ETF Fees Continue to Fall

Competition between fund providers continues to result in lower fees on exchange traded funds (ETFs).

A very good thing if you are a proponent of cost minimization when investing.

I read a short article that discusses this subject and makes a couple of useful side points.

"In the Trenches of the ETF Fee War" offers some thoughts that should be kept in mind when investing in ETFs.

Diminishing Returns on Reducing Fees

> *We've come to the point where the ETF industry's fee war is becoming inconsequential for investors*

The point here is that there is not much difference between many ETFs in the same peer group (e.g., large cap Australian equities). True, but be sure to make apples to apples comparison. Fees may not differ significantly within a fund category, but they will still vary between fund categories (e.g., mega cap U.S. equities versus small cap U.S. equities).

Further, that the minimal differences between offered funds is not worth shifting money from old to new. Again, true. Even over very long periods, 2 basis points difference in fees will not make or break you. That said, every penny in your pocket is preferable.

Again, compare apples to apples. The article notes:

> *the average ETF costs 0.65% today, compared to the 0.56% charges in 2010, according to Morningstar data. Apparently, the higher costs niche or specialty ETFs are pushing the average higher even as large providers are cutting costs on*

> *large, broad-based ETFs.*

You can invest in a S&P 500 index fund for less than 10 basis points per annum. iShares costs 0.07%. The difference between this fund and the 0.65% "average ETF cost" will add up over time. And as you get more exotic, the ETF costs will continue to rise. For example, the iShares MSCI India Small-Cap ETF (SMIN). It carries a 0.74% expense ratio.

For a few more thoughts on fees, please read "ETFs Over Funds: Investment Costs".

Need to Consider More than Price

> *investors should not base an ETF purchase on price alone, there are many other factors that play into the equation of an outperforming fund.*
>
> *Efficient trades, low bid-ask spreads and tax treatment are especially pertinent for total return.*

Yes, that is true. The smaller the fund, the more exotic the fund category, the more active the fund strategy, the less efficient the capital market, etc., the greater the cost to the fund.

Until you develop a substantial investment portfolio, I suggest you stick with the larger funds and passive index strategies. These will tend to have higher efficiency and (on average) less turnover than a smaller, more actively managed, fund.

Your Trading Habits are a Cost

> *Operating expenses are another area investors must consider. Every trade that is executed costs the investor, so for those who trade frequently, an ETF can be expensive.*

There are an increasing number of funds that are "transaction free" or "no-transaction fee". Availability and number differ between brokerage houses, so see what is offered where you trade. Or, if considering creating a brokerage account, factor this into your comparison.

If you use a general buy and hold strategy, your portfolio turnover will not be significant.

Where you may need to be careful is in using a dollar cost averaging approach to build your holdings. Dollar cost averaging is an excellent tool for small investors. But watch the transaction fees.

If you invest $100 each month and pay $10 in brokerage commissions, transaction fees will ruin your returns. Instead, accumulate capital in a cash account or low cost, no-load money market mutual fund. When you reach a critical mass – maybe 4, 6, or 12 months out – then invest in the chosen ETF.

Should You Be Selling Your Winners?

"It's tough to sell winners and buy laggards, but it's smart."

That is the lesson from MarketWatch's, "Force yourself to rebalance your portfolio."

Good advice. But difficult for most investors to follow.

Human Nature is to Ride the Winners

> *The basic human instinct when an investment gamble has been*

> *paying off is to let it ride; rebalancing involves culling winners and putting the proceeds into laggards in order to follow a plan.*

It is hard for investors to sell successful investments and move the proceeds into underperforming areas. But that is the correct strategy much of the time.

Note that I (nor MarketWatch) am not talking about individual (non-diversified) investments like stocks. There are way too many variables that impact individual stock performance and often market leaders can maintain their edge for lengthy periods. Rather, we are talking about markets, as a whole, and asset classes and sub-classes.

Take Emotion Out of Investing

> *That is why, ideally, rebalancing is done unemotionally, based on a schedule set either by how far off-plan a portfolio gets, or by regular calendar intervals. The bigger the portfolio, the more these differences matter, creating more need to rebalance on a scheduled basis; experts note that average investors with moderate portfolios can get away with rebalancing every year or two, or when the portfolio is 5 to 10% off-target.*

Take the emotion out your investment decisions. Adhere to a predetermined fixed plan for reviewing your portfolio. Rebalance as necessary.

