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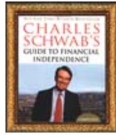
STEP 12 Invest & Relax



"Most of the mutual fund investments I have are index funds, approximately 75%."

- Charles Schwab, Author, Guide to Financial Independence, Random House, Inc.*

"A decade ago, I really did believe that the average investor could do it himself. After all, the flesh was willing, the vehicles were available, and the math wasn't that hard. I was wrong. Having emailed and spoken to thousands of investors over the years, I've come to the sad conclusion that only a tiny minority, at most one percent, are capable of pulling it off. Heck, if Helen Young Hayes, Robert Sanborn, Julian Robertson, and the nation's largest pension funds can't get it right, what chance does John Q. Investor have?"

- William Bernstein, "The Probability of Success,"efficientfrontier.com/ef/103/probable.htm

"So passive investing may not be the most exciting method of investing or the most talked-about method, but it's certainly the most prudent. So keep your investments passive, and save the active behavior for your retirement lifestyle."

- Charles Massimo, *Plan, Diversify and Relax Your Way To a More Profitable Retirement*, www.moldmakingtechnology.com/articles/090405.html

"Most institutional and individual investors will find the best way to own common stock is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals."

- Warren Buffett, 1996 Shareholder Letter

12.1 INTRODUCTION

Step12: Invest, relax and stay balanced.

It is possible to invest and relax without fretting over the ups and downs of the market. This 12-Step Program has explained many advantages of passive indexing over active investing. Investing in this passive approach provides freedom from stress, anguish and the panic of active investing. Remember, indexing is not designed to be a quick fix and does not carry the seductive quality of gambling or day trading. This approach neither has the sizzle the media likes nor does it feed the adrenaline rush of chasing leads or returns. Active investing often leads to lost opportunity. Like most things of value in life, passive investing takes discipline and time to reap the rewards. It is the most intelligent and prudent way to build wealth over the long run. Indexing is a journey, a lifestyle, a process based on a solid academic foundation of empirical research. Look again at this quick review of the 12-Step Program. It substantiates the case for passive indexing by demonstrating the following:

- It is virtually impossible to beat a market over time through active investing.
- Indexing is backed by Nobel laureates who have provided unbiased, rigorous, empirical research, most notably Modern Portfolio Theory.
- Stock pickers are analogous to gamblers who rely on feelings and emotions when making bets.
- Time pickers or market timers move money in and out of different investments in an attempt to profit from short-term

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cyclical events, which is a futile endeavor.

- Manager picking is not a reliable practice because the past performance of money managers does not predict their future performance. Star money managers fall from their stature sooner or later, since their stellar performance is attributed to Lady Luck rather than skill.
- Style drift is detrimental in maintaining an efficient portfolio because it changes the portfolio's risk exposure. This is a problem when risk exposure has carefully been chosen based on an investor's predetermined risk capacity.
- Silent partners in active management diminish an investor's wealth by eating large slices of the investment pie.
- Understanding riskese, the language used to discuss the relationship between risk, return, and time is essential to engaging in the ownership of risk.
- To achieve above average returns, assets must be exposed to above average risk over a long period of time because of the relationship between time, risk, and return.
- Index funds are based on a long history of data dating back to 1926. Knowledge and understanding of this long-term historical data helps investors make intelligent decisions on portfolio asset allocation.
- Each investor has a personal risk capacity, a key component in choosing a portfolio.
- The mixture of indexes in a portfolio or the asset allocation accounts for 100% of the variance of long-term return. Asset allocation is the most important decision an investor can make.
- The most efficient way to invest is to hold a portfolio comprised of global diversified index funds.
- Dimensional Fund Advisors (DFA) offers the highest rated, most efficient and lowest cost institutional funds, now available to individual investors through registered investment advisors.

12.2 Definitions

12.2.1 Registered Investment Advisors

An understanding of the 12-Step Program for Active Investors may lead investors to believe they can do it on their own. They absolutely can if they wish, but working with an investment advisor is still recommended. Taking the steps to gain a knowledge base of what works and what doesn't work in the market is critically important, and every investor owes it to himself to learn this information. Knowing that money managers cannot beat the market over the long run is essential when choosing an investment method. Many investors decide to manage their own investments through the no-load index funds now available on the market through various mutual funds.

Although indexing can be done on one's own, there is a high value to working with a qualified registered investment advisor (RIA). Many RIA's have been registered with the SEC and can provide valuable ongoing advice and education. A study by Dalbar found that active investors who invest on their own are more apt to attempt market timing and less inclined to stay invested in a mutual fund for an average of 2.6 years. This is where an investment advisor can help. A good investment advisor supports the process of indexing, encourages long-term buy and hold and rebalancing strategies, advises prudent investing through the ups and downs of the market, and builds a long-term relationship with the client.

