, and therefore low return, should be accumulated to meet emergency needs, cash flow needs, and shorter term spending requirements (e.g., college tuition, purchase of a home or car). Once you have created this safety net, the balance of your capital should be invested. This combination of savings and investments (your portfolio's asset allocation) will help you to ride out the often dramatic fluctuations in the market if you have confidence in the long-range success of your investment strategy.

There is no one right portfolio for everyone. Each individual's needs for savings are different. Everyone's investment time horizons are also different. In addition, not everyone can have peace of mind and accept the virtually inevitable bad years.

Quotable Thought

Chapter Three, Page 70

Seventy percent of success in life is just showing up.

— Woody Allen

Excerpt #6

Major League Investing

Chapter Five, Page 126 — Baseball scouts, when sent to look at the latest hot prospect, are trained to evaluate a player's skills in five areas; speed, throwing arm, fielding, batting for average, and hitting with power. How a prospect rates in these five skills has proven to be an excellent predictor of whether or not he will make it to the major leagues. Similarly, financial economists have determined that there are five factors that determine the vast majority of expected returns from a diversified portfolio. Three factors are related to the portion of the portfolio that is allocated to equities, and two factors are related to fixed-income assets. When one combines these into the five-factor model, one can determine the expected return of a balanced-equity and fixed-income portfolio.

Chapter Seven, Page 149 — In baseball the general manager's job is to put together a team that is well balanced between hitting, fielding, pitching, and running speed. While teams that are built around one area of strength may go on brief winning streaks when everything is going right, they are unlikely to win often enough over a long season to be champions. A general manager succeeds by building a team with diversified strengths. Similarly, individual investors succeed by building and properly managing diversified portfolios.

Excerpt #7

Investor, Know Thyself

Chapter Eight, Page 176 — While more money is always better than less, at some point most people achieve a lifestyle with which they are very comfortable. At that point, the taking on of incremental risk required to achieve a higher net worth is no longer acceptable to most people. The reason is that the potential damage of an unexpected negative outcome far exceeds the benefit that would be gained from incremental wealth.

Thus each investor needs to decide at what level of wealth their unique utility of wealth curve starts flattening out — begins bending sharply to the right. Beyond this point there is little reason to take incremental risk in order to achieve a higher *expected* return. Many wealthy investors have experienced devastating losses that could easily have been avoided if they, or their advisors, considered this important issue. It is one of the great ironies of investing that the very people who can most afford to take risk (the very wealthy) have the lowest marginal utility of wealth and therefore the least need to take risk.

The Only Guide You'll Ever Need

Avoiding playing the active investing "loser's game" and constructing a passively invested portfolio are initial hurdles between you and a winning investment strategy. Another — and critical — challenge is to maintain the discipline you need to stay the course, especially when the markets turn ugly. Sometimes, guidance from an advisor ally can make all the difference.

Excerpt #8

How Does Your Garden Grow?

Chapter Ten, Page 193 — My wife is a passionate gardener. She tends her garden with great care and discipline. Each season brings with it the need for certain tasks; if she does not accomplish these tasks, her garden might be filled with weeds, her plants destroyed by bugs, and her trees decayed by disease. The garden must undergo regular care and maintenance or it will not produce the desired result. The same regular maintenance must be performed on an investment portfolio or the investor will lose control over the most important determinant of risk and returns — the portfolio's asset allocation. One of the two most important items on the portfolio maintenance agenda is rebalancing. The other is tax management.

Chapter Ten, Pages 196-197 — In addition to being a passionate gardener, my wife is an excellent cook. However, she always runs into problems when trying to get a recipe from her mom, who measures ingredients not by teaspoons or tablespoons but by "a little bit of this" or "a pinch of that." My wife does her best to interpret this folk wisdom, but her dishes never taste quite the same as my mother-in-law's. When the manager of the actively managed domestic mutual fund you own decides to "ad lib" and buy some shares of Mexican companies, this manager is subjecting you to what is known as style drift. Instead of merely having a dish that tastes funny, you will own a portfolio that varies from the risk profile you expected and were willing to accept.

Rebalancing a portfolio restores the investor's original recipe: his/her desired risk profile. Without regularly rebalancing a portfolio, an investor will find that style drift has crept in. Not only should you not allow market movements to change your asset allocation and undermine your chosen strategy, but you should not allow active portfolio managers to subject your portfolio to style drift.

Excerpt #9

Helping Hands

Chapter Eleven, Page 220-221 — Tennis players know that a pro can teach them the skills needed to make the variety of shots required for a well-rounded game. The pro can also provide the winning strategy and the discipline to stick with that strategy. That is why even the top players in the world continue to have a coach. Investors can benefit from "coaching" in the same way a tennis player does. Just like the tennis pro, a good financial advisor will provide:

- The education necessary for the investor to play the game.
- The winning strategy.
- The discipline to stick with that strategy.

Quotable Thought

Chapter Eight, Page 168

Your ultimate success or failure will depend on your ability to ignore the worries of the world long enough to allow your investments to succeed. It isn't the head, but the stomach that determines [your] fate.

— Peter Lynch

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**

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