THE EDUCATED INVESTOR

Summer 2002

Investment Adventure or Bad Venture?

In today's business climate of Enrons and Worldcoms, the risk inherent to investing in the stock market certainly has revealed itself more apparently than in recent decades. What's an investor to do when the mean side of equity investing reveals itself? Should one fight or take flight?

Stock-market risk can take on (and for many recently has taken on) monstrous proportions, but the prudent investor can defend his or her portfolio by being forearmed with basic knowledge and techniques.

Know Yourself (In Advance)

The most successful investor is the one who predetermines how much risk he or she can tolerate. Ask yourself how much your portfolio could dip before you would begin to lose sleep and question your earlier investment decisions. And answer yourself honestly! If you construct a less-risky portfolio, you must expect lower long-term returns on your investments. (More on that in a moment.) But if you take on more investment risk than you can tolerate, you are likely to damage your portfolio's returns much more seriously by panicking and making rash and ill-advised investment decisions at the worst time.

Once you decide upon your risk tolerance, write it down in the form of an investment policy statement that outlines how much of your portfolio will be comprised of more risky investments with higher expected returns, and how much of it will contain safer investments with lower expected returns. Even better, create your investment policy statement with your investment advisor, so he or she can help you remember during bear markets that such times of trouble were actually part of the plan all along.

Know Thine Enemy

Integral to knowing your own risk tolerance is an understanding of what risk means to your investments. Be aware that bad things are highly likely to happen to some of your investments some of the time. But, ironically, some worse-than-expected news actually translates to good news for your long-term portfolio. Consider it this way: If you were faced with two investments and you perceived one to be more risky than the other, you would never choose the riskier one unless you also had a reasonable expectation that you would receive a higher return for investing in it. At the same time, accepting the greater risk is also accepting the greater chance that your expected return premium for that holding will not be achieved. The goal is to take on enough "different" investments (i.e., those with low correlation) so that the overall reward will be greater than the overall risk.

In short, risk is a two-edged sword. Which leads us to our next piece of advice.

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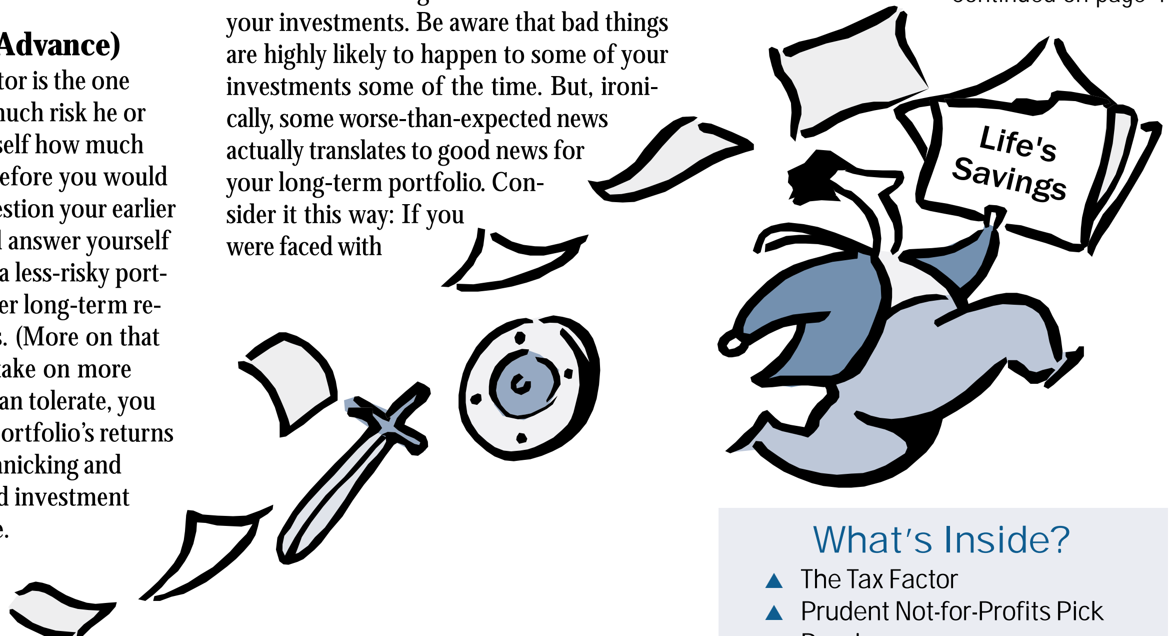

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The Tax Factor

Every penny saved is a penny earned ... particularly if it's a tax-efficient penny. While the vast majority of a portfolio's expected risk and return is governed by your asset allocation decisions – i.e., deciding what percentages of your portfolio should be placed in which asset classes – another important factor is asset location – i.e., deciding which asset classes (asset class funds) should be placed in your taxable versus tax-deferred accounts.

