Should You Be Selling Your Winners?

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

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

Good advice. But difficult for most investors to follow.

Human Nature is to Ride the Winners

> *The basic human instinct when an investment gamble has been paying off is to let it ride; rebalancing involves culling winners and putting the proceeds into laggards in order to follow a plan.*

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

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

Take Emotion Out of Investing

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

5 to 10% off-target.

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

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

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

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

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

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

Momentum Investing

Browne, of FundX, follows a strategy of investing in funds

> *and ETFs that have the hot hand, trying to ride category leaders in the areas that look best*

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

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

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

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

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

Types of Stock Traders

Investors come in all shapes and sizes.

There are also a multitude of ways to trade investments.

Today a brief look at the various types of traders.

Investopedia asks "What Type Of Trader Are You?"

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

Fundamental Traders

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

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

Noise Traders

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

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

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

Sentiment Traders

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

Market Timing Traders

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

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

Arbitrage Traders

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

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

Traders Versus Investors

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

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

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

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.

Investors Shun Risk

A relationship exists between investment risk and expected return.

The safer the asset, the lower the expected return. The greater the investment risk, the higher the required return. Or it can be a tad more technical if you like.

Investors should take an objective view of investment risk. Unfortunately, investors tend to be emotional creatures and these volatile times lead people to become fearful of investment risk.

So what is happening? And what should you do as an investor?

Investors Shun Risk

According to Morningstar, *Shaken Investors Shun Risk*.

> *The demographic bulge of aging baby boomers is becoming ever more risk-averse as it continues its march toward retirement. At the same time, investors as a whole have become financially and emotionally scarred by bear markets. The result, says financial-services consultant Goshka Folda, has been a flight to safety.*

The first sentence makes sense. Younger investors have a significant time horizon. Young investors have more time to ride out the increased volatility of higher risk assets. As such, young investors should seek out relatively higher risk assets to reap higher expected returns.

As investors approach retirement, there is less time available to deal with highly volatile investments. Safety and certainty are more important. That is why you see older investors shift their capital into lower risk asset classes. And receive lower returns.

The second sentence though, reflects how emotions play a significant role with investors. Emotions should be avoided when investing. That said, I realize how hard it is to maintain a disciplined, unemotional, investment strategy when markets are moving like a roller coaster.

How This Impacts Asset Allocations

> *Of the more than $3 trillion in investible assets of financial wealth, more than $1 trillion is sitting in deposits (Source: Household Balance Sheet Report, 2011 Edition). In addition, close to another $1 trillion consists of short-term instruments with maturities of less than one year.*

A lot of investors appear to be heavily invested in low-risk, low-return assets.

While this low risk approach might be reasonable for retirees (but beware that a 65 year old retiree may live until 90, so may still desire/need some higher risk assets to finance a 25 year retirement), a low risk strategy is probably not suitable for younger investors.

Asset allocation is extremely important for investing success. It should not be based on emotion and fear of loss. Your asset allocation should be unique for you, based on your personal situation.

What to Do?

> *"After so much damage, clients are now in a risk-averse stance," says Folda, "But the reality is that many households still need growth, they need exposure to at least some equity."*
>
> *"So volatility, while damaging for everybody," says Folda, "can be opportunity for advisors to even further underscore the importance of good advice and solid solutions in establishing the right risk profiles for portfolios."*

I think there are a few keys to effectively deal with volatile markets.

Investors need to construct investor profiles and Investment Policy Statements. These will determine a proper target asset allocation and help maintain long-term focus during periods of short-term volatility.

A properly diversified portfolio will reduce portfolio risk without lowering expected returns.

Low cost investments such as open-ended index mutual and exchange traded funds will help with diversification and cost-effective investing.

While I understand that many advisors, banks, brokers, etc., want to sell investors innovative new products (that usually are quite profitable for the seller), be cautious. Minimizing your costs is a key to maximizing long-term success. Do not pay someone else 1-2% of your capital each year simply to purchase the flavour of the day.

Dollar cost averaging will also assist in dealing with volatility and staying disciplined.

