How Investors Use ETFs

How do investors use exchange traded funds (ETFs)?

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

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

Market Timing

Because ETFs are typically very liquid, a:

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

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

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

But I do not recommend jumping in and out of ETFs to try and time short-term volatility. This goes back to the active versus passive management argument. Active managers often try to time market movements. Usually with little to no success.

If the professionals cannot prosper through market timing, it will be even more difficult for amateur investors. So be careful.

Day Trading Speculation

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

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

Following the Experts is Confusing

No wonder investing is confusing for the average investor.

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

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

I saw a good example of this in Yahoo News.

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

Dow May Soar

“Dow 36,000 Is Attainable Again”, claims two experts.

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

Stock Rally Will End Badly This Year: Marc Faber

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

Now Marc Faber is telling me that:

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

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

Who to believe? What should I do?

Who to Believe?

I have my thoughts, but who really knows.

Hassett and Glassman

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

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

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

He was quite giddy that day.

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

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

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

Doctor Doom

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

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

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

Both Could Be Right

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

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

However, there will be bumps along the way.

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

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

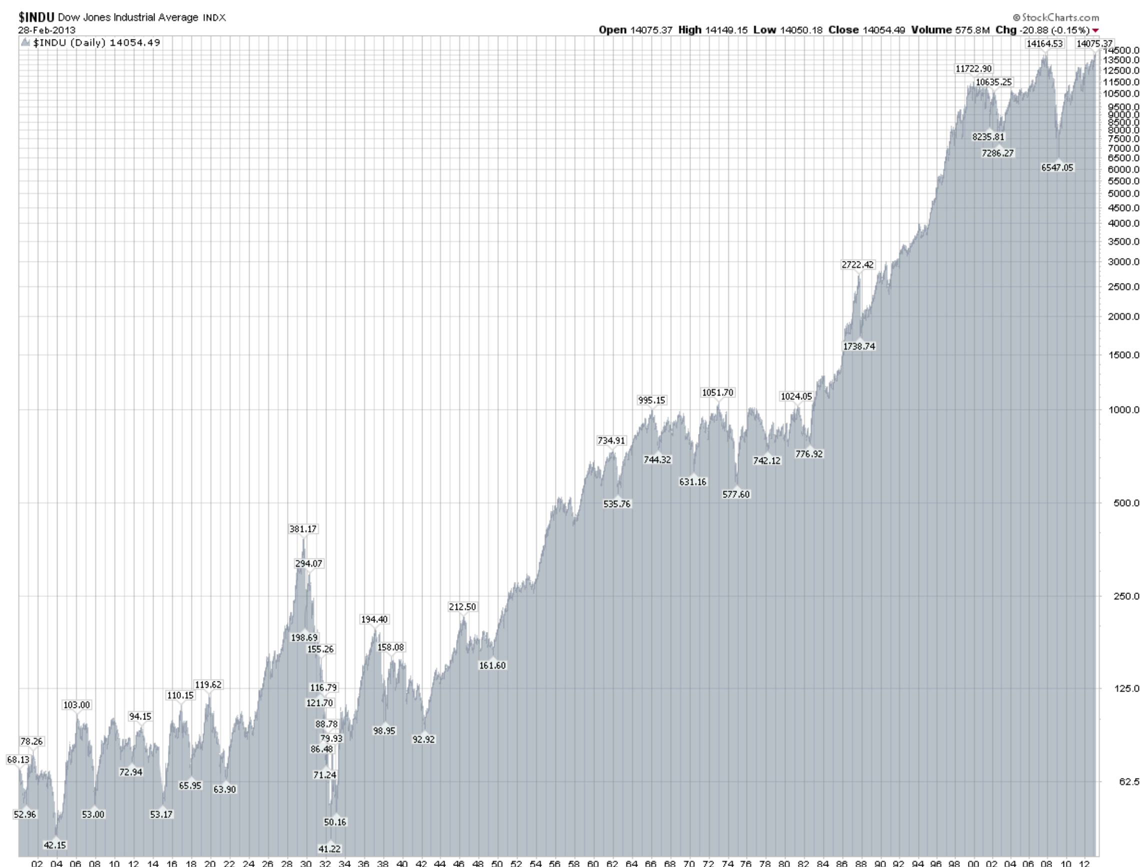
What to Do?

