How Much to Invest Abroad?

Individual investors may reap diversification benefits by investing internationally.

The level of benefit is based on many factors – cross-country correlations, major industries, domestic companies that operate globally, etc. Over time, global diversification benefits have fallen. However, investing outside your home country is still worthwhile.

The question then, how much should you invest abroad?

This question was asked of a panel in The Wall Street Journal. Some good responses. I will comment on a few and include my own view of the world.

My Thoughts (Since No One Asked)

The global market is 100%. Your domestic market is a piece of the pie. The U.S. is the largest financial market with about 33% (plus or minus – you actually may see some claim it as high as 46%, but that is too high) of global market capitalization. Canada has only about 4% of the global market share.

Some experts recommend investing in line with relative global weightings. So roughly 33% in U.S. equities, 4% Canada, etc. Fine by me. An easy way to do this is to simply purchase a global equity fund. For example, the Vanguard Total World Stock ETF (VT) or iShares MSCI All Country World Index (ACWI) ETF (ACWI).

Both are extremely inexpensive and do an excellent job of replicating the global equity markets in reasonable weightings. I use “reasonable” as global equity funds tend to overweight U.S. equities. In this case, both Vanguard and iShares invest about 48% in U.S. equities. The higher weighting in funds versus actual real world weightings has to do with investable assets and a slight U.S. bias. Not a huge issue if you are looking for one single fund to invest in. Canada's weighting sits at its proper 4%.

Some experts recommend home country bias when investing. If you live in Canada, instead of 4%, you might want to invest between 10 and 20% in Canadian equities.

Why? Your life is tied to your domestic financial markets. If you live in Canada, you are paid salary in Canadian dollars (CAD). Your debt is in CAD. Interest rates, inflation, unemployment, are all tied to Canadian-centric events. What goes on in Canada impacts Canadians disproportionately to world events. As a result, you may want to have greater exposure to Canadian equity markets.

I might add that some experts make the exact counter-arguement. That you should underweight your home market because of all the other impacts.

Me? I do not mind using either relative global weightings or home country bias. I think you need to consider other factors (what is your home market, debt load, other investments, cash flow requirements, etc.) before choosing one or the other. For many individuals who do not want currency and interest rate impact, a home country bias may be preferable. For younger investors, relative global weightings may prove better.

So what do the experts from The Wall Street Journal say? And bear in mind these folks are speaking as U.S. based investors. What might make sense for Americans may not be optimal for Aussies, Channel Islanders, or Malaysians.

Gus Sauter: Keep a Home Country Bias

> *In my view, investors should have a home-country bias because they face risks that are peculiar to their home country.*

> *So, an investor should invest a significant portion in their home country, but invest enough internationally to take advantage of diversification.*

Gus does not provide a suggestion for Aussies. But at 3% global weighting, a home country bias would probably put Australian equities at 10 to 20%. But some would say that more like 30 to 50% is suitable. Too high for me, but just letting you know.

As an aside, I have heard Gus speak a couple of times. Sharp guy.

Manisha Thakor: Don't Think About Where a Company is Based

> *As the consumer class around the globe continues to blossom, growth rates in emerging markets continue to eclipse those at home.*

Good advice. You need to consider the prospects for your home market versus foreign markets.

Also the region in which you live. If you live in Argentina, what goes on in Chile has more significance in your home market than what is happening in Germany. Conversely, Poles need to monitor the German market very closely given physical proximity and trade partnerships.

> *So the real question I think is: What is a non-U.S. investment?*
>
> *To date, corporate domicile has typically been the litmus test for the categorization of an investment as domestic or international. Going forward, I think it's important to pay attention to the source of revenue and profit generation*

So, so true.

Is Apple an American company? Much of its manufacturing is in China. Its customers surround the globe.

Is Nestle a Swiss company? Is Samsung only South Korean? HSBC solely British? Obviously not. These companies operate globally and derive much of their revenue outside their domestic markets. Yet if you look at each country's main indices, Nestle, Samsung, and HSBC dominate the domestic weightings.

As an aside, you can actually create an internationally diversified portfolio by strategically choosing domestic companies.