If you use these techniques you will reduce emotion in your investment decisions. This will improve your portfolio construction and your probability of long-term investment success.

Emotional Investing Decisions

Investing based on emotions or instincts is a difficult issue.

So challenging that an entire field, Behavioural Finance, examines how investor psychology and emotions affect investment decisions.

Recently I read an article where the author believes that financial planners prefer clients with little investment knowledge. That way, it is easier to sell them whatever you want.

Yes, there are financial planners, brokers, etc., that operate this way. But in my experience, good financial planners would rather deal with well-educated investors.

And often the reason relates directly to emotional investing.

Rational Investors Are Better Investors

Investors who better understand the investment process have an easier time investing rationally. Investors who appreciate modern portfolio theory. The concepts of diversification, asset correlations, investment risk, asset allocation, etc.

By knowing the underlying principles behind successful investing, investors can make more rational and appropriate investment decisions.

A decent Investment Policy Statement should incorporate these aspects. It will help keep the investor focussed on the big picture. Especially during turbulent times.

The Investment Policy Statement allows investors to examine their unique personal circumstances and then create an asset allocation strategy that meets their investment objectives and constraints.

What Jim Cramer or the other media talking heads are screaming through the television play no part. Nor does the investment that made your sister-in-law some money five years ago.

Unfortunately, the vast majority of investors (yes, even many “sophisticated” ones) get caught up in this sort of emotional investing.

These investors want to fill their portfolios with the flavour of the day. The same investment everyone else is chasing. The end result usually is a bursting investment bubble.

Or they focus on past successes that may no longer be suitable in today’s world.

Are Your Investing Decisions Based on Emotions or Instincts?

The Vanguard Group offers a short video addressing this question. It is well worth watching.

Key comments in the video, include:

> *One of the biases that behavioral finance talks about is this selective attention to information: That in making a decision, you're only listening to really confirmatory views about what you already believe.*

Selective attention, also called "confirmation bias", is a problem for many investors.

If you are simply looking for positive reinforcement on a decision that you have already made, feel free to "research" in this manner. But if you are truly trying to arrive at the optimal conclusion, keep an open mind. Consider all information, even if it does not coincide with your preconceptions.

> *be very careful about predicting the recent past, the information you have about the recent past, to the future.*

Yes, trends can occur over time. Strong management today may continue in the future. Companies with monopolies yesterday may also have monopolies tomorrow. So look to the past for clues as to future events. That is much of how one researches investments.

But do not automatically assume that past events will continue. Sadly, this is another problem with many emotional investors.

Circumstances shift over time and their impact on investments change. Gold has performed very well in recent years. But has it reached a peak or will its relatively high returns continue?

Just because gold has performed well in the past does not mean it will continue to do so. You need to examine factors today to assess how they will impact future results.

Photo for Sale

I took a great photo the other day and am looking to sell it.

What would you pay?

It is a pretty picture. Lovely river, green grass.

Like I said, pretty nice.

What Value do You Place on the Photo?

So what would you pay for that photo?

$1, $10, $100? Or perhaps you are thinking that you could wander down to your local river and take something of equal value for free?

Now how about I tell you that the photo was not taken by me, but instead by world famous photographer, Andreas Gursky. Does that change your opinion of its value?

How about the knowledge that this photographer has received millions for previous photos? Are you starting to look at the photo in a slightly different light?

Or what if I told you that only six limited editions of this exquisite picture were produced. And three are exhibited in major international art galleries? Does this change your valuation?

Now what if I tell you that the photo recently sold at auction through Christies for USD 4.3 million? Yes, million. What impact does that knowledge have on your estimate?

The Value of Art

Beauty truly is in the eye of the beholder.

The value of art, like many other investments, lies solely in the mind of the investor.

Part of that value is based on one’s knowledge of the asset class. If you did not know this photographer’s identity and reputation, you might not even consider the above photo at a garage sale. Without fully understanding the market for photographic art and its production processes, you may never have given the photo a second thought.

