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.

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.

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 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.

[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.

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.

A Formidable Investing Foe

There are many variables that make successful investing a challenge.

And one of your biggest foes may just be you.

What do I mean by this?

Are You Your Own Worst Investment Enemy?

In my last post, Mutual Funds Lag Their Benchmarks, I linked to a Wall Street Journal article, It's Not Your Fault Your Fund Can't Keep Up.

According to the article, you are also at fault as to why your portfolio lags its benchmark.

> *The average equity-fund investor saw annual returns of only 3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.*
>
> *For the average investor, that's more than half the possible returns left on the table.*

That is significant in both relative and absolute terms.

If you started with $100,000, made no additional investments, and earned 3.49%, over 20 years your capital would grow to $198,595. But had you earned 7.81% annually, that $100,000 would become $449,967. A lot of money to leave on the table.

Why the discrepancy?

> *The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher*

price. They also are apt to leave the market after it has dropped, therefore selling at a lower price.

The result: investments that will massively underperform against their benchmarks.

A lot of this is due to emotional investing based on lack of investment expertise. Individuals wait too long before buying – they want to see a clear upward trend first – and/or miss the price peaks. A good example of this would be investment bubbles.

Even many knowledgeable investors can get caught up in the hype. It is not easy or popular to take contrarian stances. Better to get it wrong like everyone else, than to get it wrong while everyone else is correct. The herd mentality is quite common in the investment world.

Also, it is extremely difficult to time market or stock movements. Or identify the best individual investments. Even if you manage to stay unemotional. That is why professional money managers typically underperform their portfolio benchmarks. And why the "best" investment analysts seem to change from year to year.

What to Do?

investors looking to close the gap should be buying mutual funds, whether they be stock or bond funds, for the long term. Don't be tempted to bail when performance is poor because, over time, that has been shown to be a losing strategy.

And don't try to chase performance by getting into funds that have performed well recently. This is the equivalent of buying high and selling low—the exact opposite of what investors should be doing.

You know me.

If You Cannot Beat Them, Join Them

If you cannot beat the market, try to match it as closely as possible. That means passive investing in open ended index mutual and exchange traded funds (ETFs). Keep costs low and replicate the benchmark as best you can. Actively invest under only a few scenarios.

ETFs Over Mutual Funds

As for the article's comment on ETFs over mutual funds, I generally agree.

I prefer ETFs for their potential trading and cost advantages. But there are a wide variety of cost effective mutual funds out there. Many are extremely popular with investors. I still think they have a place in one's portfolio. So long as you focus on cost and net performance.

Also, as the popularity of ETFs grow, so do the number of ETFs offered. Not all are cost-effective or simple structures that replicate clear benchmarks. Be careful if considering investing in such things as leveraged ETFs, actively managed ETFs, life-cycle ETFs, alternative asset ETFs, and ETF wraps.

Buy and Hold

Identify solid investments and invest for the long-term.

I like the buy and hold approach for funds, although not so much for individual non-diversified assets. The buy and hold promotes investment discipline and works well for most investors in shifting markets.

Note that you still need to periodically review your holdings and rebalance as necessary.

Dollar Cost Average

I also like a dollar cost averaging approach.

By investing a fixed amount on a periodic basis, you buy relatively more shares when the asset is cheap and less shares when the price is high. That smooths your purchase stream and provides some protection over time against volatile markets.

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8 Keys to Financial Security

Knight Kiplinger, head of Kiplinger financial media, created a nice asset management video.

8 Keys to Financial Security is exactly that. Tips for protecting your assets and growing wealth.

As per usual, I add my two-cents to Mr. Kiplinger's wealth management recommendations.

Kiplinger's 8 Keys to Financial Security

I like this short video because it reminds me of something created in the 1950s (it seems to have been created in 2011 though). Kind of like a Simpsons' episode where Bart or Lisa is forced to watch an outdated instructional movie in school.

But while the video is a little quirky, the points are very relevant and useful.

httpv://youtu.be/Lx3b9-5hHiI

1. Invest in Yourself

This is why I write about education and career issues in a wealth management blog.

Individuals invest their capital in stocks, bonds, and so on.

But you need to create that capital first. The more wealth you can create, the more you can save and put to work for you. Therefore, the best investment that you can make is to invest in yourself.

Invest in, not spend on yourself. Always look at the cost-benefit of any expenditure.

That may be technical skills in high demand industries (not puppetry or poetry). Complementary skills – such as industry specific knowledge, basic business skills for technical graduates, or foreign languages – that add value to your core training. There are many ways to improve your chance of career success.

2. Protect Yourself and Your Loved Ones

The need for protection depends on your personal situation and job.