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

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

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

Works well. Give it a try.



[Want to Invest Like a Pro?]

Want to learn how to invest like a professional investor?

Maybe a good plan, maybe not. But our friends at Investopedia discuss how to [“Invest Like a Pro”.]

Article highlights and my comments below:

Strategy Before Investing

> *A strong investment philosophy should be outlined before any investment strategies are considered. An investment philosophy is the basis for investment policies and procedures and, ultimately, long-term plans. In a nutshell, an investment philosophy is a set of core beliefs from which*

all investment strategies are developed.

Per Investopedia, the keys to developing a strong investment philosophy are in defining your: core investment beliefs; investment time horizon; risk tolerance; target asset allocation; diversification.

Basically what we talked about in developing your Investment Policy Statement.

You start out by creating a comprehensive Investor Profile. It takes into account your current financial situation, investment objectives and constraints, time horizon, and personal risk tolerance. The result should be used to drive your investment strategy. And by investment strategy, we are talking your target asset allocation, including diversification and asset classes.

I firmly believe that if you take the time to lay a proper foundation it will improve your actual investment decisions and long-term performance. Sadly, too many individuals ignore this part of the investing process.

Secrets of Success

Match Investments to Investor Profile

> *Successful firms also implement product funds that reflect their investment philosophies and strategies.*

Develop an investment plan that meets your individual situation. Then invest in appropriate products that will best meet your goals.

If you are retired, highly risk-averse, and need investment income to meet your monthly cash flow requirements, then lower risk assets that provide a consistent cash flow are best. But if you are 25, with a 40 year investment window, and do not

require investment income to live, then perhaps you are best suited for more volatile investments with higher potential returns.

Match your investments to your personal situation and profile.

As your circumstances change (family, approaching retirement, career success, etc.), you should adjust your profile. As a result, your investment strategy, target asset allocation, and individual investment choices will also evolve over time.

Avoid Sector Bets

> *Successful firms also limit their abilities to take large sector bets in their core products.*

Not sure I necessarily agree with this one, or at least with Investopedia’s phrasing. I think what Investopedia means is that one should not deviate from the core approach to make significant bets in any specific sectors or sub-asset classes.

For example, you have a well-diversified equity portfolio, but the financial pundits all say that tech stocks are the place to be during the upcoming year. So you ditch your utilities, commodities, retail, etc., and load up on tech equities. This is what Investopedia seems to be referring to.

The issue here is essentially market timing. And can you, or even the professional investors, correctly time market (and sub-market) movements? History shows that very few professionals get it right.

How often to economists get it correct? I could post examples like this every week if I wanted. Or what about the best investment analysts out there. Why do the “best” seem to change every year? How many professional investors were screaming when Apple dumped Steve Jobs back in the 1980s? Or why do mutual funds typically lag their pre-determined benchmarks if fund asset managers can time short-term market

movements and trends?

The classic passive versus active management debate. It is difficult to beat the market, do not try.

If you are jumping in and out of sectors, you will incur higher transaction costs, as well as lose potential capital by timing poorly. You are investing for the long run. Select a strategy that meets your unique situation and follow it. Do not get caught up in the short term noise and stay the course.

Fully agree. Well, with short term sector bets or chasing trends. However, I do make longer term sector plays. Does that make me a bad guy? A fool? Possibly.

Well, Avoid Short Term Sector Bets

I am more a macro investor, so that is what I do myself to a large extent. I study trends and recommend investments that fit those trends. But I am more interested in medium to longer term trends. I do not think it possible (at least for me) to time short term volatility and I utilize probabilities more than gut feel.