Part of the value comes from the amount of information that you possess. The more information you obtain, the better your decision-making. In our example above, you may have heard of the photographer. But knowing prices received for his other photographs will help you value a new one. When assessing any investment or purchasing decisions, make sure you get as much information as you can.

Part of the value is also based on aesthetics and personal taste. Especially with collectible assets, there may be an emotional element involved in the valuation. This can be tricky for potential investors.

Value is What Someone is Willing to Pay

The value of any asset is what someone is willing to pay in an arm's length transaction.

You can do as much quantitative and qualitative analysis as you want to arrive at the true intrinsic value of an asset. But unless you can find someone that shares your conclusions you will not be able to close the deal.

With stocks and bonds, there is a fair amount of publicly available data and many investors use similar pricing models. Based on current information a reasonable market value may be found between buyers and sellers.

But as you move to less efficient markets, there is more differentiation as to value. That is why you sometimes see large spreads between the bid and ask prices for investments in less efficient markets. With fewer traders, less available information on companies, fewer analysts tracking the assets, etc., there is less agreement on the "true" value for investors.

As you move into more exotic assets, such as collectibles, the differing of opinion on value can become even greater. There may be millions of shares outstanding for a public company. Apple Inc. has 929 million shares outstanding. You can easily see what many investors paid for the same share within the previous hours.

But consider the above photo.

> *"Of the edition of six, three are in public museums (Moma, Tate, Pinakothek der Moderne, Munich), one is with a private museum (Glenstone, Potomac) and only two are left in private collections, of which this is one. In other words this is almost as rare as a one-off painting," says Outred.*

How do you definitively value an item where you have no direct comparables? Yes, there are some measures (appraisals, insurance estimates, sales prices for indirect comparables such as other photos by the same or equivalent photographers, scarcity of the asset, etc.), but it is much, much trickier than evaluating the current value of Apple Inc.

This is why I believe that only those with strong expertise in a specific alternative asset class (art, coins, stamps, porcelain dolls, etc.) or inefficient market should invest in those areas. The rest of you should avoid the market. Or, if you want to invest for diversification purposes, be prepared to pay for expert advice. Either directly through the use of expert consultants or indirectly through higher management fees in a specialty fund.

Psychology Plays a Part

With many exotic assets, other factors often play a role in valuation. Aesthetics, personal tastes, peer pressure, emotions, etc., all can factor into what someone considers an asset’s worth.

For example, I love fine art. But I have no real understanding what makes a great painting great.

I have visited the Mona Lisa on numerous occasions. As I walk through the Louvre, I see thousands of paintings. Some I like, some I think blah.

I like the Mona Lisa. But I must admit that if it was not world renowned, separated from the rest of the paintings, roped off in its own area, and covered in protective glass, I would not see it as any better than many of the other paintings I walk past on the way to see the Mona Lisa.

A large part of my attraction to the Mona Lisa is its reputation. How other people see the Mona Lisa shape my own view.

I suspect you are exactly the same way. When you saw the photo above, maybe you thought it was nice. Maybe not. Probably not worth much.

But then you learned the photo was taken by a famous photographer and not by me. That likely enhanced its value in your eyes.

Then you learned that previously auctioned Gursky photos have sold for millions. That undoubtably increased its value in your mind.

Finally, upon hearing how rare the photo, that may have also added to its worth.

But it is the same photo that you probably thought was worth little.

Yes, the added information helped you to adjust your viewpoint. But the psychological impact also affected your valuation. How others viewed the photographer and the value of other photos he sold.

But it really should not have direct bearing on how good this particular photo is. Maybe he had a bad day. Maybe the photo was actually taken by a relative and Gursky claimed credit. Maybe there are more than 6 prints in existence. Maybe there are 600. If you think this is not possible, google Salvador Dali for these sort of tactics.

Because psychology affects valuation significantly in exotic assets, it adds to the uncertainty.

I would note that psychology often impacts investors on conventional investments as well. The result of which is usually an investment bubble.

While gaining additional information usually assists in valuing assets, when you rely on psychological aspects, you may just get caught up with the masses. Be careful. Minimize the emotions and following the herd.