Frank Holmes: Anticipate Before You Participate

> *when you combine non-U.S. stocks, U.S. stocks, real-estate securities and commodity-linked securities, the resulting portfolio historically outpaced any individual asset class with less volatility.*
>
> *understand the typical price movements of an asset class before you invest.*

Not quite sure what Frank's point is here. Whenever you prepare a portfolio you must consider historic returns and volatility (i.e., risk). That really is the whole point of diversification. Adding non-correlated assets to try and enhance overall portfolio returns while maintaining the risk level. Or reducing portfolio risk while maintaining the existing expected return levels.

Charles Rotblut: No Crystal Ball? Then Best Diversify

> *unless a person has a working crystal ball, it is impossible to predict where one should invest right now to maximize returns for the next 10 years. By mixing domestic equities with foreign equities, an investor increases the odds of being allocated to the right geographic region at the right*

> *time.*

Diversification spreads out the risks. Unless you are certain of the future, hedge your bets.

> *by diversifying internationally, an investor's wealth won't solely be dependent on the strength or weakness of the U.S. dollar.*

This is a two-edged sword. If your cash needs (living income, debt repayment, etc.) are in your home currency, investments in foreign currency denominated assets might be risky. But if you do not have these concerns, owning assets in a different currency may add value.

The Other Experts

Mostly dross. But you can see that there is no consensus on how much to invest outside your domestic market.

If you have a decent risk appetite and long time horizon, look to higher levels of non-domestic equities. Especially in emergent (and smaller) markets.

If you have substantial liability exposure to your domestic currency or you require income flows in local currency, then focus on a significant home bias.

Financial Tips for College

Graduates

U.S. News offers 10 financial tips for young adults.

Actually, financial advice for anyone starting out in the work world. Or even for those who have been working for awhile and now want to begin investing.

Good advice. A few comments from my side.

I shan't cover all the points, but do want to make a few observations.

Start Saving From Day One

Good investors save, invest, and grow their funds.

Enroll immediately in a plan where money is automatically deducted from your pay each period. Company plan, personal tax-deferred investment account, etc.

You did not have any income yesterday. Missing $50 or $100 per pay period will not be felt. But if you wait and get used to the extra cash in your chequing account, it will be more difficult to lose it later on.

Invest for the Long Term

How you invest should, in large part, reflect your phase in the life cycle.

Presumably you are young. With 40 plus years until you need to access your retirement funds. Starting out in the world, you hopefully are entering an accumulation stage of life.

With a long time horizon, you can handle some volatility in your portfolio. That means you should consider relatively riskier assets when you are young.

No, not betting double zero on the casino roulette wheel. Nor even putting half your money in corn futures. This is speculation. I am talking investment risk. Based on your personal risk tolerance and individual circumstances. For a typical young investor, that often means a well-diversified portfolio with an emphasis on equities.

Do not shun risk at a young age. Risk can be an asset for young investors. Just make sure it is well considered, prudent investment risk.

As your time horizon decreases and your personal circumstances change, then you can slowly move to a lesser risk portfolio.

Maintain an Emergency Reserve

Last in, First out (LIFO). An inventory term in accounting.

But also a reality for young employees who lack seniority within a company. If things go sour, new employees often suffer.

Start investing on day one. But also start accumulating an emergency reserve in case you suffer a loss of employment income. The amount should be based on various factors. A good benchmark is often 3 to 6 months of living expenses.

Don’t Live Like a King

Or queen. Or my nephew.

Yes, it is nice to finally get out of your parents’ basement and begin earning real money. But live within, or even below, your means.

Try to keep life frugal and invest any spare cash. Take advantage of your youth and the power of compound returns. Yes, you may enjoy that week in the Dominican Republic. But investing the money and watching its compound growth over time will allow for many more weeks vacation down the road.

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”.

Portfolio Rebalancing Strategies

Defining a target asset allocation is critical to investment success.

Equally important is ongoing portfolio monitoring and periodically rebalancing the actual asset allocation back to your target allocation.

The Wall Street Journal has a good article on strategies for rebalancing investment portfolios.

Worth reading in its entirety, buy I want to highlight a few points.

Investors Are Poor Rebalancers

Periodic portfolio reviews and rebalancing (as required) are very important to the investment process. Yet many individuals ignore this crucial area.