As the above quotes states, reviews can be based on how much the actual asset allocation deviates from your target allocation. Or it can result from regular calendar intervals.

Personally, I would factor in the volatility of the portfolio (a.k.a., portfolio risk, portfolio standard deviation). The riskier the portfolio, the greater the frequency of monitoring. I would also review the portfolio in the event of a material event.

A key takeaway from the embedded quote should be: “average investors with moderate portfolios can get away with rebalancing every year or two, or when the portfolio is 5 to 10% off-target.” Moderate refers to portfolio investment risk.

The more you rebalance your portfolio, the greater the transaction fees (and potential triggering of taxable capital gains). Your investment goal should be cost minimization, so watch out for too much trading. If you decide to rebalance every month, expenses will impair long-term performance.

As well, the higher your portfolio risk, the greater the acceptable asset allocation variance. The article recommends 5-10%, a good range for moderately risky portfolios like an S&P 500 index fund. But what if your equity allocation consists of small African mining companies? Perhaps they can fluctuate up and down 30% each year. Do you want to be buying and selling the shares every time they get 10% from target allocations? No.

Momentum Investing

> *Browne, of FundX, follows a strategy of investing in funds and ETFs that have the hot hand, trying to ride category leaders in the areas that look best*

As a side note, I want to mention momentum investing. Not quite what Browne is doing, but it came to mind when I read the quote.

If you are nimble, perhaps you can take advantage of short term movements. But there are a lot of traders out there playing this game. If you want to trade, trade. If you want to invest for the long-term, might be best to not worry about momentum investing.

I do not like momentum investing, although I will admit to following this path on occasion in my youth.

I do though, to some extent, tactically invest. But I prefer to do so using longer term trends, rather than simple pricing anomalies or short-term movements. And I prefer to utilize diversified investments (e.g., index funds) to take advantage of macro-economic trends, rather than guessing if Apple will continue to outperform over the short-term. Also, for clients, I recommend building a strong overall core portfolio, then utilizing tactical moves to augment the core. Not tactical as a stand-alone strategy.

I would caution readers that tactical asset allocation requires a fair amount of investment expertise and experience. If you wish to go this route, I strongly suggest working with a competent advisor.

Types of Stock Traders

Investors come in all shapes and sizes.

There are also a multitude of ways to trade investments.

Today a brief look at the various types of traders.

Investopedia asks “What Type Of Trader Are You?”

I think the type of stock trader one may be reflects investment experience, general view of how the world functions, amount of capital to invest, and risk tolerance.

Fundamental Traders

I prefer fundamental analysis. In large part because I have a professional accounting and finance background, so possess the ability to analyze companies. I also take a longer term investment perspective and therefore desire well-managed companies that have strong long-term growth potential.

The article associates fundamental trading with the buy and hold approach. But note that it is more closely aligned to buy and hold than a short-term trading strategy. True. But fundamental analysis on its own does not necessarily equate to buy and hold.

Noise Traders

I do not like technical trading. That said, some do well investing this way.

With so many similar computer trading tools out there, I think technical trading at times becomes a self-fulfilling event. I "identify" a trend/pattern with my software, so I make the appropriate trade. Many, many other traders "identify" the same trend/pattern and they make the same trade. That impacts supply and demand for the investment and shifts the price.

Perhaps your trading program says that Apple should increase in price. You purchase Apple shares (or buy call options, etc.). As others read the same signals, they also buy shares of Apple. The increased demand increases the share price and the prophesy becomes self-fulfilled. A good strategy if you are one of the early buyers. But if you are "late to the party" you may get caught up in an investment bubble.

Sentiment Traders

A combination of fundamental and technical traders. I would also say an equal dose of behavioural trading. So a little of everything.

Market Timing Traders

Of note here is that it is difficult to consistently time market movements over the longer term.

Unless your career is day trader, I suggest you avoid market timing. I would also recommend avoiding a career in day trading.

Arbitrage Traders

I agree that the opportunity for arbitrage continues to shrink with each year.

I think for anyone regularly reading this blog, that you will not have access to the tools, exchanges, or experience to successfully arbitrage investments.

