THE THREE WAYS TO MANAGE MONEY

The first and most important part of the actual investment implementation process is deciding how to manage your assets. Generally, there are only three ways to make investment decisions. The one I prefer for individuals is called Asset Allocation. There are also two other parts of the portfolio implementation process that are commonly used by investment managers. These are called security selection and market timing. Every investment decision uses either one of these three, or a combination, of the three methods.

Asset allocation is investment jargon that means how the money in your portfolio gets divided up between the different asset classes. An asset class distinguishes one type of investment from another. For example, Cash savings in the bank earning interest is very different from real estate. Most investments can be categorized into one of four major asset classes:

1. Stocks – Microsoft, Nestle, GE etc.

2. Bonds – Government Bonds, Corporate Bonds

3. Tangibles (things you can touch) – Real Estate, Gold, Oil, Other commodities etc.

4. Cash – Savings accounts, time deposits, certificates of deposit, money market

Additionally, investment funds / mutual funds usually contain more than one of the above asset classes.

There are dozens of asset classes in the world markets.

Security selection is deciding which asset to purchase, or sell, compared to others of the same type (or within the same asset class). For example, deciding whether to buy a corporate bond or a growth stock would be an asset allocation decision. Deciding whether to buy Cisco or Intel would be a security selection decision because both stocks are in the same asset class (large-cap U.S. growth stocks).

When practicing security selection, most people use articles in the press, company web sites, investing web-sites, suggestions from friends and family, stockbrokers, etc. Professional investors tend to use information from services such as Morningstar and Bloomberg when starting their analysis; if they buy investment funds, they will sometimes talk directly with the investment fund managers.

When screening for mutual funds, investment advisors normally look at several characteristics including performance against peer group, management tenure, fee- structure and comparing underlying investments to the classification of the fund. Funds that are highly ranked in their category, peer group, or asset class tend to remain highly ranked over time. Screening should generally be performed for all of the asset classes except for cash and cash equivalents (e.g. money market).

At this phase, the total return number is one of the key considerations. The risk of each asset class at the individual fund level is not so important because these risks are mostly diversified away during the asset allocation process. In fact, for some asset classes, we want to see funds that are the most risky (highest Beta numbers) in their asset class. Small-cap funds, for example, should have very high Betas – the higher the better. When the markets go up – this asset class should roar ahead much more than an Index such as the S&P 500. When the S&P 500 goes down, it is expected this asset class to go down much more than the S&P 500 too. If the fund behaves in the future like it did in the past, then the gains in the good times should more than make up for the losses in the bad times.

For the more conservative asset classes (e.g., bonds), low Betas are more important. To adjust individual asset class/fund risk for each client's risk tolerance, investment advisors use less of the risky asset classes/funds for conservative investors and more for aggressive investors. They should also use more of the conservative asset classes for conservative investors, and less for aggressive investors. This is what asset allocation is all about - reducing risk through diversification while still getting good long-term returns.

THE OTHER TWO METHODS OF INVESTING

You don't hear about asset allocation in the media very much because it's so boring! What you tend to hear about all the time is stock picking and market timing - both of which is impossible to get right all the time. If someone were to get it right all the time, they would be on the front page of every newspaper every day.

What you hear in the media are just people's guesses, even though they make it seem like they are able to predict the future. Most of the time, people in the news just want to tout the stocks they currently own so people will buy enough of them to make the price will go up, so these geniuses can sell them at a profit. They also are big on touting stocks that their firm's have investment banking relationships with (the investment firm brought the company's stocks and bonds to the marketplace) so they can sell their inventory to the public easier. This is where most of the money is made on Wall Street.

If this doesn't sound right to you, you're right - it's not, and there are a lot of things wrong with the financial markets that will never be fixed because of big money buying influence. The SEC in the US is starting to clamp down on this as you can see by news anchors asking these "geniuses" on air these days if they own the stocks they are recommending or if they have investment banking relationships with their stock picks. On average, a stock will revert to its "normal" level 2 weeks after it is featured in the press.

When it comes to individual stock picking, most empirical studies have shown that common screening practices add little value. There are just too many stocks, too little information available, the information is quickly outdated, there is never enough time or resources to do a thorough analysis, things change significantly on a daily basis, everyone is using essentially the same software and methodologies, and the critical information needed to forecast where the stock may be headed is just not available.

Generally the only people with the pertinent information needed to forecast the critical variables on where a stock may be headed (earnings, growth rates, etc.) are "insiders." Some examples of insiders are the corporate executives, other key employees, their investment bankers, lawyers, accountants, etc. These insiders are prohibited by law, and from corporate policy, from disseminating this information to the public. Most are not even allowed to trade on this information themselves. Because of these problems, the bottom line is that the vast majority of stock pickers lag the market (or their proper benchmark index) over time. In light of this, other than screening mutual funds, the practice of security selection (stock picking) is not appropriate for most individuals (unless they are doing it for fun and with an amount of money they can afford to lose). Security selection and market timing are best left to mutual fund managers because they have the resources to specialize on a single asset class. This is about the only way to get decent results from security selection (and market timing).