> *In a Charles Schwab Corp. survey of American investors approaching retirement, published in November, 20% of respondents said they hadn’t rebalanced their portfolio in the past five years or didn’t know when they had last rebalanced; an additional 9% had never rebalanced.*

The probability of long term successful wealth management is very low if you do not rebalance. You need to periodically ensure that your actual asset allocation accurately reflects your target allocation.

Be sure to include the mechanics as to how you review your portfolio and the remedial measures you will take when creating your Investment Policy Statement.

WSJ Rebalancing Strategies

The Wall Street Journal article looks at portfolio rebalancing on both a calendar and threshold basis.

> *With the calendar approach, an investor rebalances according to a set schedule (usually monthly, quarterly or annually), regardless of how much—or how little—a portfolio has drifted from its target allocations.*
>
> *threshold rebalancing is triggered only when a portfolio's asset allocations change by a set degree. The common rule of thumb is a change of five percentage points in the weightings for the major asset classes in your portfolio.*
>
> *Some advisers combine time and threshold strategies. For instance, you might review your portfolio every quarter but make changes only if an allocation is out of whack by a set degree.*

My Rebalancing Approach

The article is generally in line with my philosophy for portfolio reviews and rebalancing.

I like to combine both time and deviations in actual from target asset allocation.

Portfolio Volatility

But I also factor in portfolio volatility.

If you own only low risk assets, your portfolio will not be very volatile. Remember, higher risk equals higher standard deviations equals higher volatility. With less volatile portfolios you should have less fluctuations. So you can increase the time between reviews and reduce the variance from your target benchmark when determining rebalancing thresholds.

If you own nothing but stock options, your portfolio should be highly volatile. In this case, you may want to review weekly (daily?). On the other hand, there may be some extreme short term swings in asset valuation. So a 5% threshold variance may mean that you are constantly buying and selling to return to your target allocation. You will want to increase the thresholds to reflect the higher portfolio risk. Otherwise your transaction costs will skyrocket.

Material Events

Individual and market circumstances may also dictate review and rebalancing.

A material event is something that impacts your decision making. Gas prices at the pump rising 5% may not reduce the amount you drive your car. Gas prices rising 105% may impact your driving plans. Being single lets you lead a certain lifestyle. Suddenly having a baby forces changes on you. The Securities Exchange Commission (SEC) reviewing a company you own shares in may put you on alert. The SEC charging the company with illegal activity may be the material event that causes you to actually sell.

Material events differ between individuals. Obviously, personal circumstances impact people at different stages in life. Not everyone has a baby, loses a job, gets hit by a bus, etc., at the same time.

And an individual's risk tolerance affects what he or she considers a material event. For those with little risk tolerance news of a potential SEC investigation may be enough to dispose of the company's shares. Investors with moderate risk tolerance may decide to wait until the result of the investigation before making any decisions. And a very aggressive investor may view an investigation as a buying opportunity.

Regardless of how you view material events, they should factor in to your review and rebalancing.

For example, your policy is to review your portfolio every June 30th and to rebalance when your asset classes deviate 15% from targets. A reasonable combination of the calendar and threshold.

But on March 1st, the government announces new regulations that will negatively impact one of the companies in which you own shares. Should you wait until June 30th or the share price falls more than 15% before assessing and perhaps selling?

Or maybe you get laid off on September 1st and cannot find a new job. Should you wait until June 30th to assess your portfolio? No. In this case, you probably will want to modify your asset allocation. Move into a lower risk portfolio to safeguard exiting capital and generate cash flow to help offset the loss of employment income.

Always Consider Costs

As the article states, watch your costs on rebalancing. They need to be factored into your review and rebalance equation.

And never forget that taxes are a huge cost to investors. So watch when triggering taxable capital gains in dispositions when rebalancing.

I consider the cost issue in my post, How to Rebalance an Investment Portfolio.

Summary

Portfolio reviews and periodic rebalancing back to your target asset allocation are crucial for successful wealth accumulation.

Define the process for reviewing and rebalancing your investment portfolio before starting to invest. Use a written Investment Policy Statement as a formal framework to guide your investing program.