If you are young, with a new family, insurance is a great way to protect your family if something happens to you. But if you are single, maybe insurance is not a big need.

As you age, perhaps your family assets will provide all the security you require. Or perhaps your job includes disability and death coverage.

Examine your unique needs. Reevaluate your needs over time and whenever a significant event takes place in your life. Then decide if insurance is necessary. It just may be.

3. Borrow Sparingly

If it was me, I might say borrow prudently rather than sparingly.

I understand, and agree with, Kiplinger's belief. Borrow for appreciating assets (home) or required large expenditures (car for work). Avoid borrowing on wasting assets.

I differ in that I am comfortable with prudently borrowing for investment purposes. Leverage, used responsibly, can enhance returns. But it must be used prudently and only by those who understand investing and its risks.

I also differ a little on borrowing for homes and houses. Do not borrow beyond your needs or ability to comfortably repay.

Banks like to lend money. They make great profits off consumer loans and mortgages. Banks will happily lend you as much as you can tolerate and repay. Not what you need.

You need a car for work? You have $15,000 in cash, but based on your financial situation the bank is happy to lend you $85,000. Should you take advantage of the entire offer and buy a brand new BMW? Or should you only borrow $5000 and buy a slightly used, but still under warranty, vehicle for $20,000? Borrow if you must, but borrow wisely. The interest you will pay on that $85,000 loan will cost you dearly in the long-term.

4. Pay Yourself First

Use direct deposits so that you never see the money. If you do not have that $100 (or more) in your account every month, you cannot spend it. And like rent, utilities, loan repayments, etc., you quickly get used to not having the cash on hand.

Most mutual funds provide direct debit investing options. Sometimes initial purchase requirements may be high for small investors (but not with all fund companies, so check around), but usually subsequent purchases are very reasonable in size.

You can also look at other investing options that simplify share acquisition. Dividend reinvestment plans (DRIPs), direct stock purchase plans (DSPPs), and employee stock purchase plans (ESPPs) may allow for direct investing in a company’s shares.

5. Don’t Go For the Home Run

Finding that next Apple or Google is great, but difficult to do. Individual investors strike out many more times than hit a home run.

That is why I typically recommend a steady, consistent investment strategy. One that passively invests in well diversified, low cost assets. Using dollar cost averaging and a general buy and hold approach.

6. Diversify, Diversify, Diversify

I might even add a fourth diversify.

Diversify between asset classes, within an asset class, and by time.

How you diversify is based on your unique investor profile and Investment Policy Statement.

7. Live Simply Today

Remember our discussions on compound returns?

A dollar saved today grows substantially over time.

You can try to keep up with the Jones’s now. Or you can scrimp a little today and surpass them in retirement.

8. Give Generously of Yourself

I shall leave the giving back to each of you.

My only comment on charitable donations is to know where your money is going.

There are too many charities that distribute too much money to staff salaries and advertising versus using that money for its stated purposes. Check out a charity’s financial statements before contributing your hard earned cash. Your money may be going to pay the President's salary or lobbying efforts instead of helping that starving family or curing a disease.

Is Buy and Hold Investing Dead?

Is the buy and hold investment strategy dead?

I have argued no in previous posts. There are many advantages for investors who utilize a buy and hold approach.

A short video from Vanguard nicely summarizes my position.

A Quick Reminder of the Buy and Hold Investment Strategy

The buy and hold investment strategy works well for most long-term investors who purchase index funds. I am not a fan of the buy and hold approach for individual company shares.

Also, it is reasonable buy and hold. You always need to periodically review your portfolio and rebalance against your target asset allocation. Buy and hold does not mean bury the investment in your back yard and forget about it until retirement.

Is the Buy and Hold Investment Strategy Dead?

The Vanguard video asks the questions:

> *I think a lot of people are saying, "Is buy and hold dead? Should you be pursuing a strategy of moving to the right segments of the market?"*

According to Gus Sauter, Chief Investment Officer of Vanguard:

> *It’s really a question of how much confidence you have. But I wouldn’t say anything’s different in the capital markets that would lead you to that type of a strategy. It’s just a question of how confident you are in your ability to move to the right segments of the market. And today is no different from a decade ago or 20 years ago. If you had that capability 20 years ago, you probably should have been doing it. If you have the capability today, go ahead and do it.*

So if you know what you are doing and can correctly identify market shifts, then go ahead and actively manage your assets. I fully agree.

But it is questionable as to whether investors – even professional money managers, investment analysts, or economists – can consistently time market fluctuations.

As Mr. Sauter states in respect of investors being able to correctly time market movements:

> *Again, as we’ve said throughout, we’re just skeptical of our ability, and the ability of most investors, to be able to really execute that successfully.*