The **Informed** Investor

Five key concepts for financial success

Many people today face difficult choices in achieving their financial goals and, as well they should, they are asking serious questions. Our goal with The Informed Investor is to help you see through the noise of the marketplace in order to make wise decisions about your money.

Because educated investors are the most successful investors, we have created *The Informed Investor* to show you a Nobel Prize-winning approach crafted to optimise your investment portfolio over time. We have designed it specifically to not only support your efforts to preserve what you already have, but also to capture efficiently the market's returns for your investments.

In addition, because we recognise that reaching your financial goals requires more than just good investment management, we have described an approach - comprehensive wealth management - that systematically addresses your entire range of financial issues.

We believe in empowering people to make the best decisions for themselves or, if they wish, to astutely choose a financial adviser who can implement sound wealth management strategies. We believe in sharing our financial knowledge with everyone who wants to make wise decisions about their money.

We are pleased to present *The Informed Investor* to our clients and prospective clients. We sincerely hope that it will provide you with a framework for an intelligent approach to making financial decisions that will help you achieve all your most important dreams.

Taking a comprehensive approach to your financial life

Money means different things to different people.

Each of us has different dreams.

You may want to achieve or maintain financial freedom so that you never have to work again - even if you plan on working the rest of your life. You may want to make a high quality education possible for your children or grandchildren. You may want to provide the seed capital that will give your children or grandchildren a great start in life, whether that's with a home or a business. You may dream of a holiday home on the beach or abroad. Or you may have achieved tremendous success throughout your career and want to leave behind an enduring legacy that will enable your favourite charity to continue its work.

Whatever your dreams are, you need a framework for making wise decisions about your money that will help you achieve all that is important to you. Chances are that you have a wide range of financial goals, as well as diverse financial challenges.

Common sense tells us that such a wide range of issues requires a broad, comprehensive outlook. It's for this reason that most clients want their financial advisers to help them with more than just investments. They want real wealth management - a complete approach to addressing their entire financial lives.

Many financial firms these days say that they offer wealth management. The trouble is that many of these firms just provide investment management and offer a couple of extra services - such as KiwiSaver advice - and call that comprehensive wealth management. The challenge for anyone who wants help addressing all their financial needs is finding an independent firm that provides clear and objective advice to help you achieve your goals.

We define wealth management as a formula:

$$WM = IC + AP + RM$$

Investment consulting (IC) is the astute management of investments, over time, to help achieve financial goals. It requires financial advisers to understand deeply their clients' most important challenges and then design an investment plan that takes into account their time horizons and tolerance for risk, and describing an approach that will maximise the probability of them achieving their goals. It also requires financial advisers to monitor both their clients' portfolios and their financial lives so that they can make adjustments as needed.

Advanced planning (AP) goes beyond investments to look at all the other aspects that are important to your financial life. We break it down into four parts: wealth preservation, wealth enhancement, wealth transfer and philanthropy. In our experience, very few financial advisers offer these services.

Relationship management (RM) is the final element. True wealth managers are focused on building relationships with three groups. The first and most obvious group is their clients. To address their clients' needs effectively, they must foster solid, trusted relationships with them. Second, wealth managers must manage a network of financial professionals - experts they can call in to address specific client needs. Finally, wealth managers must be able to work effectively with their clients' other professional advisers, such as their lawyers and accountants.

Our focus in this resource guide is the first element of wealth management - investment consulting. However, bear in mind that managing your investments is just one part of a comprehensive approach to your financial life. At the end of this guide, we'll describe what you should expect from a true wealth manager so that you can make an informed decision when choosing which financial professional to work with.

Let's turn now to our discussion of the concepts that can make you a more successful investor.

Rising above the noise

Some investment professionals work hard to make investing complicated. They have a vested interest in creating investor confusion.

They use jargon that can intimidate and make it difficult to understand relatively straightforward concepts.

Investing is actually not that complicated. It can be broken down into two major beliefs:

- You believe in the ability to make superior security selections, or you don't
- You believe in the ability to time markets, or you don't

Let's explore these belief systems and where you should be with your own beliefs.

Exhibit 1 classifies people according to how they make investing decisions.

Exhibit 1 - The Investment Decision Matrix

Quadrant one is the *noise quadrant.* It's comprised of investors who believe in both market timing and superior investment selection. They think that they (or their favourite financial guru) can consistently uncover mispriced investments that will deliver market-beating returns. In addition, they believe it's possible to identify the mispricing of entire market segments and predict when they will turn up or down.

The reality is that the vast majority of these methods fail to even match the market, let alone beat it.