Traders Versus Investors

I like Investopedia's use of the term "trader" as opposed to "investor".

Short-term, active strategies are more trading in nature. Not necessarily speculative, but not the route I think individual investors should pursue.

Individual investors saving and investing for their future retirement should take a more structured approach. A long-term focus, emphasis on asset allocation, cost minimization, etc. Trading activities are not well-suited to long-term investing.

Buy Index, Not Actively Managed, Funds

Invest in passively managed index funds, not actively managed mutual funds.

A constant theme of mine for individual investors.

Today, a short video courtesy of The Motley Fool.

http://www.youtube.com/watch?feature=player_embedded&v=wbiJAVUEMAs

Keys to note in the video:

0:20 – note the big discrepancy in expense ratios between the Spider Index Fund (9 basis points) versus the other funds. Every cent you pay in additional fees negatively impacts your performance. And your ability to reinvest your returns for compound growth in the future.

0:20 – note the correlation between expense ratios and performance. Look at the 5 year return. A strong correlation between higher expense ratios and lower relative performance. That gets to my point about how difficult it is for active investment managers to consistently outperform their benchmarks over time. Smart investors stick with low cost index funds.

1:00 – the commentator discusses performance over the last month and three months. When considering investment alternatives, ignore short-term results. Luck or external events can impact short-term performance. Focus on mid to long-term results when researching investment products. Given the number of new offerings out there, three year results may suffice. But if you can assess five and ten year data, much better.

The commentator does not discuss, but when comparing investment options be certain to do apples to apples. In this video, they compare the S&P 500 to a variety of funds. To ensure you are comparing similar risk-return profiles, you want to check to see what benchmark each actively managed fund uses. If it is the S&P 500, then comparisons are probably reasonable. But if the benchmark is something else, then it is not fair to compare the fund to the S&P 500. In this case, the listed funds are primarily large cap U.S. equity funds, so S&P 500 is okay. But if a fund focussed on micro-cap technology stocks or Japanese equities, then using the S&P 500 as a benchmark is useless.

Active Manager Praises Passive Funds

Next we will see cats lying with dogs.

In "ETF Expense Ratios Between Countries", I looked at how the same fund can have widely different expense ratios depending on which exchange it was listed.

I read an interesting article that reinforces a key point I made. And adds a couple more worthy of note.

In "Active Manager Praises Passive Funds", Wilfred Hahn talks about the proliferation of exchange traded funds. A few interesting points:

Proliferation of Cost-Effective Investment Options

> *Ten years ago, Hahn recalls, there were only about 150 ETFs globally. Now, with nearly 5,000 ETFs in his investment universe of potential picks, there's very little need to trade on overseas exchanges. Nearly all of the ETFs that the portfolios now hold are listed on either the Toronto Stock Exchange or U.S. exchanges. "That's good news because it makes international investing more cost-effective," Hahn says.*

In 10 years, from 150 ETFs to 5000. A lot more investment options.

I looked at this issue of ETF proliferation previously. More is not always better. You need to watch out for a few potential problems.

Maybe cost-effective for North American investors today. Over time, I expect to see the rest of the world's developed markets improve their fund offerings. And the more competition, the better the cost structures in the funds. Good news for investors around the world.

ETFs Covering All Investment Needs

> *At least 75% of each portfolio will consist of core holdings in equities, fixed income and cash. Some or all of the remaining 25% may be held in more opportunistic investments, such as ETFs dedicated to specific commodities. Hahn and his colleagues have identified more than 60 asset types that can be held via ETFs.*

ETFs allow for investing in a wide range of asset classes and subclasses.

Yet the bulk of Hahn's portfolios remain invested in the three core asset classes. It goes to show that investors can do quite well without having to branch out into exotic or alternative investments. Focus on your core. As you accumulate significant wealth, then consider augmenting your portfolio.

A key reason why you probably do not need alternative asset classes?

Consider a very simple example in the TSX 60. The largest 60 stocks in Canada. You want real estate exposure? You got Brookfield Asset Management. Oil and gas? Canadian Natural Resources. Gold? Goldcorp. Silver? Silver Wheaton. Copper? First Quantum Minerals. Nuclear energy and uranium? Cameco.

Agriculture and potash? Potash Corporation.