Key Takeaways

I have jumbled a few different points in this post.

One key takeaway should be that the more information you can obtain and the more expertise you have in the asset class, the better it is in valuing the investment.

Two, the more publicly available information and the more traders, the better the pricing. Conversely, the less information or less number of traders, the less efficient the market, and the more difficulty in determining fair value. This is part of the Efficient Market Hypothesis.

Three, exotic or alternative assets tend to lack substantial information and traders. Pricing can be difficult. Unless you have significant expertise in one or more of these assets, best to avoid them. Unless you want to pay for expert assistance.

Four, psychology plays a role in the value of assets, both conventional and exotic. Try to avoid emotional investing. Stick to the available information and avoid getting caught up in the moment.

Holding on to Losing Investments?

Behavioural finance (a.k.a. behavioural investing) examines how psychological factors impact an individual's investment decisions.

One likes to imagine that investors are rational creatures, but that is often far from the case. I find behavioural finance very interesting in how it explains certain, less logical, investing actions.

Today a look at how investors often keep their losing investments longer than they should.

The Wall Street Journal nicely summarizes “Why We Can’t Let Go of Our Losers”.

Research shows that investors often hold their losing investments longer than they should. Conversely, investors often sell their profitable assets more quickly.

For example, one study found:

> *“that individual investors are 50% more likely to sell a winning stock than a loser—even though, on average, the stocks these investors sell go on to outperform while those they hold onto underperform.”*

The linked article provides additional research findings on investors holding their losers. As you may have guessed, behavioural finance helps explain why.

The article offers advice on dealing with losers. I have no problem with their suggestions, but I do not think they get at the heart of the issue. Namely, how to keep your emotions in check.

Humans are Emotional

Emotions play a big role in investment decisions. They should not, but they do.

I think a key to successful investing is developing discipline and objectivity.

Easy to say, difficult to achieve. But try your best.

One way to accomplish this is to create a written Investment Policy Statement. One that incorporates your investment objectives, personal constraints, and investment strategy. A well-planned, written document will aid in keeping you focussed, especially during periods of market volatility.

Make sure that it is written. I find that a written document is easier to adhere to than trying to keep your plan in your mind.

Is Not the Buy and Hold Approach a Problem?

Possibly. If you own a losing investment and hold it forever, you might end up keeping a dog.

That is why I prefer the buy and hold approach for well diversified assets, not individual stocks or poorly diversified investments. With diversified assets, the risk is spread throughout the holdings, thereby lowering the impact of any one loser.

With index funds, for example, you also have natural attrition within the index holdings. Over time, longer term losers within the index are deleted from the index. Not necessarily because they are losers, but because they have fallen in share price, market capitalization, etc. (this will vary based on index criteria) and no longer warrant being in the index.

Portfolio Review and Rebalance

It is also why you need to review and rebalance under a buy and hold approach.

The portfolio review should be an objective assessment based on current economic conditions and future expectations. As mutual fund prospectuses like to say, past performance is no indication of future results. You need to examine where an investment is going, not where it came from.

Based on the review and changes in economic conditions or your personal circumstances, you may need to rebalance the portfolio or make changes in holdings. Again, this should be an objective and disciplined process, based on your unique situation. It should not be predicated by emotions and getting caught up in market hype or by what you heard from a talking head on the financial channels.

Develop a formal approach to investing with an emphasis on your long-term objectives. Spend time (and possibly money for a financial planner) to create an appropriate investment plan that meets your needs. Then take a long-term perspective, tune out the short-term market noise, and adhere to the plan.

If you do, you will reduce the probability of letting emotions rule your investment decisions. And that may mean improved long-term performance.

Emotional Investing

Investment markets have resembled roller coasters in recent times.

Up, down, sideways, making many investors sick to their stomaches.

While investing is an emotional experience at any time, this turbulent period makes things even worse for lots of investors.

So what should you do?

Avoid Emotional Investing!

Emotional investing should be avoided.

Easy to say, difficult to adhere to. It is extremely tough to maintain a level head when your savings are at stake.