Base your rebalancing strategy on a calendar, threshold, or (preferably) combination basis.

When determining your strategy, consider other aspects as well. Factor in portfolio volatility, how material events affect your holdings, your personal risk tolerance, and the impact of costs and taxes when rebalancing.

If you follow these tips, I think you will increase your chance of long term success.

Are Investors Driven to Trade?

I like a general buy and hold philosophy for investing. Find solid, well-diversfied, low-cost investments (i.e., passively managed index funds), acquire by dollar cost averaging, and only adjust holdings to reflect your target asset allocation over time.

But can investors follow this model?

Or are we hard-wired to be traders?

Are Investors Driven to Trade?

In Why Your Brain is Killing Your Portfolio, the Wall Street

Journal considers this question. The article makes some interesting points.

> *In a study published last month in the Journal of Neuroscience, researchers from California Institute of Technology, New York University and the University of Iowa looked at how people use past rewards to predict future payoffs.*
>
> *The neuroscientists found that the two control groups tended to make their next bet based largely on how much a slot machine had paid off on the two most recent bets.*
>
> *Almost as soon as the pattern of payoffs appeared to change, the participants in the control groups dumped one slot machine and jumped to the next. Although they did take longer-term results partly into account, "the healthy subjects appeared to be extrapolating their most recent experience into the future and choosing predominantly on that basis," says Nathaniel Daw, a neuroscience professor at NYU who helped conduct the study.*

In short, people make future decisions largely based on recent actual results.

Smart, not so smart? No idea. But how does this relate to investing?

How This Relates to Investing

Well, if you have ever read a mutual fund prospectus (or managed to read the fine print on a mutual fund television commercial), you will always encounter the phrase, "past performance is no guarantee of future results." Or something similar.

And that is quite true.

> *Among the mutual funds that were in the top half of*

> *performers in late 2009, according to Standard & Poor's, only 49% of them still remained in the upper half a year later; a year after that, only 24% were left. That is just about what you would get if you flipped a coin. Trying to find the winners is futile if victory is determined largely by luck.*

That means it is difficult for an actively managed mutual fund to consistently outperform its peers. If you are investing based on the latest hot fund manager (and paying higher management fees for that privilege), you may be shifting your money around every year or two (and often incurring transaction costs and triggering tax payable when you do).

That leads back to my buy and hold approach above. But perhaps our brains make it tough to follow this philosophy.

> *When confronted with the unpredictable, however, the frontopolar cortex refuses to admit defeat. It draws on all your computational abilities to search for patterns in random data.*
>
> *In the absence of real patterns, it will detect illusory ones. And it will prompt you to act on them.*
>
> *No wonder so many investors find it hard to muster the willpower to buy and hold a handful of investments for years at a time.*

As For Buy and Hold Being Dead

I have covered this extensively. The buy and hold strategy is not dead.

I am not a fan of buying and holding individual stocks forever. Too much can change over time with a single, non-diversified asset.

Nor am I a fan of simply buying a fund and forgetting about it. You still need to monitor the portfolio. Then, as needed, rebalance your portfolio and bring your actual asset allocation back in line with your target.

But as for the general concept of buy and hold being dead, I think not. Stick to low-cost, well-diversified investments and you can hold the core portfolio for a long time. It will only need to be fine tuned as your personal circumstances evolve over time and/or market fluctuations in specific asset classes dictate the need to realign.

Final Thoughts

The article makes another couple of good points.

> *Most of the folks who say buy and hold is dead don't talk much about their long-term returns. Instead, they stress how they have done recently, a tactic that for many potential clients has the same irresistible appeal as the last couple of pulls on a slot machine.*

So, so true. And people usually talk more about their winners than losers. In my circle, it seems everyone I know made a killing on Apple and no one I know was ever invested in Research in Motion.

So take what all your friends tell you with a grain of salt.

> *Every investing decision you make should be the result of a deliberate process.*
>
> *Start by creating a checklist of criteria that every stock or fund must meet before you buy or sell. Make sure you never buy or sell an investment exclusively because its price has gone up or down. In advance, list three reasons having nothing to do with price that would justify buying or selling.*
>
> *After you sell, track the returns of those investments you*

sold, after you sold them, to see if they did better than whatever you bought in their place.