That is just one example for each. There are more for various alternative investments. Heck, you can even invest based on (the highly profitable) Canadian consumption of doughnuts (and low cost coffee).

And given the countries where many of these companies operate and/or market their products, simply investing in the TSX 60 provides substantial global exposure.

Buying these 60 largest Canadian traded companies, you get more than mere plain-vanilla Canadian-centric equities. If you look at any major index around the world, you will see that the companies within typically cover a wide range of industries and world regions.

These major indices are very good for portfolio diversification. You may not need to supplement your core portfolio with alternative asset classes or geographic markets. Your home market index may provide adequate diversification.

As an investing aside, I prefer a broader Canadian index. For example, the TSX Capped Composite Index. Whereas the TSX 60 covers about 73% of the Canadian equity market, the Composite covers 95% with 257 companies included. Slightly more diversification and exposure to companies and industries. For example, the Composite includes additional alternative asset classes like diamonds (Dominion Diamond) and timber (West Fraser).

ETFs Aid in Prudent Portfolio Management

> *Hahn seeks to avoid what he calls "classic" portfolio mistakes such as not enough diversification, too much risk and too little fixed income. His exclusive use of ETFs, as opposed to direct holdings in stocks and bonds, enables him to minimize company-specific risk.*

Note that Hahn uses passively managed ETFs (i.e., pure index ETFs) to create tactically managed portfolios. That is very different than an actively managed ETF. And for more experienced investors, I have no issue with tactical asset allocation strategies. I employ them myself in my business. More for longer term trends though than market timing.

For a look at strategic versus tactical allocation, Investopedia reviews a few styles.

Regardless of approach, index funds can definitely assist in enhancing portfolio diversification and risk management on a cost efficient basis.

It is what I recommend to you.

As your total capital and expertise accumulates, then consider expanding into non-traditional asset classes and possibly tactical asset management. But wait until your wealth grows. And more importantly, you develop strong investment knowledge and experience (or work with a competent financial advisor).

Tips to Diversify Your Portfolio

Diversification is crucial for long-term investment success.

Proper diversification, that is.

Today, how to better diversify your investment portfolio.

A Quick Refresher on Diversification

We covered diversification a while back, so just a quick reminder on this important concept.

What is portfolio diversification?

A little deeper look into portfolio diversification.

Portfolio diversification in action.

Portfolio diversification and asset correlations.

Diversify with emerging markets.

Mutual fund holdings and diversification.

Efficient and effective portfolio diversification may be the main determinant of long-term investing success or failure. Please make certain you understand this crucial subject.

Investopedia provides "5 Tips For Diversifying Your Portfolio". We have covered these tips before, but it is a nice summary.

1. Spread the Wealth

Reduce your portfolio's non-systematic risk (i.e., the diversifiable risk) by spreading out your capital. Diversify within and between individual asset classes (e.g., equities, fixed income) and asset sub-classes (e.g., natural resource equities, junk bonds). Diversify across geographic regions (e.g., emerging, developed) and time (e.g., 5, 30 year bonds).

There are diminishing returns to diversifying. And the benefits of diversification are more a function of the correlation between the assets selected, not simply the number of investments you make.

2. Consider Index or Bond Funds

Cost effective. The funds are often well-diversified within the tracked index. And it is easy to create a diversified total portfolio with very few investments (though each fund will have a large number of holdings).

For example, consider the iShares S&P 500 index exchange traded fund (IVV). You buy one single investment product. Yet you receive the benefit of 500 companies representing a wide variety of the U.S. equity market. All for a minimal annual cost of 0.07%.

3. Keep Building

Fully agree that dollar cost averaging can aid in effective diversification.

Dollar cost averaging promotes investing discipline, a consistent approach, and portfolio quality. It is an excellent investing technique for small investors.

4. Know When to Get Out

I like a general buy and hold approach when investing in mutual and exchange traded funds. I do not think buy and hold forever works with non-diversified investments, like individual stocks or bonds.

One has to be aware of potential problems, but I think the advantages of buy and hold for funds win out for investors.

I like buy and hold. But that does necessarily mean buy and hold (forever, locked away in a drawer). Buy and hold, but review. As necessary, rebalance your actual asset allocation back in line with your target allocation. There are a few strategies available to rebalance.