George Loewenstein, professor of both economics and psychology at Carnegie Mellon, discusses emotions and investing in this CNNMoney interview. It is well worth a read.

I think that if you can identify areas where emotions may take over from rational investment practices, you can watch out for these potential traps and try to limit their impact.

Plan When Times are Calm

As Dr. Loewenstein states, it is "dangerous to make long-term decisions based on short-term emotions." You need to develop a fundamentally sound investment approach on which to make your decisions.

This approach should include short, medium, and long-term investment objectives.

It should also provide guidance for dealing with future investing issues (e.g., investment bubbles, bear markets, inflation) before they actually arise. It is always easier to determine a logical course before a crisis erupts.

Stay Focussed During Volatile Markets

To counter emotional investing problems, Dr. Loewenstein suggests using a professional advisor. Preferably someone that understands the ups and downs of the markets and can advise in a rational manner.

I would also suggest using some tools that we have previously discussed.

Develop a written Investment Policy Statement (IPS) when you begin to invest. Your IPS will be the framework with which you invest. It will also keep you on the correct path and help you avoid making investment decisions based simply on short-term emotional factors.

Utilize prudent risk management techniques. Key among these are portfolio diversification with attention to asset correlations and proper asset allocation for your investor profile.

Use common sense to identify potential investment bubbles and do not get greedy with unrealized gains.

There is no evidence that investors successfully time market volatility over the long run. So invest in a diversified, low-cost investment portfolio using a buy and hold strategy. For those who say buy and hold does not work in volatile markets, I disagree to some extent.

When managing your portfolio, employ dollar cost averaging to take advantage of market dips and to reduce acquisitions when markets are potentially becoming overheated.

It also means that you should review your portfolio on a periodic and consistent basis. Do not wait until the wolf is at the door before assessing your investment holdings.

If your objective, non-emotional review indicates rebalancing is required, feel free to do so. This can be done by reallocating existing holdings, adjusting future investment allocations, or through profit-taking.

Following a well-designed investment framework and strategy as outlined in your IPS will help you keep calm when the markets are volatile. Put in the effort to develop a sound IPS when starting out on your investing path. If you do, you will be rewarded over your lifetime by (hopefully) solid portfolio performance and a less stressful investment life.

Behavioural Finance and Stock Trends

I find behavioural finance very interesting as it relates to personal investing.

Behavioural finance looks at human emotion and psychology to try and explain investment decisions and financial trends.

It is an area I will explore more later this year.

For today, a few quick thoughts triggered by an article I read on the weekend.

You can learn the basics of behavioural finance in a series of Investopedia articles. They are well worth your time.

When I discussed the Efficient Market Hypothesis last week, I stated that I believed most developed markets to be semi-strong or even higher. That means that all publicly available information is instantaneously reflected in the asset price.

However, there are aspects of behavioural finance that pop the odd hole in that belief. One favourite is the January Effect. Less pronounced now, it has occurred with some regularity over previous years. There are many other examples of recurring phenomena that also make one question the existence of semi-strong markets to some degree.

That said, I am still a believer. But a cautious one.

Over the weekend, I was reading Three Trends to Look for Before Jumping Back into Stocks. The article reminded me a little of technical analysis and a little of behavioural finance.

The three trends are: Chicago Board Options Exchange Market Volatility Index (VIX); insider trading activity; corporate buybacks.

The Volatility Index

The VIX attempts to quantify the implied volatility of Standard & Poor’s (S&P) 500 index options. It is known as the “fear gauge” (emotion, psychological = behavioural).

In general terms, VIX values above 30 indicate high volatility (and fear) is anticipated. VIX values below 20 indicate complacency in the markets. At current levels of about 43 there seems to be a high amount of fear and the potential for significant changes in asset values.

As this involves historical trend analysis, it can also be considered a form of technical analysis. Especially if one trades simply based on the current VIX value versus historic averages.

Insider Trading

Insider trading is another interesting area for investors to monitor.