Unfortunately, most of the public is in this quadrant because the media - as they try to sell newspapers, magazines and website subscriptions - plays into this thinking. The media's job is getting you to come back to them time and time again.

Quadrant two is the *conventional wisdom quadrant.* It includes most of the financial services industry. Most investment professionals have the experience to know that they can't predict broad market swings with any degree of accuracy. They know that making incorrect predictions usually means losing clients. However, they believe there are thousands of market analysts and portfolio managers with MBAs and high-tech information systems who can find undervalued securities and add value for their clients. Of course, we all want to believe that if you're bright enough and work hard enough, you will be successful. After all, it works in other disciplines.

Unfortunately, as irrational as it seems, in mostly efficient markets this methodology, on average, adds no value. While there are ongoing debates about the efficiency of markets, most economists believe that, fundamentally, markets work well as a means of setting price.

Quadrant three is the *tactical asset allocation quadrant.* Investors in this quadrant somehow believe that, even though individual securities are priced efficiently, they (and only they) can see broad mispricing in entire market sectors. They think they can add value by buying when a market is undervalued, waiting until other investors finally recognise their mistake, and then selling when the market is fairly valued once again.

We believe that it's inconsistent to think that individual securities are priced fairly but that the overall market, which is an aggregate of the fairly priced individual securities, is not. No prudent investors are found in this quadrant.

Quadrant four is the *information quadrant.* This is where most of the academic community resides, along with many institutional investors. Investors in this quadrant dispassionately research what works and then follow a rational course of action based on empirical evidence. Academic studies indicate that investments in the other three quadrants, on average, do no better than the market after fees, transaction costs and taxes. Because of their lower costs and more disciplined approach, passive investments - those in quadrant four - have higher net returns on average than the other types of investments[1].

Our goal is to help investors to make smart decisions about their money so that they are firmly in place in quadrant four. To accomplish this, we help investors move from the noise quadrant to the information quadrant. We believe this is where you should be to maximise the probability of achieving all your financial goals.

[1]Michael C. Jensen, "The performance of mutual funds in the period 1945 – 1964", Journal of Finance, May 1968.

Mark M. Carhart, Jennifer N. Carpenter, Anthony W. Lynch and David K. Musto, "Mutual fund survivorship", unpublished manuscript, 12 September 2000.

Christopher R. Blake, Edwin J. Elton and Martin J. Gruber, "The performance of bond mutual funds", The Journal of Business, 1993:66, 371-403.

Edwin J. Elton, Martin J. Gruber, Sanjiv Das and Matt Hlavka, "Efficiency with costly information: A reinterpretation of evidence from managed portfolios", The Review of Financial Studies, 1993: 6, 1-22

Five key concepts for financial success

While investing can at times seem overwhelming, the academic research can be broken down into what we call the *Five Key Concepts for Financial Success*.

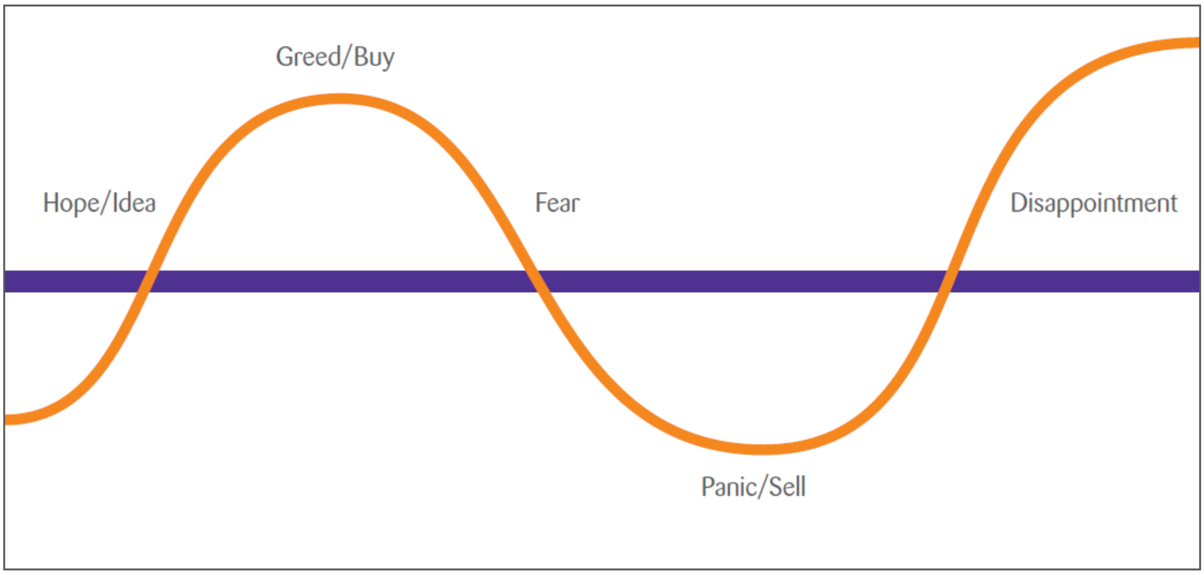
If you examine your life, you'll find that it is often the simple things that consistently work. Successful investing is no different. However, it is easy to have your attention drawn to the wrong things. These wrong things - the noise - can derail your journey.