5. Keep a Watchful Eye on Commissions

Yes, watch commissions on mutual funds. I recommend seldom (usually never) buying into any fund that charges a commission. There are too many good no-load funds out there.

Besides commission, keep an eye on all your investment related expenses.

Brokerage fees when buying or selling mutual funds, exchange traded funds, stocks, bonds, etc.

Annual expenses charged to an investment product. These can significantly impact investment returns for both mutual funds and exchange traded funds. They can also materially differ between investment products and offerings. So do proper due diligence prior to investing in any one product or fund.

Why? I cannot tell you which fund or asset class will outperform next year. But I can tell you with some confidence that lower costs will result in stronger performance over time.

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3 Essential Investment Rules

StreetAuthority looks at three essential investment rules of master investor, Peter Lynch.

Excellent investment advice for those wishing to invest in individual equities.

Unfortunately, I do not know any non-professional investors who could actually follow two of the three keys. Ah, the joys of investment advice.

Only Invest in What you Understand

A good point. But what does the average investor understand?

First, most investors should avoid complex investments such as options, futures, forwards, commodities, etc. Stick to traditional fixed income and equities to go with cash balances.

But what about equities? The normal investor should have a well-diversified portfolio. That means small, medium, and large cap stocks, in a variety of industries, throughout multiple geographic locations.

If you are only supposed to stick with things you know, how can a Canadian investor add Russian, Australian, or Japanese stocks to the portfolio? Or the British investor may know something about Coca-Cola, Bank America, and McDonald's, but has he ever heard of smaller companies like Rush Enterprises, Sonic Automotive, and CommVault Systems? I haven't.

In this era of globalized markets, I am not sure one can stick only to investments that you understand. Even with traditional fixed income and equities, if you only invest in what you know, it will be difficult (impossible) to create a well-diversified and effective portfolio.

Understanding the Fundamentals of a Company is Key

Also a good point.

If you analyze companies as part of your investment process you do need to look at fundamentals. The "quants and the quals" if you want to talk sexy and impress my nephew.

But how many amateur investors understand ratios including, percentage of sales or price/earnings to growth? I am not even certain the article's author fully understands percentage of sales, as he states:

> *Be certain the item or service that first attracted you to the company makes up a significant portion of its sales.*

What is "significant portion"? 20%, 40%, 80%?

What about if you were attracted to Blackberry products, then

Apple comes along with the iPhone and eats RIMs lunch (and dinner)? The “eggs in one basket” thing can be a problem.

What about having a single client that purchases a significant of the company’s product? Is that good? Hint: no.

With price/earnings to growth (PEG):

> *When the PEG hits two or higher, it may mean future growth is already built into the stock price.*

It “may mean”? Is this a rule you should carve in stone? Nope.

> *It’s important to note that the PEG ratio is best suited for non-dividend paying stocks, since it does not take dividend returns into consideration.*

That is good to know. I am glad that not many companies pay dividends. Oh wait. Lots of companies pay dividends?

You also want a company with a:

> *Strong cash position, little debt*

As stated in the article, important for dividend paying companies (that is, the ones that are not suited for PEG calculations). What the …?

This cash to debt is another ratio that might be a positive, but is often a negative. For example, how do companies grow? They use internal cash flow, raise capital, or borrow money to invest in their business. Research and development of new products, marketing existing services, buying new equipment and plants, expanding operations into new regions, etc. If you are sitting on a pile of cash, are you likely growing your company (which usually means higher share prices as profitability also grows)? Probably not.

Yes, investors do need to analyze the fundamentals. But it sure helps if you have the technical knowledge and experience to comprehend the numbers.

For a thoughts on a few common ratios, check out price-earnings, price-book, dividend yield, and growth premiums.

Also recommended, a comparison of investing for growth versus value investing.

Invest for the Long Haul

A third good point. One I can actually agree on without an asterisk.

Take a long-term perspective. Do not sweat the short-term volatility.

I would be a little cautious on taking a long-term strategy for individual stocks. Yes, some companies have dominated for many years. But technology and other variables can change very quickly. Be very careful employing a buy and hold strategy for individual stocks. You may miss out on the next Apple while holding on to Eastman Kodak.

What Should You Do?

Focus on your investor profile and the resulting target asset allocation. The process is more important to long-term investment success than the actual individual holdings.

