

Great Ideas

When I was a kid I saw the classic movie *The Invisible Man* starring Claude Rains. He could be seen only when he was wearing clothes. He wrapped his face with something that looked like an ace bandage, wore a hat, sunglasses and a phony nose. Talk about spooky looking. But after watching that movie I had the great idea that it would be fun to be invisible. Just imagine -- I could spy on my friends, get into the movies for free or do a cannonball off the high board and scare the life out of a pool full of grownups. While drying off after my dive, I would look like a towel fight in an empty room. I'd never again have to listen to my parents complain about my body language or that smirk on my face. Sign me up!

But I was only a kid and didn't have an adult perspective on things; I missed a few of the more notable drawbacks of invisibility. To get into the movies for free, I would have to be naked. I'd have to walk around the movie theater in my bare feet and sit in one of those gum infested chairs in my birthday suit. And how could I buy popcorn? It would be hard to make new friends -- or keep old ones for that matter. How would I deal with tooth decay? Whenever I went outside, even on the hottest day of summer, I'd have to wear long pants, a hat and something to cover my face -- like one of those rubber Bill Clinton masks.

Parents have the important responsibility of warning children that their latest great idea might not really be so great. This is also why airlines insist that first officers are accompanied by captains in the pointy end of the jet. And great ideas that prove to be less than advertised play a big role in why individual investors achieve investment returns that are far below market averages.

For the past 16 years, Dalbar has published its *Quantitative Analysis of Investor Behavior*. This study analyzes mutual fund inflows and outflows to determine if investors achieve short-term gains by correctly anticipating the direction of the market. Guess what? They don't. The 2010 study covers the 20 year period from January 1, 1990 through December 31, 2009. This period contains the two worst market declines since the Depression (2000-2002 and 2007-2009). Yet during these 20 years, the S&P 500 Index produced an average annualized rate of return of 8.2%. This is what Rip van Winkle would have earned if he invested his money in an S&P 500 Index fund on January 1, 1990 and fell asleep for 20 years. Dalbar reports that his neighbors, by acting on great ideas, earned a 3.2% average annual return in their stock mutual funds. Inflation averaged 2.8% during these years, so individual investors earned an inflation adjusted 0.4% for all the grief and agitation that accompanies stock investing. What investors needed these past 20 years wasn't market beating investment ideas but rather a trusted advisor to help them achieve market equaling returns.

We must conclude from the Dalbar study that it wasn't mutual fund performance but it was investor performance that caused the poor results. Great ideas gone bad. Another phrase for investor performance is investor behavior. Investors do not always behave rationally, often acting in ways that harm investment returns. We are loss averse, quick to sell during market declines because we naïvely expected large returns with no risk. We're too quick to act on "great" investment ideas when things look rosy. But what seem to be great ideas at the time often prove to be not so great in the long run. The average investor holds a stock mutual fund for only three years -- a much shorter holding period than Rip van Winkle's. I guess this means that the average investor gets a great new investment idea about once every three years without considering if it is appropriate for his goals, risk tolerance or time horizon.

Media risk is a new culprit making its appearance in studies of investor behavior. I can't prove it but I believe that most of our "great" investment ideas come from something we've heard or read in the media. Too often, investment decisions are made in an emotional response to news - the particulars of which will be long forgotten before the consequences of poor decision-making are remedied. Most news is the report of an isolated event with no long-term importance. More often than not the daily news is a cacophony of distracting shouts, a siren's call

that raises blood pressure and distracts us from keeping a long-term perspective. (Do I really need a real-time video showing oil spewing out of a broken pipe at the bottom of the Gulf of Mexico? I get it already.) I'm tired of those people I call "eco-grouches". You've seen them. They just cannot get over the fact that the stock market rose 75% while they were proclaiming the imminent end of the world. How sad it must be to go to bed hoping that something really bad happens tonight so that you can wake up tomorrow feeling vindicated. It's hard to take a heavy dose of the financial media without walking away with an anxious feeling that you have to do something. I call this Media Anxiety Disorder (MAD). It's a low-grade uneasiness that exists just under the surface of our consciousness. It works on your peace of mind like stomach acid in your tummy after a big Mexican dinner and too many chips.

I'll also add investment books to the media risk category. It's my opinion that the great majority of the books in the personal finance section of your favorite bookstore are worthless. They're published to make money by appealing to the greed or fear du jour. Most will be out of date and irrelevant a year from now. There are good books that give readers insight into our behavioral tendencies as investors, the lessons of history and how the markets work but they are few and far between and don't usually have the words rich or millionaire in the title.

Most investment advice is nothing more than someone's great idea about how to make money in the immediate period ahead -- this week, this month or this quarter. Yet when it comes to making accurate short-term predictions -- whether about the economy or the stock market -- no one has a consistent track record. Let's just think about this for a minute. How is it possible to predict what will happen in a world of 6 billion people, half of whom (for the first time in history) live in political freedom, engage each other in commerce and can communicate instantly with one another? Yet, every day we hear economists giving their predictions about whether the economy will continue to improve or whether Great Depression II lurks around the corner -- never mind that economist still can't agree on what caused Great Depression I.

In one of his annual letters to shareholders, Warren Buffett wrote that it takes only two things to invest successfully: having a sound plan and sticking to it. He went on to say that of these two, it's the sticking to it part that investors struggle with the most. I think most of us can say amen to that. This is why I'm such a strong advocate of having a written financial plan. One designed to meet clients' long-term needs but is flexible enough to be modified if necessitated by changing client circumstances.