A traditional approach to asset location has been to hold actively managed equity funds in tax-deferred accounts and to hold bonds in taxable accounts (generally tax-exempt bonds for investors in all but the lowest tax bracket). The argument for this location decision is that the high turnover rate of actively managed equity funds generally leads to tax inefficiencies caused by the fund managers' required distribution of realized gains; the tax-deferral provides valuable shelter for assets with high expected distributions.

But sometimes traditions require reexamination. A 2001 study, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," concluded that this traditional approach is no longer likely to be the most efficient way to create wealth.[1] With the more recent availability of tax-efficient and tax-managed passively managed/index funds, and tax-efficient exchange traded funds (ETFs), the study authors concluded that a better strategy is to hold as much equity as possible in taxable accounts and hold taxable fixed income investments in tax-deferred accounts. This seems particularly applicable with the efforts made by some tax-managed funds to minimize the most tax-inefficient component of equity returns even further by minimizing dividend income.

Thus we would suggest — with some important exceptions to the general rule of thumb — that the prudent strategy is to hold tax-efficient equities in taxable accounts and taxable bonds in the tax deferred account. Exceptions include the following:

- If you may need to spend part of your taxable holdings in the relatively near future, you'll require some liquidity. You may want to hold assets earmarked for shorter-term expenses in fixed income vehicles within your taxable accounts, which might require you to shift some equity into your tax-deferred account.
- If you seek a rate of return that requires you to hold a very high equity allocation, you may need to hold some of your equities in your tax-deferred account. In this case the least tax-efficient equity holdings (such as REITS or non-tax-managed value funds) should be allocated to the tax-deferred account.
- Alternatively, you may be able to achieve the same expected return with a lower overall equity allocation, but a greater allocation of equities to the value and small-cap asset classes, which can be expected to yield higher long-term returns than the growth and large-cap asset classes. This might allow you to hold more or even all of your equity in your taxable accounts, resulting in greater efficiencies in meeting your financial objectives.

The preference for holding equities in your taxable account can also offer the following benefits:

- Tax-deferred accounts such as IRA and 401(k) saving plans convert long-term capital gains on equities into ordinary income upon distribution. Most likely, your ordinary income tax rate is higher than your capital gains rate.
- By holding equities in tax-deferred accounts you lose the "step up" in basis for estate tax purposes, which could otherwise potentially eliminate capital gains taxes for your estate.
- Capital gains taxes are due only when realized, which means, in a taxable environment, you have some control over when you pay the taxes by timing when you realize the gain.
- When holding a diversified portfolio of equities and/or equity mutual funds in a taxable account, there may be more opportunities to perform tax-loss harvesting, producing greater tax efficiency.

Each tax-planning component may yield seemingly modest benefits in and of itself. But when your advisor helps you combine them into a total asset location plan, they can significantly impact your final wealth.

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[1] Robert M. Dammon, Chester S. Spatt and Harold H. Zhang, *Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing*. Carnegie Mellon University, 2001. http://www.gsia.cmu.edu

Prudent Not-for-Profits Pick Passive

Of course we recommend a prudent investment approach for all investors, but when the investor is a not-for-profit organization (NFP), a passive investment strategy can provide the protection that NFP fiduciaries are required to practice.

Regardless of fiduciaries' level of expertise and direct involvement in portfolio management, how can they feel confident that they are meeting the legal and ethical obligations with which they have been entrusted?

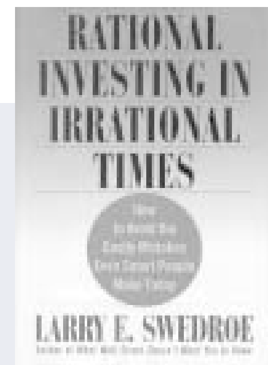
In May 1992, the American Law Institute adopted the Third Restatement of the Prudent Investor Rule, on which states have based their legislation. Within the restated rule, the ALI determined that the tenets of Modern Portfolio Theory (MPT) were the standards by which fiduciaries could invest in a manner that offered clear guidance to safe harbors.