Invest consistently in low-cost, well-diversified investments. That means passively managed index exchange traded or open ended mutual funds.

The nature of index funds is such that as the quality of the underlying holdings change, weaker stocks are deleted from the index and up and comers added. While you may not be buying at the best time nor selling at the peak, you do get some protection and benefit from the index adjustments over time.

As an added bonus, by investing in well-diversified funds, you do not have to analyze the fundamentals or completely understand the individual holdings. Your focus will be on your target asset allocation, not on the underlying components.

For a refresher on what you should do, please read my “Summary on How to Invest”.

How Financial Advisors Use ETFs

We looked at “How Investors Use ETFs”.

Today we consider how financial advisors use exchange traded funds (ETFs) in their business.

How Financial Advisors Use ETFs

ETF Trends article, “How Financial Advisors are Using ETFs”, makes some good points.

ETFs Protect Against Deceptive Practices

ETFs tend to be low-cost instruments, with no commissions, retrocessions, kickbacks, etc., paid to the salesman by the fund.

> *“We’ve found that using ETFs as part of a passive portfolio management strategy provides a very effective shield against the deceptive business practices so prevalent in the retail funds industry.” Ric Edelmanan of Edelman Financial Services said.*

The article does not really flesh out what constitutes “deceptive business practices”. I assume they refer to the potential for mutual fund salesmen to push products that provide the salesman with high commissions, rather than what may be the best product fit for the client.

Not all mutual fund representatives do this. But it does occur. You need to understand how the financial advisor is being remunerated to protect your own interests.

It all comes down to the commission based versus flat fee financial advising discussion. Be sure to know the pros and cons of both.

ETFs Aid in Objective Financial Planning

A client who is concerned as to whether a recommended financial product is the best fit for his needs, or simply the product that pays the advisor the highest commission, should worry as to whether he is obtaining objective advice.

> *“”The use of ETFs fits perfectly into an investment process where an advisor serves as an objective voice to help investors focus on their longer-term goals.”*

You want an “objective voice” advising you on products that meet your financial objectives. ETFs, where the advisor is not earning a sales fee, can help ensure you are getting a low cost solution to your needs. Not a high priced product that may enrich the salesman, but might not be your best fit.

To improve the odds of getting objective advice, determine if your advisor is a fiduciary.

ETFs Assist in Benchmarks and Evaluations

An important part of investing is being able to assess performance over time. On a stand-alone basis, as well as against predetermined benchmarks and peer groups.

> *As the ETF industry matures, more advisors are able to put together a score card for an investment portfolio.*

As a greater number of ETFs develop lengthy track records, it is easier for a financial advisor to compare performance over time against benchmarks and peer groups.

If lower cost ETFs demonstrate they do outperform similar (but more expensive) mutual funds, clients will demand ETF inclusion in portfolios. This will cause open-end mutual funds to become more competitive on pricing, a benefit to investors (but not to fund salesmen).

How Investors Use ETFs

How do investors use exchange traded funds (ETFs)?

Many investors utilize ETFs as a cost-efficient means to create long-term, well-diversified portfolios. But some investors use them for other investment tactics.

"How Investors are Using ETFs" makes a couple of good points in respect of ETF strategies.

Market Timing

Because ETFs are typically very liquid, a:

> *growing number of investors that have increasingly used ETFs as a tool to speculate on a market segment. Investors enjoy the ability to jump in and out of the stock market with a quick trade.*

There is a temptation to use ETFs to engage in market timing tactics. You should be aware of this and avoid it as much as possible.

I have no problem with using ETFs to take specific positions or take advantage of longer term trends. For example, with North American interest rates so low, I would not likely recommend currently investing in very long term bonds. Rather, short term durations are preferable (for many reasons). However, if I am building a long-term core portfolio, I would want some longer exposure to go with medium and shorter term durations.

But I do not recommend jumping in and out of ETFs to try and time short-term volatility. This goes back to the active versus passive management argument. Active managers often try to time market movements. Usually with little to no success. If the professionals cannot prosper through market timing, it will be even more difficult for amateur investors. So be careful.

Day Trading Speculation

Even more care should be taken with respect to speculation. Often in the form of day trading. ETFs can be effective tools to day trade, but it is a tough business to be in. The number of losers vastly outweighs the successful speculators.

