



Ruminations on Investment Philosophy

This is an attempt to describe our investment philosophy and the investment experience our clients should expect. Our approach is driven by academic (as opposed to Wall Street) research and therefore is grounded in what is believed to be optimal and prudent rather than oriented toward the fads and fashions of the moment or what will sell well to the public. Remember, when Wall Street builds a better mousetrap investors are generally the mouse. Our approach is long-term, strategic, and based on well-established financial theory, empirical data, experience, and judgment. Specifically:

- With a few caveats (see next two points), we accept that markets are efficient. This means that individual securities are generally priced correctly *ex ante* and incurring additional costs in the hopes of finding a mispricing is wasteful though of course apparent mispricings will seem obvious *ex post*. In short, active management does not consistently add value through security selection or market timing thus **we will invest almost exclusively through index funds and other passively managed vehicles.**
- Notwithstanding the overall validity of market efficiency described above, value stocks tend to outperform growth stocks over time due to widespread investor confusion between a good (bad) company and a good (bad) investment. This outperformance is particularly pronounced in areas where the “story” has more salience such as small companies and emerging markets. Thus, **we will tilt portfolios toward value stocks** and away from growth stocks.
- Similarly, we believe it is possible that the stocks of smaller companies will outperform the stocks of larger companies in the long run. Thus, **we will tilt portfolios toward smaller companies.**
- Both diversification and cost control are crucial. Thus **we will use mutual funds or exchange traded funds (ETFs)** to gain exposure to various asset classes due to their broad holdings, low costs, and low turnover (which also reduces costs). Diversification between risky asset classes (domestic stocks and foreign stocks for example) is beneficial in prosperous times to ensure exposure to whatever area is currently doing well. During market turmoil however the benefit of diversification between these risky asset classes largely vanishes as they all decline together. Diversification still works however, but it is the diversification of also holding safe assets (investment grade bonds) in a portfolio.
- **During poor markets, investors should expect the risky portion of their portfolios to decline by approximately half.** From peak to trough, U.S. stocks declined in nominal dollars by between 45 and 55 percent in 1973-1974, 2000-2002, and 2007-2008. Thus, an investor with a \$1,000,000 portfolio that is 60% stocks and 40% bonds *should* experience a decline to \$700,000 periodically (though hopefully not often). This is the necessary price to achieve the higher returns that are expected from risky assets. If stocks did not occasionally experience losses, they would cease to be priced attractively enough to earn superior returns. It is our job to make sure client portfolios are positioned at an appropriate level of risk and that our clients do not increase their risk taking when things look rosy (e.g. 2006) and do not decrease their risk exposure when the outlook is frightening (e.g. 2008).
- Foreign investments will be used for additional diversification. Thus, **for international exposure we will invest in smaller companies and/or emerging markets companies** rather than in large companies in developed countries since they offer much less diversification benefit to an investor who already owns large U.S. companies.

- For additional diversification, “alternative” asset classes are appropriate. Thus, **a portion of the portfolio will generally be invested in REITs (Real Estate Investment Trusts) and high yield bonds (aka junk bonds)**. While it would be imprudent to place a large percentage of a portfolio in these investments, in smaller proportions they can improve the risk/return profile. Dose determines toxicity.
- Depending on the specific inflation exposure of each client outside of their portfolio, **some or all of the bond allocation may be to TIPS** (Treasury Inflation Protected Securities).
- While we review portfolios and the market environment frequently, we make changes very infrequently. Turnover has costs and generally doesn’t add value (though it does make everyone feel better to “do something” rather than simply stay the course). As Warren Buffett has said, “Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell.” He also stated, “Lethargy, bordering on sloth, should remain the cornerstone of an investment style.” Once a client’s portfolio is invested appropriately, **we will not do much trading** aside from opportunistic tax loss harvesting. This is a sign of prudence and patience, not inattention. We do not trade simply to appear busy.

Notes:

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