Passive asset class investing is based on the same MPT tenets. It is consistent with the ALI assumption that alternative approaches of stock picking and market timing offer little or negative payoff, particularly after research and transaction costs. By adopting a passive investing approach, fiduciaries can enjoy several benefits:

1. They can minimize personal liability if they have chosen to be directly involved in managing the NFP portfolio.
2. Those who lack personal expertise can still minimize their liability by exercising reasonable skill and care in delegating to an agent who will be held to the same standards (eg., by selecting an advisor with expertise in implementing a passive investment approach).
3. Passive investing based on the principles of MPT further enables fiduciaries or their agents to structure an organization's portfolio in such a manner that it can be expected to maximize returns for the degree of risk being taken.

By accurately identifying the organization's willingness, ability and need to accept investment risk, fiduciaries or their agents can determine appropriate diversified allocations for the NFP's assets. Such an approach helps strike a proper balance between ensuring that a prudent investment approach is being pursued and maximizing the organization's ability to achieve the desired growth level for its assets.

A Book to Invest In: *Rational Investing in Irrational Times*



If you enjoy reading our *Educated Investor* newsletter and would like to learn more about the passive asset class investment approach that guides our articles, you will value Larry Swedroe's latest book, *Rational Investing in Irrational Times: How to Avoid the Costly Mistakes Even Smart People Make Today.*

"Fifty years of experience has persuaded me that successful investing results not from rigorous security analysis and complex management strategies but from simplicity as basic as regular saving, financial discipline, realistic expectations, and common sense. ... Larry Swedroe's fine new book will help you to avoid the potholes that punctuate the road to investment success."

— John Bogle
Founder & Former Chairman
Vanguard

"Whether readers have a few thousand or many millions to invest, they can learn — and likely recognize some of their own foibles — from the common investor mistakes outlined in Rational Investing in Irrational Times."

— John Biggs
Chairman, President & CEO
TIAA-CREF

Investment Adventure (cont.)

Capture the Entire Market

While one shouldn't expect improved returns without accepting incremental degrees of risk, there are two types of risk that can (and should) be easily avoided. These are the risks of investing based on an active approach — picking specific stocks or guessing in which direction the market is headed.

As we have all witnessed, the risk of holding individual stocks such as Tyco or Global Crossing can be unexpectedly realized in a very painful manner. Imagine that your investment "sword" represents the entire stock market. By holding the sword at its hilt – that is, by investing in the entire market — you can expect to capture its overall returns. Trying instead to select individual stocks or market sectors is similar to trying to hold the sword by its blade. Indeed you are taking on a great deal more risk, but where is the commensurate reward?

Instead, we suggest adopting a passive asset class investment approach, whereby you capture domestic and international equity markets by investing in selected component asset classes — small-cap, large-cap, growth, value and real estate.

Implement Your Strategy

How do you translate your personal risk tolerance and an understanding of passive asset class investing into a customized portfolio? Your investment advisor can help you devise the precise mix that makes the most sense for you, but here are some general guidelines:

1. Determine how much of your portfolio should be invested in equities and how much should be in fixed income. This overall decision should reflect the degree of risk that you are willing, able and needing to take. If your risk tolerance is low, weight your portfolio with greater amounts of fixed income; if it is high, you can increase your equity allocation.

2. Your appropriate risk exposure can be further fine-tuned by purchasing larger or smaller amounts of the riskier equity asset classes. For example, international small-cap value stocks are perceived to be riskier than US large-cap growth stocks. Thus, over time, they can be expected to yield greater returns, while also causing more volatility (risk) within your portfolio. Such volatility can be dampened by implementing an appropriate mix of riskier and safer equity asset classes.

Seek an Ally

Last but not least, we recommend you ally yourself with our investment advisors. We can contribute an in-depth understanding of the nature of risk, the expertise to help you determine your risk tolerance (today and tomorrow), and the tools necessary to implement a long-term strategy that will help you withstand the many challenges you are likely to face throughout your adventurous investment journey.

Worth Repeating

Worth Repeating

"Imagine that you had to drive from New York City to Los Angeles. You're in downtown Manhattan and hopelessly stuck in traffic. Bicycle messengers are whizzing past. You jump out of your car, sell your car on the spot (at a ridiculously low price), buy a bicycle, and continue your trip to the West Coast.

As absurd as this scenario sounds, investors do it every day when they make short-term decisions for long-term journeys. Stick with a vehicle that will take you to the end of the road."

— Don Connelly
Senior Vice President
Putnam Investments

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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