Do not get caught up in what the talking heads say on the business channels. Focus on your unique investment objectives and constraints. I think that your asset allocation is more important than your actual investment choices, so get that right first. Then worry about your portfolio holdings.

Do not chase the hot stock or fund manager.

Make investment decisions that are right for you, with the focus on the long-term.

Planning to Start Investing?

Just starting to invest?

Perhaps you just graduated from school, got your first real job, and now want to start saving money and building wealth.

Or maybe you are older but personal issues precluded you from beginning to seriously invest for future retirement. Student debt, home mortgages, and children, are just a few things that greatly impact the ability to invest for individuals in their late 20s and 30s. But now you have decided to focus on wealth accumulation.

Regardless of where you are in the life cycle, today some good tips for those beginning to invest.

The Wall Street Journal offers four simple recommendations to new investors. I have covered them myself, but they do bear repeating.

Start Early

The sooner you start investing, the better your long term wealth accumulation. This is due to the power of compound returns.

> *"A study by Maria Bruno, a financial planner with Vanguard Group, illustrates why: No matter how conservative or aggressive the hypothetical portfolio, projected median portfolio balances at age 65 are significantly higher for investors who started saving at an early age than for investors who began saving at older ages."*

It is incredible how beginning to invest early in life has such an impact on capital growth over time. If you are in your 20s, this is great news. Hopefully it will spur you to sacrifice a little now when money is tight, because the lon-term benefit is so high.

Now if you are in your 40s, it is all right to groan a bit at this realization. But what is past is prologue. You did not save in your 20s and we cannot turn back the clock.

On the positive side, not too many people do begin saving in their 20s and early 30s. Not the best approach, but the common one among adults. So if you have yet to start seriously saving, you have plenty of company.

Today is the first day of the rest of your life. Or, as another old saying goes, the longest journey begins with but a single footstep.

The power of compound returns works at any age. The sooner you start investing, the better the results. But you need to make that first step and then continue onwards.

Starting at 25 is better than 35, but so too is starting at 45 better than starting at 46. Additionally, life expectancy today may be between the ages of 80 and 85. Even at 45, you have ample time to allow your wealth to accumulate over time. But every day delayed negatively impacts wealth building.

So assess your financial situation today. See where you can make some modifications in spending and come up with money to invest.

Save Often

> *"Ms. Bruno found that the amount of money someone ended up with at retirement was more influenced by how much money was saved than by how that money was invested."*

How often and how much you save is more important than what you invest in.

Obviously, this refers to a well-diversified portfolio of assets and not investing everything in the next Apple. Nor placing all your money in a term-deposit of savings account.

But the point still stands. Timing and amount are more crucial to long-term wealth accumulation than the individual assets invested in.

Invest Early and Often

> *"The two levers an investor can directly control—savings time horizon and savings rate— will generally provide a higher probability of success, rather than relying on the possibility for higher portfolio returns."*

I wanted to highlight this statement.

Asset growth over time is a function of three variables. The rate of net return, time horizon, and invested capital.

If you are 25 years of age and invest $4000 annually for 40 years earning 8% per year, your ending capital is about $1,119,000. If you wait until 35 to begin, you will have to contribute $9150 annually at 5% to reach your goal. Perhaps that is doable. But if you wait until age 45, you will need to find $22,650 annually to reach $1,119,000. Perhaps not so doable.

Within limits, you can control when you begin investing and how much you invest over time.

However, your actual investment returns are out of your control. It is difficult to consistently identify individual assets that will outperform the market. That is why active asset management does not normally beat a passive approach.

You can control your asset allocation and that does affect your portfolio’s risk-return profile. For example, by adding higher risk (with higher expected returns) assets to your portfolio. But asset allocation and adding assets with greater return potential can only go so far.

In our above example, say you waited until age 55 to start saving. At the 8% return, you would need to invest $71,500 annually over 10 years to reach $1,119,00 by age 65. Not very likely.

Even projecting higher annual returns may not help that much. Say you manage 16% per annum, you will still need to invest about $45,500 annually to hit $1,119,000. Or you get 24% (triple our original figure which means a lot of added risk), you still must contribute $28,500 each year. A fair bit of free money to find beneath the sofa cushions.