If you ask me what Apple will do over the next 6 months, I can analyze the data and provide a reasoned opinion, but my confidence level will be low. There are too many non-systematic risks in play with individual companies to assess performance. Consider UBS. How many people out there knew a rogue trader in London was going to create so much aggravation for the company? Not me.

This is why we use diversification. To minimize non-systematic risks in our portfolios.

It is also why I recommend passive investing, utilizing a diverse portfolio of low cost index funds.

Looking at systematic risk, how many investors anticipated the September 11, 2001 attacks? Huge short term impact on the

financial markets. The S&P 500 fell 11.6% between September 10 and September 21. Yet a month later it was back to pre-attack levels.

So short term volatility and market timing is hard to accurately assess. Or so I believe.

But I do think that smaller, professional investors can take advantage of inefficient markets and longer term trends.

Consider interest rates in Canada or the U.S. Currently, they are extremely low on a historic basis. In a low, medium, and high probability analysis, the odds of interest rates falling are negligible. We can debate forever as to whether they will remain stable or increase over the next 3, 6, 9, 12, or 24 months. But I am pretty confident they will rise over the medium term, if not the short.

Without getting into the correlation between interest rates and fixed income prices, suffice to say when rates fall, bond prices generally rise. When rates rise, bond prices fall. And the impact is greater the longer the bond's duration (term to maturity, in layman's terms). If I think rates will fall, I want to own 30 year bonds. If I think rates will rise, I want to hold 1 year bonds. As I calculate a higher probability of rising rates going forward, I believe that investors should shorten their fixed income portfolio durations.

But that is me. I listened to the two top guys at Vanguard last week make a slightly different argument (when they put up a video for the talk, I will post it). They said that perhaps low rates will stay in place for a longer period. By reducing durations, you are giving up yield (generally speaking, longer maturities equals higher yield) needlessly if rates do not increase. And they made some excellent points in support of their position.

If Vanguard is correct and I am not, then I am costing myself income by placing a sector bet on short-term duration bonds.

We shall see over time. But I do think for an amateur investors – the doctor, teacher, fireman, etc., who does not spend 10 hours a day studying the markets – stick to a general strategy and that will serve you well over time.

Stay Consistent and Disciplined

> *When defining an investment strategy, it is very important to follow a strict discipline.*

The chasing trends part we covered above. But I highlight the discipline part also in respect of consistency over time.

Use a dollar cost average approach to gradually build your holdings. When markets are down, you will be buying at a discount. When markets are too high, you will buy less and avoid overpaying. You likely cannot time market or individual investment highs and lows. So buy a fixed dollar amount each week, month, or quarter. That will smooth your purchase prices over time and better serve you.

Stay disciplined in your investment style. If you cannot time market volatility, should you even try?

A Final Thought

It is said that a picture is worth a thousand words.

Here is a good example of market volatility and whether one can time markets.

How many investors were able to time the market lows in early 2009? Versus the number that bought in mid-2008? But if you consistently invested $1000 monthly over that period, you may have done all right.

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.

Life of a Day Trader

Day trading in financial markets is not something I like to see in clients.

I prefer having clients take a long-term investing perspective, utilizing passive management strategies. Day trading – also known as stock flipping or high frequency trading – is the polar opposite to this. Active management to the nth degree.

Successfully flipping stocks, bonds, and other asset classes is a tricky business. One that requires expertise, adequate time to research and continually monitor your portfolio, and nerves of steel in volatile markets. A closet full of Milk of Magnesia might not hurt either.

That said, many individuals want to learn about day trading. A look at this topic today.

SmartMoney Magazine takes a look Inside the Life of a Stock Flipper. The article is well worth a read for those who wish to become day traders. And for those with no desire to flip assets, reading the article will reinforce your decision.

