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Article: Aligning Beliefs With Investment Strategy

(by Jerry Verseput, CFP®)

Although discussing investment strategy is a little like discussing religion, I thoroughly enjoy an honest debate on different investment strategies. One thing I've noticed, however, is that many people do not first examine their own beliefs about market behavior and investment philosophy before developing an investment strategy, which can lead to inconsistencies between beliefs and behavior.

Here are questions that should be wrestled with and resolved before developing an investment strategy.

> ***Belief #1: Which is more important: meeting financial goals or beating a benchmark?*** Although investors may say that meeting financial goals is more important, relative performance is usually the reason people change strategies or advisors. People seem to feel a lot of angst when others are making money and they are missing out.
> ***Belief #2: Will the market always come back?*** A buy-and-hold philosophy is based on the idea that any amount of loss will eventually be recovered because the market always comes back eventually. This has held true in the U.S. market over the last 100 years or so, although secular bear markets and sideways markets can last an awfully long time.
> ***Belief #3: Does history repeat itself?*** The average return for stocks is often looked at over long periods. Often, these timeframes go back 50 years, or 100 years, or since 1929, etc. When using an average return for stocks, there is an underlying assumption that past performance does indeed reflect, or at least give clues to, future performance.
> ***Belief #4: Is the market efficient, or are under-valued stocks possible?*** An efficient market means that everything that can be known about a company is instantly reflected in its stock price, which also means there is no such thing as an under-valued stock. Spending effort looking for under-valued stocks assumes that markets are inefficient.
> ***Belief #5: Is diversification important, and if so, diversification between what?*** An individual stock investor may view diversification as meaning owning stocks from different sectors (Technology, Healthcare, Energy, etc). A mutual fund investor may view diversification as owning funds across various asset classes (large cap/small cap, U.S./foreign, growth/value). In order for diversification to be effective, investments must have some degree of non-correlation.
> ***Belief #6: Is the market truly random?*** Burton Malkiel (auther of "A Random Walk Down Wall Street") made this question famous by claiming that "a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts." If you believe this, it should have a profound impact on investment choices.
> ***Belief #7: Is it possible to time the market?*** This is the grand-daddy question of them all, and encompasses many of the previously stated questions.

What do inconsistencies look like? I often have conversations with people who are adamant that markets are efficient, but invest in value-oriented mutual funds. Or others who swear you can't time the market, but have either increased (or decreased) their cash position because of current market conditions, or pay relatively high annual expenses for an active mutual fund manager to buy and sell stocks at the right time.

Here is a rundown of my own beliefs and the actions that these beliefs lead to:

1) Financial goals are more important than beating a benchmark. This means I'm willing to risk "missing out on a surprise up day" when it seems prudent to take some risk off the table.
2) The market is under no obligation to return to or surpass its previous highs within an investor's time horizon. Therefore, it's more important to try to limit losses as opposed to riding out the bumps.
3) History includes a series of market-affecting events (energy crisis, technology bubble, three decades of falling interest rates) that will likely cause the next 30 years to look very different from the last 30 years.

4) Short-term, high frequency trading by large brokerages and hedge funds (flash trading, textual analysis, pairs trading, etc) make it next to impossible to tell what factors have been priced into an individual stock, and these factors may have nothing to do with business fundamentals. Therefore, I prefer index-oriented investments that offer low-cost exposure to the sectors I want, as opposed to hiring a mutual fund manager to do stock picking.
5) Diversification is important, but company size (large cap/small cap) and where a company's headquarters is located (Silicon Valley, Peoria, Dubai) is increasingly irrelevant for diversification. Among equities, it is more important to have exposure across sectors (Energy, Technology, Financials, etc) than to own a small company and a large company within the same sector. If this assumption is true, then it makes sense to control sector exposure directly instead of owning several managed mutual funds that all may favor the same sector(s) at the same time. I like to maintain this control using sector-based ETFs and keeping them relatively equally weighted.
6) Burton Malkiel recently said that he still believes the market is random, *except for the phenomenon of trend*. I believe that the most money is made during strong uptrends (bull markets), and that strong downtrends (bear markets) can be devastating to financial goals. Therefore, it makes sense to try to discern signs of a downtrend and avoid as much of the loss as possible, and to be ready to reinvest at the first confirmation of an uptrend.
7) As can be seen from my prior belief statements, I believe it is possible to time the market, provided that buy and sell decisions are not based on emotion. Almost everyone has an emotional limit on the amount of loss they can accept. When investors reach this emotional limit and exit the market, then the decision to get back in is typically made when they feel better, which almost by definition means the market must be higher (sell low, buy high). Although this is the kind of data that is often used to argue against market timing, it is completely irrelevant when evaluating a strategy that uses objective criteria to avoid major losses.

I state all of these as "beliefs" (as opposed to facts) because I recognize that 10 investors or advisors can look at the same information and come up with 11 different conclusions. The important thing is to at least examine your investment beliefs, and then make sure your investment behavior is consistent with those beliefs. If you use an investment advisor, it is critically important to understand the beliefs that drive his or her decisions, and that they are compatible with your own.