Taking Advantage of What Is Offered

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Over the long term financial markets have been extremely generous. For example: $1 invested in the 1977 S&P500 would equal $33 in 2007. That is a 33-fold increase in 30 years. That result was yours for the taking just by being in and staying in the market over those 30 years. No star mutual fund manager was necessary.

Why do most investors not come close to achieving this type of return? When it comes to investing many of us are our own worst enemy. We fail to know ourselves (behavioral finance), there is not a full understanding of the significance of proper diversification, and we fail to understand the impact of the costs involved in investing

Know Yourself: How will you react when the markets are going against you and you see a significant drop in your portfolio value? It is bound to happen, and those drops can last a long time. Are you going to be able to tough it out during those uncertain times? The S&P can sometimes drop 10 percent as often as twice a year. A 20 percent drop can be expected on average every three to four years, and two drops of over 45 percent occurred since 1972. Understanding these facts ahead of time will help prepare you for those unpleasant events.

Taking a scientifically based risk assessment test can also shed some light on your risk tolerance (your emotional reaction to financial loss). That information can help you design your portfolio to more closely match your risk tolerance. Put in writing an Investment Policy Statement (IPS) stating what maximum and minimum percentage of your portfolio you are willing to expose to different asset categories. Base the percentages on your time horizon, your risk tolerance, the amount of risk you need to take to achieve your goals and your risk capacity (your ability to absorb financial loss without it affecting your life style). Also include in the IPS the mechanisms you will use to monitor and rebalance the portfolio to keep it at the level of risk that is most suitable for you.

Possessing a properly drafted IPS to refer to during any major swings, up or down, in the market will go a long way in keeping fear or greed from damaging your opportunity to take advantage of the long-term excellent market returns available to you.

Diversification: If you do a Google search for "Callan Periodic Tables," you will see a table that shows the annual performance of several asset categories compared to each other. There is no particular pattern that the different asset categories follow from year to year. One year, or for several years, an asset category will give the best return of all the asset categories, and the next year or years that same asset category may give the absolute worst return. If one could accurately predict ahead of time which categories will do best and when, one could accumulate incredible wealth.

Unfortunately that combination of luck and fortune telling is not likely to happen consistently over time. How the different asset categories perform compared to each other is called by academics "random variables." Think of each of the assets categories lining up for a performance race at the beginning of the year. If you place a big bet on a particular asset category expecting it to beat the performance of the other asset categories by the end of the year, you are speculating and not investing for the long term.

Since the asset categories' performance are random variables, how can you prudently take advantage of that fact? Buy several asset categories for your portfolio. The less the assets correlate with each other the better. That way, as each asset category takes a turn as one of the top performers for the year, your portfolio will benefit. At the end of each year, when the random variable asset category performance race is over, bring each asset category in your portfolio back to their pre-determined IPS percentages (rebalancing).

The process is counter intuitive. You sell off some of the winning categories that have grown to a higher percentage range than dictated by the IPS and purchase more of the losing categories to bring them back up to within their proper percentage range. You end up consistently buying low and selling high with this strategy. At the same time, you are keeping the risk in the portfolio suitable for your situation. The above has been an excellent long-term investment strategy and is very different from speculating.

Costs Matter: None of us would buy a house like many investors buy mutual funds. Let's say you went to a new housing development and were shown two essentially identical houses for possible purchase. Both had great locations and amenities. The prices were the same and you like both equally. Upon further discussion and research on your part, you find that one house includes a 5.75 percent commission and the other has no commission. Furthermore, the annual additional tax (expense) on the 5.75 percent commission house is 1.3 percent annually verses a 0.3 percent additional tax on the house without the commission.

Very pleasant and convincing sales people tried to convince you to purchase the commission-house because the commission-house would appreciate more than the commission free house. Basic research on your part told you otherwise. That research made it easy to resist the sales efforts, and you purchased the commission-free house. If both houses appreciate equally, it is clear you are going to come out ahead because of your decision.

The same logic applies to stock market investing, yet thousands of investors choose high commission mutual funds with high annual expenses over identical funds with no commissions and much lower annual expenses simply because that was what was being sold to them.

Why does this happen and how can it be avoided?

The financial profession is far bigger and much more fragmented than the dental profession. There are several regulatory bodies instead of one. Instead of one ethical standard there are several standards. One standard is the suitability standard, and another is the fiduciary standard. The suitability standard is sales-oriented in nature. A financial product may be recommended that is suitable for a client but the choice of that product may be unduly influenced by the size of the commission involved in recommending that product. Many times advisors will be strongly encouraged to recommend products created by the firm for which they work.

The fiduciary standard requires a

much higher standard of care to the client. It is similar to the relationship the dentist has with their patients. The fiduciary advisor makes recommendations based entirely on what is in the best interest of the client.

What do you look for when trying to identify and select a trusted advisor that will have a fiduciary relationship with you? Use a Registered Investment Advisor. Make sure he or she will put in writing that he or she will be acting as a fiduciary to you at all times and does not have a sales relationship with you. If you want to tie your investments to overall financial planning, select someone with a CFP® designation. You know that person went through formal financial planning training, passed a rigorous (two-day, 10-hour exam) and has at least three years of experience in the financial industry. Someone with a CFP® designation is also bound to a fiduciary standard to retain that designation.

The fee-only model of compensation for a financial advisor is one of the best models to eliminate commissions. Commissions are not charged when purchased through a fee-only planner. You will be able to avoid having to incur initial purchase commissions and additional commissions with each purchase during rebalancing

If you choose to have someone manage your portfolio, what can you expect to pay for professional management of your portfolio? Fees normally range from 1.25 percent to 0.25 percent. The larger your portfolio, the lower the percentage will be. (Very large portfolios may have an even lower than 0.25 percent management fee.) After the initial financial planning fee, many CFP® advisors will include routine financial planning updates in the portfolio management fee.

You can get more information about Behavioral Finance, Diversification and Evaluation of Cost by reading *Wise Investing Made Simple* by **Larry Swedroe** or the latest edition of *A Random Walk Down Wall Street* by **Burton Malkiel**. Both are easy reads and would be excellent starter books.

In summary, knowing yourself, diversifying and watching investment cost can greatly improve most dentists' long-term investment success. ■

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