There Are Lots of Day Traders

As I said above, day trading is not my cup of tea (or vodka, tequila, et al). But many, many people do engage in stock flipping. And not just the Matt's of the world.

> *In 2010, 70 percent of all purchases and sales of all stocks and bonds in the world were made by high-frequency-trading programs, called algo-bots. And that figure has increased since then.*

As computing power increases and more complex software develops, high frequency trading may continue to rise. Even if you do not want to become a day trader, it is useful to read about how they operate.

It will also help you understand what is taking place when the next "flash crash" occurs.

Day Trading is Not Investing

High frequency traders are not investors. They are pure speculators. What do they do?

> *They gamble. When Matt decides to buy stock in a company, he has no interest in the price/earnings ratio, who the CEO is or what the sales figures are. He's only going to own these shares for a few seconds before selling them, hopefully, for 5 or 20 cents more than he paid. All he cares about is how the stock price is moving.*

If you want a career in speculating, consider becoming a day trader.

If you want to build wealth for a comfortable retirement, focus on being an investor.

Day Trading is Not Fundamental

High frequency traders utilize technical analysis in their trading.

> *the simplest and most important day-trading move is "trend following": If a stock is shooting up, buy some and ride it up until it falls. "Fading a move" is where you think a stock has ridden far enough up, so you bet against it by shorting it, hopefully predicting its downward movement.*

Whereas fundamental analysis involves assessing the qualitative and quantitative "fundamentals" of a company (and its peers, benchmarks, etc.) to determine if it is a potentially good investment.

Technical analysts care little, if anything, about fundamentals. In fact,

> *At one point, Matt gestures at one of his lists of companies' fluctuating stock prices: "I'm watching SINA, Sina Corp.,*

> *which is – I don’t even know.”*

Day Trading is Volatile

Given the speed of transactions, the high amount of competition (tons of individuals staring at the same software screens, rapidly punching buys and sells), the leverage being used, etc., day trading is a highly volatile activity.

> *At one point, in those minutes when the market was falling irrationally and Matt was buying, he was $90,000 down. “I get a little sick still, just thinking about it,” he says. He ran to the desk of Adrian Nico, the firm’s risk manager, and begged for more leverage, which Adrian gave him, allowing Matt to put $20 million of the company’s money into the market. “It seemed like it was the end of the world. No one was buying,” Matt says. “I feel really proud of what I did that day. I stepped in when no one was willing to.” He made $220,000. Another guy at the firm made more than $2 million. Another guy was at the dentist.*

Volatility requires significant capital to handle the large value swings. If you want to day trade, have enough access to capital to handle down periods and cash calls on leveraged accounts.

Volatility requires constant monitoring. The greater your portfolio volatility, the more attention you must pay to your investments. If you have the time to constantly watch your assets, maybe you can become a day trader. If you work a regular job and cannot give enough focus to high frequency trading, think hard before giving it a try.

Volatility also requires strong nerve. With fundamental analysis, you can take some comfort that the underlying investment has upside potential due to its products, revenues, competitive advantage, management, and so on. And with a

relatively long investment period (relative being more than say 250 milliseconds), you anticipate that other investors will see the same things over time that you did, buy the asset and drive the price upwards. But with technical analysis alone, you need confidence in your software and your speed to identify anomalies and execute trades.

Day Trading is Risky

It is too bad that we only read about Matt's story. And as Matt tells it.

Not to appear paranoid, but I have dealt with many "successful" investors in my life. Some have been truly successful over time. But many like to talk loudly about their success stories and not utter a peep on their losers.

And what about the other high frequency traders out there? While day trading is not necessarily a zero sum game, I do expect that when Matt prospers through his analytical tools, speed, experience, and nerve, his counterparty (who is less adept at flipping) may be losing on that transaction. Always remember, for every buyer there must be a seller.

It would be interesting to see the attrition rate for day traders. How many go bankrupt? How many break even but burn out? I suspect there are a lot of losers in the day trading business.