No, not insider trading in the illegal sense. Rather, the actions of corporate insiders – as defined by securities legislation – is studied to see if the individuals who know the company best are bullish or bearish on future results. In theory, if the President of a company is buying shares in the firm then he presumably believes the company is undervalued. If he is buying, then you should too.

One study found that insider trading can indicate outperformance of the general market.

There may be something to this. However, there are many other possible reasons for the results. For example, when company management acquires shares of their own firms, other investors see this and wish to invest as well. This increases demand for shares and drives prices upwards.

One also must be cautious about insider trading. It is not always about company outlook.

The President may need to sell shares to finance his daughter's wedding, not because he thinks the company's prospects are poor. Or perhaps the President cannot sell shares due to public perception and its impact on company share price. Or there may be a blackout period in place where insiders cannot trade shares no matter how much they want. There are many reasons other than future corporate results that can explain why an insider buys or sells shares.

Corporate Buybacks

Corporations should use their assets to increase shareholder value.

That means investing capital in new products, technology, processes, debt repayment, etc., so as to enhance profitability. If there are no opportunities to invest capital, companies may pay out cash as dividends. The idea is that the shareholder can achieve a better return on the capital than the company can.

The company may also engage in share buybacks. This serves two purposes.

One, it sends a signal that the company believes its shares are undervalued. By repurchasing shares today, a company may believe that they are buying at a discount value and will be worth more tomorrow.

Investors following this approach will also buy these undervalued companies.

Two, by reducing the number of shares outstanding, it increases earnings per share (EPS) and other per share financial data. These increases may trigger share price increases for those that buy based on certain per share valuations.

For example, a company with 1 million shares and net earnings of $1 million has an EPS of $1.00. If companies in the same industry trade, on average, at 10 times earnings (the price/earnings ratio), then the company will trade at about $10.00 per share.

But the company decides to repurchase 200,000 shares. Assuming earnings stay constant (a questionable proposition given the large cash outlay), suddenly the EPS is $1.25. If the company continues to trade at 10 times earnings, it share price will rise to $12.50 from $10.00. Not bad.

Of course, companies that can find no better way to invest their money than by repurchasing shares may not have great long-run potential. After all, the purpose of a company is to grow and increase profitability, not to make its financial ratios look good. So maybe these companies are not that great a deal all the time.

Investing based on insider trading activities and corporate buybacks is a form of behavioural finance. Individuals acquire and divest investments based not on actual business results. Instead, investors merely watch what the company does and invests based on those actions.

Money may be made by following these strategies. But they are not foolproof. And given the sheer number of investors employing these two tactics, one has to move very quickly to buy or sell. If you are late to the party, any opportunity for profit will evaporate as prices rapidly adjust to the information.

If you wish to follow the above trends, use them as indicators as to whether you should buy or sell. One of many variables you assess. But never substitute the VIX, insider activity, or share buybacks for proper quantitative analysis and research.

Buy and Hold Perceived Disadvantages

There are some interesting, for lack of a better word, articles on the buy and hold strategy.

If you google the phrase, you will see that the strategy is not well thought of in many circles. Some ask if buy and hold "is still viable?" Others believe that it is "going, going, gone". And some feel that it is completely "dead".

So why do I suggest you employ a buy and hold strategy?

Well, I think some of these negative articles do not tell the whole story. Or some of the disadvantages relate more to investing in individual, non-diversified assets, rather than the low-cost, highly diversified, fund strategy that I espouse for most investors.

We will look at some of the negatives often raised in conjunction with a buy and hold strategy.

Some are legitimate concerns. Some less so.

Today we will cover the more frivolous.

It's Too Easy a System to Employ

True.

Taken literally, you buy and then hold until you need to liquidate at retirement. Or other such time that you require cash proceeds.

Not that there is anything inherently wrong with this approach. In fact, the ease of buy and hold can be seen as an advantage.

The problem with ease, is that like with dollar cost averaging, too many people believe this system should be used in the literal sense.

They buy, then they forget all about the investment until the time comes to liquidate.

The ease of buy and hold makes certain investors lazy. And that is the problem.

Regardless of the asset or system employed, investments must be monitored and evaluated. Should circumstances change, portfolio modifications must be made. This applies to any trading strategy, including buy and hold.