It will always be difficult for individual investors to stick to their plan in the face of economic and market uncertainty. The best way to achieve long-term goals is to ignore the short-term distractions. The Dalbar study shows us that the most successful investors will be those who realize that being smart isn't nearly as important as being serene. By serenity, I mean being disciplined in good times and optimistic in hard times. In the long run, managing your emotions just might prove to be more important than managing your portfolio.

The leading edge of my baby boomer generation is approaching retirement. Unfortunately we've taken two big hits to our retirement assets during the last decade. It appears that many soon-to-be retirees exited the stock market during the latter phases of the recent bear market. Their behavior is understandable but their timing couldn't have been worse. Many boomers believe that their financial future is out of their control. They find themselves bombarded by endless investment advice but little or no financial planning advice. Some believe that they must find a great new investment idea to get back on track or make up for lost time. Unfortunately many financial professionals enhance this idea by emphasizing performance and predictions that masquerade as financial planning. Quality financial planning requires an extensive analysis of a family's values, net worth, cash flow, insurance coverage, employee benefits, investing history and tax situation. Boomers need financial planning that contains a proven, comprehensible, long term strategy for achieving financial goals and managing retirement income. This is a much more difficult and time-consuming task than selling product. A strategy must precede the investments chosen for a portfolio, not vice versa. Many baby boomers find themselves seeking financial planning advice from someone desperate to make quota and it is essential that they be able to differentiate between financial planners and financial pretenders.

The increasingly complicated computer-generated investment products sold by Wall Street will not meet the needs of my generation. Math cannot bring certainty to uncertain events and computer programs are nothing more than fancy math. More often than not, the Wall Street quants who design these elaborate products are highly educated mathematicians, not financial experts. Many of these products seem to be great ideas but they often unknowingly turn investors into speculators while giving the impression of security.

I'll put it plainly. If you're more than 50 years old you have no business in a financial relationship with anyone who doesn't know your budget, your cash flow, your desired retirement lifestyle, your risk tolerance and your legacy desires. This relationship must include discussions about a portfolio withdrawal rate during retirement that will provide for an inflation-adjusted lifestyle. These discussions must also incorporate a comprehensible strategy for determining the accounts from which these draw downs will be taken and in what order. My fellow boomers need financial professionals with an in-depth knowledge of Social Security and Medicare. Social Security payments can begin as early as age 62 or as late as age 70. The decision about when to start receiving payments must be done right but I find most articles on this subject to be superficial and mathematically flawed.

We live in what I call "internet time". Each year brings a greater quantity of information into our lives. But we don't have enough time to process and evaluate what it all means. My fellow baby boomers don't need stock picking advice, they don't need market analysis, they don't need portfolio churning and they don't need any more great ideas. What they need is perspective and advice from a trusted advisor who knows them well, can help them ignore the noise and make sound decisions for their personal circumstances. Someone who can help them distinguish the true from the false, the practical from the useless and the important from the merely interesting. And I might add that it would be beneficial to find someone wise enough to admit that he or she has no ability, or desire, to predict the future. Wall Street can never provide these people to my fellow baby boomers. They wouldn't know where to find them, how to train them or how to make money employing them.

The 15 Minute Crash

I hope you were doing something more productive than watching television on May 6th when, during a period of about 15 minutes and for no apparent reason, the value of the 30 companies constituting the Dow Jones Industrial Average fell 10%. The thing I want to emphasize here is "for no apparent reason." For the next few days the explanations were flying fast and furious. A month later, nobody is sure exactly what happened or why. No sooner had the 10% drop occurred when the Dow suddenly regained most of its losses. Let this be a lesson for all of us. The daily noise and distraction of the stock market has nothing to do with long-term financial planning.

There can be no doubt that computers were behind the events of May 6th, doing exactly what they were programmed to do -- buy x or sell y if z happens. There are estimates that up to 70% of the buy and sell orders each day at the New York Stock Exchange are placed by computers that can make trades in one millionth of a second. But the unexpected can never be programmed; you'd think we'd all know this by now. Computers cannot eliminate risk because the real risk lies in the unknown. What we know is dwarfed by what we don't know or cannot see. Overconfidence is the great enemy of many smart people on Wall Street. Nevertheless, traders all around the world continue to fool themselves by believing that their computer algorithms will save them from the market's volatility. The events of May 6th occurred when computers did exactly what they were programmed to do by people who are as overconfident as they are intelligent.

Too many financial advisors believe that they must prove their value by outsmarting the rest of the world and outperforming the market. I began On Course Financial Planning at the age of 55. To an outsider like me, a latecomer to the party, this has always seemed ludicrous -- I cannot imagine what they're thinking. But it's the mindset and culture that they were trained in and most have spent decades drinking the Kool-Aid. There, I said it. The Dalbar study shows us that they would be doing yeoman's service if they just got their clients market equaling returns.

We often ignore the lessons of history despite an uncomfortable number of reminders. One lesson is that 20% - 30% declines in the stock portion of a portfolio have been normal, recurring and unpredictable. Get used to it. We don't know what the sources of the future crises will be, when they will occur or how long they will last. Investors are best served by a financial advisor who accepts the inevitability of such events and doesn't waste time or energy trying to predict them. The old idea of staying broadly diversified with an allocation to stocks appropriate for your age, goals and risk tolerance; staying invested in good times and bad has been forgotten in many circles. But Warren Buffett's advice to make a plan and stick to it is still the best advice for investors today no matter what the naysayers claim. Forget about great new ideas. Here's a great old idea - slow and steady wins the race.

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