Even Matt Recognizes the Risk

Even Matt recognizes the risks involved in high frequency trading. I thought it was extremely interesting that:

> *Though he's gambling his own money, it's only about 20 percent of what he's amassed; the rest is either in cash or in an indexed mutual fund.*

A low risk and/or passive management approach for the bulk of

Matt’s personal wealth? Sounds like a good idea to me.

And a strategy I do recommend for more aggressive clients who like some risk and excitement. Stick to a passively managed strategy of index funds for the vast majority of capital. But if you do want to take a more hands on approach (and have the time, skill, and experience), set aside (say) 10% of your capital to invest in individual non-diversified assets. Make sure you watch the leverage and do not raid the lower risk capital to finance losses though.

A good read with some positives to be found for those who want to become day traders As well as for those who do not.

You Are Not Alone

I have seen a lot of John Hancock investing commercials on television recently.

I have never dealt personally or professionally with John Hancock so cannot opine on if they are a great firm or the Satans of insurance. But they sure make good commercials.

What do I mean?

“You Are Not Alone” – Living Room

I hear these exact comments from clients and associates every single day.

The market is up, then it is down, then it is sideways. And every day the talking heads in the media have a perfectly logical explanation as to why what just occurred makes perfect sense.

A prime example is Facebook. Prior to the initial public offering (IPO), I kept reading about how the price would rise; how investors could snap up shares in the secondary market as the IPO was fully subscribed; why Facebook's business model had a great future; and so on.

A month later, I keep reading how Facebook should be valued at around $20 per share (or in one analysis, even $6); investor lawsuits are in the works; that Mark Zuckerberg should be brought up on charges.

All the analysis both before and after the IPO made (some) sense, but who is correct? Is Facebook worth $50 or $20 or something else? And what is even scarier is that often the folks valuing it at $50 are the same folks saying a month later it is worth $20 or less. Oh yeah, and by "folks" I mean finance professionals.

It is enough to reach for the Tylenol and/or buy a bigger mattress. Or, in my world, buy shares in Johnson & Johnson and Sealy (appropriately, Sealy's stock symbol is ZZ).

httpv://youtu.be/6hwt4sdl94g

"You Are Not Alone" – Bedroom

Another great little commercial that accurately reflects more of my conversations with clients.

"You can't let it get to you, it's all just noise."

So, so true. As I wrote above, one day the markets are up and there are plausible reasons why. The next they are down and there are good reasons why. Hindsight is always 20-20. It is forecasting the future that is less simple.

Try to avoid the daily minutia from talking heads on the financial news network. Focus on general trends and longer term movements.

If you do, I believe that you enjoy better long run portfolio performance. You will also sleep better at night.

httpv://youtu.be/o7xwi2ZDQzQ

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.

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.

Benjamin Graham Investing Principles

I mentioned Benjamin Graham in “Mistakes of Warren Buffett” and recommended his book, “The Intelligent Investor”.

Benjamin Graham mentored Warren Buffet and is considered the founder of value investing.

Today, a quick summary on Benjamin Graham and his three key principles for value investing. While they may not turn you into the next Warren Buffett, these investment tips will make you a better investor.

Forbes and Investopedia combined to create, “Benjamin Graham: Three Timeless Principles”.

Always Invest With a Margin of Safety

> *Margin of safety is the principle of buying a security at a significant discount to its intrinsic value, which is thought to not only provide high-return opportunities but also to minimize the downside risk of an investment.*

Identify assets whose current market value is below its true (i.e., intrinsic) value. This is done through quantitative and qualitative fundamental security analysis.

Investment downside is limited due to safety cushions such as book value, replacement value, cash on hand, cash flow, earnings, etc.

Over time, other investors will realize the asset is trading below its true value. Demand for shares will increase causing the asset price to rise until market value reflects intrinsic value.

Value investing in a nut shell.

Easy-peasey.