Focus on the two controllable factors (timing and amount) as they are more important to long run success than relying on riskier investments to provide higher returns.

Invest Frugally

> *“Investment costs are another, often overlooked variable that investors can typically control and that can have a big*

impact on a portfolio’s longterm performance.”

Often-overlooked variable? Well not if you read this blog!

Transaction costs, commissions, management fees, operating costs, and taxes eat away at your gross returns and greatly damage your long-term growth. Every dollar that you pay to someone else – fund manager, brokerage house, tax agency – is one less dollar that will compound over time on your behalf.

Put your money to work for you. Minimize your costs to the greatest practical extent possible.

Divide and Conquer

Okay, you want to start investing, but you have debts and other needs that also must be met.

> *“Mr. Ritter suggests young adults tackle these major goals simultaneously. “Put a bit of money toward each goal,” he says, “and work toward being able to do more over time.” “Once one goal is reached—for example, after debt has been paid off—you can redirect money toward another goal, such as building an emergency fund. And once that is fully funded, with around six months of living expenses, you can save more toward retirement. Even if your contributions are small and come from a parttime or lowpaying job, Mr. Ritter says, they will pay big dividends in years to come. Remember, it’s the little steps that count.”*

I agree with this approach to some extent. It gets you on the investing path. It promotes a consistent and disciplined investing style, which is important for long-term success.

Also, investing a little is better than nothing. And, as your debts are paid off, you can indeed reallocate your cash and invest more over time.

Finally, I like the psychological impact that comes from seeing your investments actually grow. Even if you still have student loans outstanding, it is reassuring to see your investment account growing every month.

So I like this approach.

That said, I tend to see debt as a negative investment. And I prefer to invest my capital where I get the most return for my money.

Say I have $1,000 in cash on hand, owe $5000 on my Visa at 18% per annum, and want to invest monthly in a balanced fund expected to return about 6% annually. Now does it really make sense to split that $1,000 50-50 between my Visa and the investment fund? No. At an 18% non-deductible interest rate, I want to get rid of that balance as quickly as possible. So while I agree with the recommendation (especially getting people started on the investment process), you do need to assess your own situation.

While I think you should start saving and investing as soon as possible (and then consistently investing over time), you also need to be aware of your debts and the interest payable on them. If the interest payable on debt exceeds what you can earn on your capital, you may want to pay off your debt first.

And make certain you factor in the tax consequences. Interest payable on debt is often non-deductible for tax purposes while interest income, dividends received, and capital gains are usually taxed to some extent. So ensure when you do your calculations you consider the after-tax amounts, not the gross.

Target Date Funds

I keep seeing target date mutual funds pop up in my daily readings. Presumably that means they are a popular item at the moment.

I can understand why target date funds might be popular with investors. However, they are not investments I would normally recommend to clients.

Here is why.

Target Date Mutual Funds

What is a target date fund? According to Investopedia:

> *A target-date fund adjusts the assets in the fund to line up with your retirement timeline. If you're planning to retire in 15 years, you might pick a target-date fund of 2025 or 2030. The fund manager will adjust the holdings and when you near retirement age, that fund will hold a lot of bonds, instead of the more risky stocks.*

You might also see these funds as life-cycle funds. I think my comments from a couple of years ago are still applicable (although I seem to have been a little more diplomatic back then).

The concept is based on sound investing theory. Investors with a long time horizon (i.e. young adults) can afford to take on relatively high investment risk in the pursuit of greater expected returns. As investors approach retirement age, they should shift their portfolio constantly over time to lower risk assets. Someone one year from retirement likely does not want to be invested in a portfolio that may fall 20% in the final year.

A target date approach is a strategy that you will use in your investing. Outsourcing it to a professional may make sense.

Target Funds Are Not My Cup of Tea

Simple, something one should do anyway, and professionally managed. So why do I not like target date funds?

The linked article covers my concerns nicely.

You Are Unique

You are unique as an investor. And definitely more than simply your number of years until retirement.