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There are many advisory options available to today's investor. This abundance of resources can be confusing and disconcerting for the average investor, making it difficult to know whom to trust. Many investors seek advice from stockbrokers, insurance sales reps, or commissioned financial planners. These types of advisors are customarily paid to sell products rather than help investors make wise investment decisions. Investors often question whose best interest these advisors have in mind — the investors' or their own? Further, a commissioned based pay structure often sets up a conflict of interest for the investment advisor.

In contrast, a fee-only advisor keeps the best interests of the client in mind, because neither the advisor nor any related party receives compensation that is contingent upon the purchase or sale of any financial products. These advisors provide investors with comprehensive and objective financial advice for a set fee that reflects a percentage of the market value of a managed client portfolio (often 1%). Since the fee is dependent on the size of the portfolio, both the advisor and the client make more money as the portfolio grows.

12.2.2 Dimensional Fund Advisors

DFA now makes their low cost, institutional index funds available to individual investors through approved registered financial advisors. This is a great opportunity for investors because these funds were previously available only to institutional investors. DFA's funds are designed based on the principles of efficient markets, diversification, asset allocation, and the relationship between risk and return. DFA works with many of the top academic financial economists who provide findings and strategies based on empirical research. They also minimize trading costs that adversely impact portfolio performance.

DFA funds provide investors with the following benefits:

- Engineered exposure to risk factors that generate higher expected returns
- Low expenses
- Low taxes, including tax-managed index funds
- Improved trading and engineering, adding value to portfolio construction
- Low turnover rates due to the passive investing approach
- Asset class persistence; no style drift

Index Funds Advisors (IFA) at ifa.com is one of the select RIA's approved to offer DFA funds to individual investors. IFA provides special online services and resources that educate clients on the principles of investing, including a risk capacity survey that matches individual investors with specific portfolios that yield optimal returns. This matching is achieved by carefully measuring an investor's risk capacity and risk exposure. A portfolio simulator and calculator are also provided to compare the risk and returns of all 20 portfolios to alternative investments.

12.2.3 Rebalancing Portfolios

Rebalancing a portfolio is one of the most important factors involved in achieving long-term investment goals. As explained in this 12-Step Program, it is best for an investor to hold a portfolio that matches personal risk capacity, a component that can best be measured through a risk capacity survey. For optimal returns, asset allocation within a portfolio should be based on an investor's capacity for risk. Matching investors

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with portfolios is a critical element to optimal investment performance.

To maintain a portfolio's asset allocation, periodic rebalancing must be done to ensure that the portfolio continues to reflect the level of risk an investor is willing or able to take. After a thorough evaluation of risk capacity, an investor may be directed to an investment allocation of 65% stocks, 35% fixed income. After a year of bull market conditions, the stock's allocation value rises to 75% with fixed-income at 25%.

This shift in asset allocation is to be expected, as asset class values change and grow at different rates. Rebalancing back to the initial allocation keeps the portfolio in balance for consistent risk exposure. In this example, the allocation would balance back to 65% stocks, 35% fixed income. Rebalancing in this particular case would entail selling some stock and buying more fixed income. The purchase of fixed income could also be accomplished by using the proceeds of the stocks sold, which may result in capital gains taxes or using additional cash on hand to invest.

Selling stocks that are performing well and buying more of the asset classes that are performing poorly is often difficult for investors, as it seems to contradict common sense. This resistance to rebalancing often leads investors to either do nothing or to sell the perceived losers and buy more of the winners, going completely against the prudent principle of rebalancing. Rebalancing often involves buying low and selling high. Many investors make the costly mistake of doing the opposite, buying high and selling low, resulting in lower returns in the long run.

In the face of a fluctuating market, it is important to maintain a portfolio's target asset allocation in order to control two important factors discussed throughout the 12-Step Program. These two factors are risk and return. Without rebalancing, portfolios will tend to become over weighted with some indexes, creating a change in risk. Rebalancing allows investors to take advantage of favorable time periods for each asset class, resulting in a steadier, less volatile performance.

A portfolio that becomes more or less risky due to lack of rebalancing also leads to less optimal returns, defeating the purpose of investing in a risk appropriate portfolio in the first place.

There are certain times when it is wise to consider changing a portfolio's target asset allocation because of a change in an investor's capacity for risk. These times include:

a. when investment goals change
b. when income level significantly changes
c. when number of dependents changes
d. at retirement
e. when life conditions change - medical emergencies, etc
f. when short-term vs. long-term expenses change

12.2.4 Rebalancing Formula

The logic behind rebalancing is that it maintains a consistent level of risk exposure. There are several rebalancing formulas that are used in the investment industry. Although rebalancing is necessary to maintain an optimal portfolio, it can incur transaction fees and expenses.