Well, except for that part about fundamental security analysis. It might require a little technical skill and investment experience to identify under-valued assets before other professional investors do.

Expect Volatility and Profit From It

> *Investing in stocks means dealing with volatility. Instead of running for the exits during times of market stress, the smart investor greets downturns as chances to find great investments.*
>
> *the market will fluctuate—sometimes wildly—but rather than fearing volatility, use it to your advantage to get bargains in the market or to sell out when your holdings become way overvalued.*

Investors, and markets as a whole, can be emotional. At times investors irrationally fall in love with assets and pay more than they are worth. Investment bubbles result from irrational love affairs gone amok.

At other times, investors hate certain assets and refuse to buy even when they are undervalued. Or maybe not hate, but the industry is boring, the company dull, or the investment just not interesting enough for people to focus on.

For example, gold mining companies are extremely sexy right now. The industrial manufacturer who supplies the mining equipment probably much less so. Yet if the mining companies expand their operations, they will require mining equipment.

Also, small companies often fall below the radar of investors and analysts. This is due to minimum capitalization requirements for funds or analysts. Or there may be a lack of

public information concerning small firms. When Bank of America sneezes, it makes the front pages of the New York Times and Wall Street Journal. When the Canyon Community Bank in Tucson makes an announcement, no one hears a word in the major press.

So how does one profit from market volatility? One way per Benjamin Graham is through:

> *Dollar-cost averaging: Achieved by buying equal dollar amounts of investments at regular intervals.*

We have previously discussed dollar cost averaging. Dollar cost averaging is an excellent tool for small investors. It promotes a disciplined and consistent investing routine, while helping to minimize emotional mistakes.

When markets are depressed, dollar cost averaging allows you to buy assets that are "on sale." When markets are overheated, dollar cost averaging curtails your purchases.

Graham also believed that one can profit from market volatility by:

> *Investing in stocks and bonds*

When Benjamin Graham wrote his book in 1949, asset classes were more limited than today.

His point here was to diversify one's portfolio "to preserve capital, and then to try to make it grow." A very risk averse strategy, but valid for many investors.

Today, there are many asset classes to include in investment portfolios. Depending on your risk profile, you can utilize other asset classes to effectively diversify your portfolio.

Also, dollar cost averaging can assist in developing a well-diversified portfolio. Just be sure to invest in quality

assets. And review your portfolio on a periodic basis. If your actual asset allocation is out of alignment with your target allocation, then you may need to rebalance.

Know What Kind of Investor You Are

Graham believed that individuals need to understand who they are as investors.

> *You only have two real choices: The first is to make a serious commitment in time and energy to become a good investor who equates the quality and amount of hands-on research with the expected return. If this isn't your cup of tea, then be content to get a passive, and possibly lower, return but with much less time and work.*

If you have the expertise, available time, and commitment to spend analyzing investments, then be an active investor. But if you lack any of these traits, stick to a passive approach.

If you worry a passive approach will not provide the same returns as an active style:

> *The fallacy that many people buy into, according to Graham, is that if it's so easy to get an average return with little or no work (through indexing), then just a little more work should yield a slightly higher return. The reality is that most people who try this end up doing much worse than average.*

Empirical evidence supports Graham. It is very tough to consistently beat the market.

Unless you have the time, energy, and expertise, you are better off investing in a well-diversified multi-asset portfolio of low-cost index funds.

Why the Current Market Volatility?

I am constantly asked why global equity markets are experiencing so much volatility right now.

I think there are a variety of significant factors working together to create uncertainty in the markets. Each on their own impacts market volatility (or risk), together they are a nightmare for investors.

Today a quick summary of the major variables affecting global markets.

I believe that the three main drivers in today's uncertain markets are: the U.S. deficits and accumulated debt; the economic difficulties of multiple Euro-zone countries; the potential weakening of economies in other countries, particularly China.

Fortunately for me, The Wall Street Journal does a pretty good job discussing these variables. The linked article is well worth a read.