Buy and hold cannot be rigid dogma. While you will adhere to it for the most part, there must be some flexibility allowed.

We have already discussed how to build a portfolio that minimizes the need to review and make adjustments. That is by primarily investing in low-cost, well diversified, index funds.

While minimizing the review process, it does not eliminate the need for periodic evaluations. Nor may it entirely avoid making any dispositions. We will consider portfolio reviews in future posts. Both when and how to evaluate your portfolio, as well as portfolio modifications.

Buy and Hold is Not Sophisticated

So it cannot work well. One needs a complex investing system to succeed. Preferably one with lots of technical data and charts.

Or so some people believe.

Sometimes the simple approaches work well.

But they are not sexy. And, for most investors, it is the lack of sexiness that is the bigger negative than a lack of complexity.

You will sound much more sophisticated as an investor discussing butterfly options strategies around the office water cooler, than in recounting how you have owned the same index fund for the last 15 years.

I suggest you worry less about how you are perceived by colleagues and friends. The purpose of investing is to maximize long-term wealth accumulation. It is not to impress your peers.

Find a strategy that works and stick with it. The grass is not always greener, or more profitable, on the other side of the trading fence. And the guys that regale you about profits from their latest trading flips, never seem to mention the ones that lost money.

Buy and Hold Can be Emotional

Another two edged sword for the buy and hold approach.

As an advantage, buy and hold is supposed to take the emotion out of investing. You buy and hold through the ups and downs of the asset's price fluctuations. You ignore the panic generated by the mass media during bear markets or sudden crashes. You are secure in the knowledge that over the long run, your investment will appreciate.

But this approach is also a disadvantage for many investors.

Holding an investment as month and after month its value diminishes is extremely difficult. In some cases, the value never comes back and you lose.

I can definitely empathize.

The difficulty as an investor is that you seldom are certain which investments will fall to nothing and which are just temporarily depressed.

Do you sell and wait for the asset to reach its bottom before buying back in? How do you know when the bottom has been reached?

Do you sell and shift your cash into another investment vehicle? Will that new asset provide better returns?

Again, find well-diversified and well-managed investments. These will help keep you sane during periodic market fluctuations.

Avoid non-diversified assets until you become comfortable understanding the difference between normal short to medium term price volatility and the permanent impairment of the asset’s value. While we have not discussed evaluating individual stocks or bonds to date, we will review fundamental analysis in the future.

Programmed Trading Makes Buy and Hold Obsolete

Computer trading programs are quite popular these days.

More effort is being spent on technical analysis. That is, these programs look at supply and demand for an investment. What are the pricing trends and market bands. This type of information is used to assess future price movements.

While some technical analysts take a longer term view of the trends, many try to take advantage of short-term discrepancies that resolve themselves quickly. This can lead to substantial trading and profits can be made on penny fluctuations in market prices.

An argument against buy and hold is that with all the computer models and short-term trading, buy and hold is no longer relevant. The real money is made in the short term and not in holding assets for 20 years.

I do agree that programmed trading by institutions has, and may continue to, caused problems for investment valuations. I think though that these are short-term blips and that over time, asset pricing reverts to its fair value. This actually bodes well for the buy and hold strategy.

I am not a big believer in individuals using computer trading techniques.

I must admit that I have known certain investors who have done well identifying price discrepancies and short-term trends to arbitrage. But usually you need significant capital to profit on small price changes. This is something that most investors lack.

These investors are also highly skilled and experienced in investing. They use advanced analytical tools. They also devote substantial time to their trading activities. Most normal investors lack the knowledge, tools, and time required to implement these strategies.

I remain unconvinced that, on average, programmed trading by individuals works. As I said, I do know some success stories. And occasionally, one reads news stories about others. But I also know and read about people that win the lottery. That does not mean everyone does.

Okay, those are a few of the less important, but commonly perceived, disadvantages of the buy and hold strategy.

Not really legitimate worries in my mind.

But there are a few real potential problems with buy and hold.

We will cover those next time.