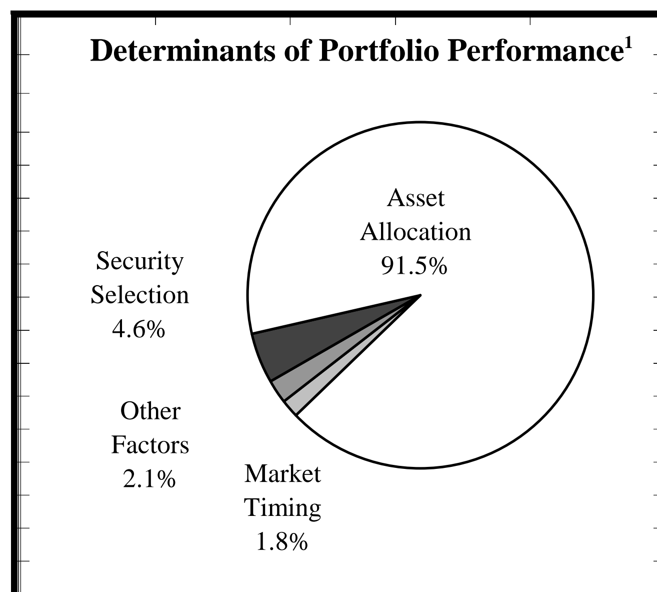
Market timing is seeing where a market or security currently is, and then betting where it may be going, and when. For example, one may have thought the U.S. large-cap growth and technology stock markets were overvalued because of the unprecedented run-up since 1995. Based on this reasoning, one would have avoided this asset class in favor of others. These "overvalued" growth stocks then continued to achieve huge gains. Then when people saw these returns, they thought the trend would never end - which it did around March 2000. Any time an investment decision has a time frame associated with it (this will do this by this time), market timing is being used.

To win at the market timing game, one needs to be correct more than 60% of the time to cover the losses caused by mistakes of the other 40%. It's not 50% - 50% because of the commissions, capital gains taxes in some countries, and other transaction costs associated with trading securities. Also the odds are very much against it because you have to be right in all four trading decisions - what to sell and when to sell it, and what to buy and when to buy it. A mistake in any of these four will usually wipe out the gains in all of the other three.

Because few people have shown a consistent track-record of being correct more than they are incorrect, market timing is also not appropriate for most individuals, especially in the short term. (Unless of course the individual is substituting investing with gambling in which case short-term guesses on individual stocks is more like buying a lottery ticket. There is a place for this and many people enjoy watching stocks move up and down; but it is normally recommended to divide long-term investments from "play" money.)

Because two of these three major determinants of portfolio performance (security selection and market timing) are not appropriate, it is recommended for individuals to focus on asset allocation. A well tuned methodical asset allocation process has, by far, the most impact on determining whether or not your portfolio will help you reach your goals. Once an asset allocation is determined that is right for you, then your selection is refined by using more detailed analysis. The most famous and comprehensive study was done by Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower in 1991. Most other findings drew similar conclusions.

The bottom line is that considering everything (commissions and other transaction costs, taxes, and mistakes), around 90% of long-term portfolio performance is derived from the decisions made regarding asset allocation. (Other studies have suggested the number is closer to 80% but in any case, it is by far the largest determinant of performance.)



[1] Gary Brinson, Brian Singer, & Gilbert Beebower "Determinants of Portfolio Performance: An Update," *Financial Analysts Journal*, June '91

Asset allocation can be looked at as an enormous board game with about 25 buckets that hold money (each of the 25 buckets could contain several sub-buckets too). There are trillions of dollars, (euros, francs, yen etc.) in all of the financial markets, and all of this money is spread between these buckets (about ten to twelve trillion just in U.S. stocks alone at the time of this writing).

The buckets all stay on the board at all times, and over one trillion dollars gets shuffled between buckets on a normal day. For example, if technology stocks go down 10% in a day, it's because more people sold, and wanted to sell, tech stocks than wanted to buy them that day. These sellers got money when they sold, and if they didn't buy any other kinds of investments, this money just went into the cash (money market) bucket. Over the next day or so, this money finds its way into the other buckets. Which buckets they go into is mostly determined by the security selection and market timing decisions of short-term traders.

One of the main points of asset allocation is to have a little bit of just about every major bucket that this cash is likely to go into. This way no matter where the money goes, you're already there. This eliminates the need for market timing, because you're in most every major market all the time. For example, if ten billion worth of tech stocks were sold net in a day, then this ten billion dollars has to go somewhere - cash, bonds, real estate, large-cap value stocks, etc. If you consistently own a little bit of everything, then it's hard to lose a lot of money long-term because it all has to stay on the table in one bucket or another. It's just a question of which bucket it will be shuffled to next, and when.

It's rare for all major asset classes (buckets) to be down at the same time for very long. So when a well allocated portfolio is down, it doesn't stay down for very long. This is because if a lot of markets are down at the same time that means everyone is hiding in cash/money markets. People don't like getting 3%-4% or less, so they're just waiting to pounce and put

this money to work somewhere. When it happens, there is usually a big sudden rally in at least one major asset class. That's why the best time to invest is when everything is down at the same time because everyone thinks the world is going to end, like the first part of 2001 (a little market timing tip!).

By playing the game this way, instead of guessing which bucket will do best in the short-term, you not only eliminate the risk of not being in the right bucket at the right time, but you also don't have to guess where the right bucket will be in the future. If you try to predict where money will move next, more than likely the bucket you took the money from will be the next place it will go, and money is just waiting to leave the bucket you picked.

If you paid capital gains taxes on the sale, you would lose on four fronts (taxes, trading costs, and being wrong with your market timing bet twice). Since nobody knows when, and by how much, money will move to next bucket, it's just best not to guess. Having a balanced mix between most of the buckets, all of the time, is the best way to minimize investment risk, and still get good returns.[2]

During the next class, we will investigate how to

- Determine our risk profile
- Put together a basic asset allocation based on your individual profile
- Choose some securities to fill each asset class
- And cover some of the steps necessary to re-align the portfolio over time.

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[2]Thank you to Mike Fulford of **Tools for Money** for his work and ideas that went into the creation of this article.

Note: This article is meant only to be used as part of an education program. No specific investment advice is intended to be given and it is recommended that you work with your own investment advisor in choosing an investment strategy that makes the most sense for you.