U.S. Policies

The Obama administration is out of control.

I do not write that as a political partisan. Especially as the Republicans are almost as based as the Democrats on spending.

My view of economic policies runs completely counter to that followed by the current U.S. federal administration. The government's proposals for increased spending and higher tax rates will not help stimulate economic growth. Instead, I

would prefer to see lower taxes and real spending cuts. Not the proposed spending reductions that will not kick in for 5 to 10 years.

As an aside, the 2011 Nobel prize winner for economics is also skeptical of these spending proposals to stimulate the U.S. economy.

I disagree with the linked article where it states that "U.S. politicians are on a war path to reduce government spending." That is not true. There are minimal short term (i.e., real) cuts proposed. Instead, the Obama administration is seeking another USD 500 billion to finance its jobs bill. This is in addition to the USD 1.3 trillion deficit for the fiscal year ended September 30, 2011.

I would love to fight the army that believes this is waging "war".

As far as the U.S. is concerned, I see continued volatility in their domestic markets and currency until the November 2012 (both President and Congress) results seem clear. The current spending levels and low interest rates indicate to me that interest rates will likely have to rise over the short to mid-term. This bodes poorly for fixed income investments. And, if there is inflation, real return fixed income products may do well.

Europe

The Euro was always an idea with inherent problems.

In the U.S., people are Americans first, then Texans, Californians, etc. In Europe, it is the opposite. Greeks are Greeks, Germans are Germans. Until there is strong central control over all the countries, it will be difficult to get individual countries to work together for what the Eurocrats see as their common good.

I would also argue that the bailout of Greece (and any other countries in distress) is more about bailing out the banks than saving the Greeks. I think Europe can survive Greece going bankrupt and leaving the union. It may be more problematic for all the banks should Greece fail. And I write this less about wanting to save the European banks. If the banks crash, there will be a huge impact on the economies of the stable countries.

Sadly, I do not see a Greek bailout actually solving the problem. It is kind of like giving an alcoholic another shot of ouzo. He will be happy for a while, then the effect will wear off and he will be a grumpy guy again. Already we are seeing that Greece will not meet its current deficit targets. Unless the Germans take over Greece's finances, I do not see Greece getting the act together even with assistance this year. As I see it today, Greece will be looking for another bailout in 12-18 months.

So what does that mean for investments? Without certainty regarding Greece and the other problem Euro countries, there will be further volatility in the markets and currency.

I think there will be a continued flight from the Euro to the USD, which is seen as a safer haven for cash. How much will the USD appreciate against the Euro is hard for me to estimate. The main problem is that U.S. economic policies are hurting the USD on a stand-alone basis.

China etal

It is difficult to determine the true economic story in China due to its structure. The flow of information is less than transparent and often appears contradictory to other measures. And I speak as someone who is in close contact to people living and working in Asia.

Some believe China's economy is fine. Others, myself included, think China is cooling down. And there may be the possibility

of economic difficulties arising soon.

To the extent that China, and other countries, do slow down economically, that means s ripple effect to other countries and industries.

For example, China is a prime purchaser of U.S. debt. If they cease buying new debt issues, that raises additional problems for the U.S.

If China cools, there will be less acquisitions of raw materials to fuel the Chinese economy. We have already seen a decrease in copper prices that, in part, reflect this. Obviously, the same holds true for other countries. As other countries slow or do not recover, that saps demand for consumer products, services, and raw materials.

Conclusion

Markets like certainty.

Given the uncertainty with so many key factors that drive equity and fixed income markets, as well as currencies, it makes sense that there should be so much volatility.

I expect this volatility to continue until at least the second quarter of 2012. By that time, there should be some idea as to where the U.S. elections are headed and what steps have been taken in Europe to safeguard the Euro. As to whether the markets will then rise or fall will depend on the outcomes.

Unless events change in the short term and certainty prevails, expect a wild ride over the next few months.