You will have short, medium, and long-term investment objectives. Retirement is obviously a key objective, but there are others. What about the home you may wish to buy in 5 years? Or the plan to quit your job and return to school?

Same with personal constraints. Perhaps an illness impacts the family, altering cash flows in and out. Or maybe you get married or have a child. These events impact one's life and investing strategies.

Accumulated wealth to date also factors in to one's investing strategy. If you are 45 with no capital saved you will may have to take on more investment risk than another 45 year old with $2 million in the bank.

So does your personal risk tolerance level.

Focus on your comprehensive Investor Profile. One that incorporates all these variables into your overall strategy.

Do not simply use a planned retirement date to determine an appropriate asset allocation over the various stages in your life cycle.

Incremental Cost

You will incur higher management fees to have someone else shift the fund’s asset allocation over time. And costs are a significant drag on investment success.

As for the expense ratios cited in the Investopedia article, the 0.71% average for stock funds is misleading. That ratio accounts for a wide variety of funds, including actively managed and niche funds. Taking a passive management approach by investing in index mutual or exchange traded funds should result in significantly lower actual fees for investors.

Paying someone to reallocate your portfolio over time is not what I consider to be a beneficial expenditure. Especially in light of the fact that, as we saw above, a one size fits all approach is probably not best for your unique situation.

Buy and Forget Is Never Prudent

Fund companies must love target date funds.

A 30 year old invests in a fund with a target date equal to age 65. The fund company has his money basically locked away with them for the next 35 years. Not bad. For the fund company.

Given the structure, I would guess that investors maintain their investments in a target date fund longer than a non-target date fund.

While I like buy and hold, I do not like buy and forget. Regardless of the structure, investors need to periodically monitor their investments and assess performance against pre-determined benchmarks.

Comparing a target date fund – with its shifting asset allocation and composition – may require a little effort from the investor. But it needs to be done to ensure that you are investing in a superior asset.

The Bottom Line

While individuals should want to gradually reduce their portfolio risk as they move through their life cycle, I am not sure target funds are the best vehicle. Investors are more complex than simply a retirement date. And the additional fees associated with target funds are, in my opinion, probably poor value.

Instead, create a well-diversified investment portfolio that reflects your individual circumstances using low cost index funds. Periodically review your portfolio and adjust your asset allocation as your situation changes. It is not that much effort and the money you save and reinvest will pay off in the long-run.

Vanguard 2012 Economic Outlook

As we move through 2012, uncertainty exists over global economic and financial markets.

Which countries' economies will prosper? Or maybe the better question is, which countries' economies will not completely crater in 2012? Which equity markets should investors consider? What should I do about all the market volatility?

There are many concerns out there for investors.

Vanguard considers these questions in, "Vanguard's Long-term Outlook for Stocks and the Economy". A short article, but one that contains some decent commentary. For example:

Will the U.S. recovery stay on track in 2012?

I think the recent data have been upbeat, which is a testament to the resiliency of the U.S. private sector. That's why we think the recovery will continue to endure, more likely than not, although there's no guarantee.

Not carved in stone confidence, but positive about the U.S. economy.

I am less bullish on the U.S. currently.

There is still extreme uncertainty on the upcoming U.S. presidential election. I believe a Romney win will be better for the economy than if Obama is re-elected. That said, while Republicans talk a good game about fiscal responsibility and lowering the U.S. national debt, their actions are not representative of their talk. It took more than Obama and his crew to get the U.S. deficits and debt to where they are today. And Romney is not known as a huge fiscal conservative.

Unless people get real about the level of debt – if for no other reason than the sheer amount of tax revenues that must finance interest payments and not grow the economy – the U.S. will continue to stumble along. And I just do not see that happening anytime soon.

Should investors be worried about high market volatility?

The markets have been volatile, but it's easy to forget that markets always go through volatile periods.

But I think we're all more sensitive now after the global financial crisis of a few years ago. This may be hard to believe, but in the last nine years, the U.S. stock market finished in negative territory in only one year, 2008. So it can be helpful to keep the longer-term perspective and remember that the reason we look for higher returns in equities is because the markets are volatile. Over time, investors have been compensated for the risks that they take

> *in stocks. So we try to coach people to expect short-term volatility and to not overreact to it.*

Very good point to keep in mind. The level of attention by the public to equity markets is very high. And I think that people remember that bad news more than the good. The media definitely contributes with its "if it bleeds it leads" mentality.