In this section, we'll walk through these five concepts and explain how successful institutional investors incorporate each into their investment plans. These plans both satisfy their fiduciary responsibilities and achieve their financial goals. You owe yourself and your family nothing less than what institutional investors have.

It's important to note here that, while these concepts are designed to maximise return, no strategy can eliminate risk, which is inherent to all investments. Whenever you invest, you have to accept some risk. It's also important to remember that you're responsible for reviewing risk tolerance and keeping your financial adviser current on any changes in your risk tolerance or life that might affect your investment objectives.

Concept One: Employ diversification to reduce risk

Most people understand the basic concept of diversification: don't put all your eggs in one basket. That's an overly simplistic view of diversification, however. It can also get you caught in a dangerous trap - one into which you may already have fallen.



Source: CEG Worldwide

Exhibit 2 - The emotional curve of investing

For example, many investors believe that they have effectively diversified because they hold a number of different shares. They don't realise that they are in for an emotional rollercoaster ride if these investments share similar risk factors by belonging to the same industry group or asset class. 'Diversification' among a large number of high-tech companies is not diversification at all.

To help you understand the emotions of investing and why most investors systematically make the wrong decisions, let's look for a moment at what happens when you get a hot tip on a share (see **Exhibit 2**).

If you're like most investors, you don't buy the share right away. You've probably had the experience of losing money on an investment and did not enjoy it - so you're not going to race out and buy that share immediately based on a hot tip. You're going to follow it for a while to see how it does. Let's assume, for this example, that it starts trending upward.

You follow it for a while as it rises. What's your emotion? Confidence. You hope that this might be the one investment that helps you make a lot of money. Let's say it continues its upward trend. You start feeling a new emotion as you begin to consider that this just might he 'the one'. What is the new emotion? It's greed. You decide to buy the share that day.

You know what happens next. Of course, soon after you buy it, the share starts to go down, and you feel a new combination of emotions - fear and regret. You're afraid you made a terrible mistake. You promise yourself that if the share just goes back up to where you bought it you will never do it again. You don't want to have to tell your spouse or partner about it. You don't care about making money any more.

Now let's say the share continues to go down. You find yourself with a new emotion. What is it? It's panic. You sell the share. And what happens next? New information comes out and the share races to an all-time high.

We're all poorly wired for investing. Emotions are powerful forces that cause you to do exactly the opposite of what you should do.

Your emotions lead you to buy high and sell low. If you do that over a long period of time, you'll cause serious damage not just to your portfolio but, more importantly, also your financial dreams.

Truly diversified investors - those who invest across a number of different asset classes - can lower their risk without necessarily sacrificing return. Because they recognise that it's impossible to know, with certainty, which asset classes will perform best in the coming years, diversified investors take a balanced approach and stick with it despite volatility in the markets.

Concept Two: Seek lower volatility to enhance returns

If we consider two investment portfolios with the same average (arithmetic) return, the portfolio with less volatility will have a greater compound rate of return.

For example, let's assume you are considering two investment funds. Each of them has had an average rate of return of 10% over five years. How would you determine which fund is better? You would probably expect to have the same ending wealth value.

However, this is true only if the two funds have the same degree of volatility. If one fund is more volatile than the other, the compound returns and ending values will be different. It is a mathematical fact that the one with less volatility will have a higher compound return.

You can see how this works from **Exhibit 3**. Two equal investments can have the same arithmetic rate of return but have very different ending values because of volatility. You should design your portfolio so that it has as little volatility as is necessary to achieve your goals.

	Consistent Investment		Volatile Investment	
	Rate of Return	Ending Value	Rate of Return	Ending Value
Start value		**$100,000**		**$100,000**
Year 1	10%	$110,000	35%	$135,000
Year 2	10%	$121,000	-20%	$108,000
Year 3	10%	$133,100	15%	$124,000
Year 4	10%	$146,410	-30%	$86,940
Year 5	10%	$161,051	50%	$130,410
Arithmetic annual return	10%		10%	
Compound annual return	10%		5.45%	