Fortunately, the majority of investors take a long-term buy and hold approach with ETFs. I strongly suggest you follow this approach.

Following the Experts is Confusing

No wonder investing is confusing for the average investor.

Many investors take a "follow the pros" strategy. Whether that means watching the business networks, tracking Warren Buffett, or subscribing in to investment newsletters, these investors invest based on what "experts" tout.

Often though the advice of one professional runs contrary to the next. What to do?

I saw a good example of this in Yahoo News.

These two articles were within 3 stories of each other yesterday evening.

Dow May Soar

"Dow 36,000 Is Attainable Again", claims two experts.

Considering the Dow 30 closed March 7, 2013 at 14,329, that means I am looking at a potential gain of 151%. Excuse me while I sell all my holdings and plunge my cash into the Dow.

Stock Rally Will End Badly This Year: Marc Faber

What the …? I thought we were heading for good times.

Now Marc Faber is telling me that:

> *the stock market's run will result in either a 20 percent correction or a more nasty sell off at some point this year*

Guess I will be buying puts on the Dow rather than going long.

Who to believe? What should I do?

Who to Believe?

I have my thoughts, but who really knows.

Hassett and Glassman

I will note that Messrs Hassett and Glassman first predicted this in 1999. They use the word “forecast”, but I would say prediction. Especially as it has not come pass to pass in the last 13 years. And they do not offer any firm timeline for reaching that point.

I forecast that a deadly meteor will hit earth. But I will not “forecast” when. Not a forecast gents. A prediction.

I will also note that the Dow 30 first hit 10,000 in March, 1999. If you go to the link, it mentions Ralph Acampora. He is a technical analyst and one of the first major analysts to predict the Dow would hit 10,000. Interestingly, I was at a CFA luncheon in the Cayman Islands on the exact day that the Dow first hit 10,000 and Mr. Acampora was the keynote speaker. He was quite giddy that day.

Anyway, the Dow reached 10,000 in March, 1999. Going to 36,000 may seem like a ton. But to reach 36,000 in the 14 years since 1999 would only require an annual return of 9.58%. In theory, very doable for equity investments.

Today the Dow is at 14,329. At 9.58% annual return, the Dow would reach 36,000 in 10 years. At just under 5% per annum, you would need 19 years to hit 36,000. So if you are 25 years of age, invest in the Dow 30, earn 5% annually in capital appreciation (excludes dividend income), when you retire in at age 65, the Dow should be at 102,000.

Simply based on compound growth, the Dow should reach 36,000 at some point in the next decade or two. It is not that wacky a prediction. I mean forecast.

Doctor Doom

I like Marc Faber. Swiss, looks a bit like a garden gnome and a lot like the stereotypical Swiss banker. Smart guy.

But you need to remember that his nickname is Doctor Doom. And that his financial newsletter is titled, “The Gloom Boom & Doom Report”. His business is pessimism.

That said, economic and financial data do indicate a strong probability for corrections in the financial markets. Whether any correction is 20% is hard to know. Personally, I could see a 8-10% correction this year. But once the market smells blood, it creates additional momentum that could further reduce valuations.

Both Could Be Right

Hassett and Glassman are optimists and Faber a pessimist. Seems like they are on opposite sides of the argument. But both could be right (or wrong).

The long-term trend for equities should be upwards. The question is at what annual rate.

However, there will be bumps along the way.

Consider the Dow 30 chart below. Perhaps hard to read, but it shows the growth of the Dow from 1900 to February, 2013. From 68 in 1900 to 14,500 in early 2013.

Over the long run, valuations have increased significantly, reflecting Hassett and Glassman’s view. But along the journey there have been some big adjustments. Faber believes there is a strong chance that one such correction will occur soon.

What to Do?

This is why I like dollar cost averaging and periodically rebalancing one’s portfolio back to target asset allocations. Both techniques provide some protection against market movements.

With dollar cost averaging, when markets are high (or over-valued), you buy less. When they fall, you buy more.

With periodic rebalancing, when equities run too high, you reallocate back to the target allocation, thereby taking some gains. When valuations decrease, you shift a portion of capital from other asset classes into under-valued equities.

Works well. Give it a try.