Volatility is risk as measured by the standard deviation of an asset's returns. The more volatile an investment, the greater the risk. But the greater the risk, the higher the expected return. Investing 101 in a nutshell.

If you wish to achieve higher long-term performance, you need to take on risk (to some degree). That is why younger investors should look at (relatively) riskier asset classes as opposed to older investors. Young investors have a longer time horizon to withstand short and medium term volatility.

What about the sovereign-debt problems here and in Europe?

> *The fear of contagion has subsided lately, as it looks more likely that Europe will muddle through.*

I am much less positive on Europe. They talk, they plan, they make cosmetic changes. But never seem to address the core problems that have created this problem in the first place.

And if you do think Europe is serious about getting their fiscal house in order, I give you the new French President, Francois Hollande. His idea of fiscal responsibility is to lower the retirement age for certain workers from 62 to 60. That should go over well with the Germans (who have a retirement age of 67), Poland (67), Sweden (increasing to 69), Britain (increasing to 66), and even Italy (increasing to 66 for males, 62 for females).

What’s Vanguard’s longer-term outlook for stocks?

> *But again, we can’t predict what’s going to happen in the next year. So if you’re saving to spend on something a year from now, you shouldn’t be in the stock market. But if you’re saving for a child’s education 15 years from now, or for retirement 20 years from now, what asset class do you think is going to provide the highest rate of return?*

Again, this reflects the link between an investor’s time horizon and their investment objectives. The longer the time horizon, the greater the investment risk that can be assumed.

But remember that all investors – even the young- have short and medium term objectives.

Maybe you are 25 and want to retire at age 65. You have a 40 year time horizon for retirement investing. Long term. Assets with higher volatility probably makes sense.

But maybe you want to buy a new car next year and will need $20,000 cash for that purchase. A short term objective. You probably do not want an investment that may swing 50% each year in case it is down over the next year when you need funds to buy that car. Same if you plan on buying a home in 5 years.

You always need to match your investment objectives to your specific investments. And all of you will have short, medium, and longer term objectives and constraints, regardless of age.

With negative headlines and volatility, should investors change their strategy?

> *To us, that means stepping back and asking yourself what is the best long-term asset mix for your situation. And once you figure that out, maybe with an advisor’s help, then I think you put a plan in place to get to your allocation of stocks and bonds. That’s what’s going to drive your portfolio’s returns.*

> *Then you don’t have to continually second-guess yourself, wondering, for example, if you should sell a bond fund if you think interest rates are going to go up. Even if that happens, your stock portfolio can help to offset the decline in bonds. That’s the advantage of diversification. You have one asset class that can support the other. You keep both because you don’t know which one needs to support the other over the next year or two.*

Very good advice. Take a long term approach. Focus on asset allocation and diversification.

> *I encourage our clients to try to minimize the attention they pay to economic news, because I think that can actually lead to the pitfall of wanting to react. The market can discount economic news very quickly—I mean in a matter of seconds. So, while it’s good to be well-versed on the economy, we have to guard against overreacting to it, because there’s much more to investing and seeking long-term returns than analyzing the latest economic news.*

Avoid getting caught up in the flavour of the day. If you have followed the FaceBook public offering you know what I mean. Before the issue, the focus was on how to get shares and be part of the FaceBook phenomena. Now it seems to be, how bad an investment is FaceBook and should (former wonder-boy) Zuckerberg be sued?

> *market volatility presents an opportunity to be proactive by doing things like rebalancing. That can be a powerful antidote to the volatility, because if stocks or bonds fall, you can rebalance to your target allocation. “Buy and hold”—an approach we endorse—doesn’t mean “set it and forget it.”*

Something I strongly believe. Utilize a buy and hold strategy for long run success. But always make sure that you periodically review and rebalance as necessary. Buy and hold does not mean buy and forget.

I would also add that market volatility also allows for discount purchasing. If you utilize dollar cost averaging, volatility aids in buying higher volumes when prices are depressed and relatively less when valuations are running high.