Rebalancing is recommended either, (1) annually, (2) when opportunities for new investments arise or (3) when a portfolio significantly shifts out of balance.

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What is considered a "significant imbalance" depends on what formula is used. One common approach is the 5%/25% variance trigger. This rule states that it is time to rebalance when an asset class either, (a) moves an absolute 5% or (b) 25% from its original allocation percentage, whichever comes first.

Rebalancing among several taxable and tax-deferred accounts is a very complicated process. A highly sophisticated spreadsheet is required with many factors to be considered, such as the need for liquidity versus the need for reduced volatility. This information has a significant impact on tax liabilities generated by the placement of indexes in different accounts. Rebalancing is required each time assets are added or subtracted from the overall portfolio.

A good rule of thumb is to test a portfolio quarterly and rebalance when necessary, generally on an annual basis. In addition, an investor's risk capacity should be measured annually or when a significant life event occurs, such as a loss of a job, purchase of a home, marriage or divorce.

12.3 PROBLEMS

12.3.1 Active Investors Procrastinate

It is often said that investors procrastinate when it comes to changing their investments. Once a prudent strategy has been identified, investors need to take action and move their investments to the new strategy that meets the four acid tests of expected risk, expected return, expenses, and taxes.

12.3.2 Active Investors "Go It Alone"

A second problem is that investors get in their own way of success. As the legendary investor Benjamin Graham stated, "The investor's chief problem, and even his worst enemy, is likely to be himself." An investor may want to consider the fees paid to an index fund advisor as a casualty insurance premium, insuring the investor against himself.

12.3.3 The Media Wants Investors to Worry

The media has a propensity to alarm investors with hyped messages of gloom and doom and make people feel they need to rely on financial news shows and investment gurus for minute-to-minute updated information on the stock market. It benefits the media to have investors hooked on financial and economic news stories and articles.

This 12-Step Program teaches investors that index funds investing does not require constant vigilance, following daily returns or listening to today's star money managers. Readers have learned that prudent investing means not worrying about the ups and downs of the market. It means being able to invest and relax.

Invest in Index Mutual Funds

The primary reason to invest in index funds is that in the long run, an indexer will achieve greater risk-adjusted portfolio performance with less stress than active investors. This 12-Step Program has demonstrated how and why indexers outperform the average active investor after fees and taxes. The following reasons provide a review of the benefits of indexing.

Asset Allocation

Research has shown that asset class allocation is the most important factor in determining a

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portfolio's expected return level. In fact, asset allocation is 100% responsible for the variance in investment performance. Since an index fund is invested solely in the securities or fixed income positions that comprise a discrete asset class, it possesses the same rules of ownership, characteristics, and expected performance of the comparable index.

Indexing makes it easier to rebalance and maintain a consistent asset allocation over time, rather than participate in the style drift of active management. An actively managed fund generally does not stay invested in the same asset class, so it cannot reliably capture the performance of any particular asset class. Active managers often buy and sell their fund's securities due to the pressure to outperform the market, which results in high trading costs and the adverse effects of style drift.

Minimization of Investment Costs

Index funds have minimal investment costs. They do not have the high annual operating expenses of active funds. These consist mainly of investment advisory fees that compensate an active fund for its manager's efforts at stock picking and 12b-1 fees that reimburse it for its sales and marketing costs. Index funds also do not have the high trading costs characteristic of many active funds. Most of these costs are due to the efforts of active fund managers to implement their stock picking ideas to beat the market. Finally, very few index funds charge commission loads, while most active funds carry some type of load.

The investment costs associated with active funds have generally increased over the last decade, while those of index funds have decreased steadily. Although there is always the possibility that this gap will narrow in the future, all evidence indicates just the opposite. The investment advantages of low costs do not depend on Lady Luck.

Minimization of Taxes

By maintaining low portfolio turnover, index funds minimize realized capital gains, which keep capital gains taxes low. Minimization of capital gains taxes results in a comparatively small difference between an index fund's pre-tax and after-tax performance. This makes an index fund a tax efficient investment. In fact, investing in index funds, especially tax-managed index funds, results in such low taxation that it is almost like putting your entire portfolio into an IRA. The best way for a taxable-basis investor to minimize taxes and thus more efficiently compound investment wealth is to assemble a portfolio of index funds and keep it for life.

Managers of active mutual funds typically manage money as if taxes don't matter. However, as a number of studies have shown taxes do matter. They actually have an enormous negative impact on investment performance. Investors who ignore this and invest in active funds are relinquishing money to Uncle Sam that could otherwise be available to compound into future wealth.

Reliable Investment Performance

An investor who holds a portfolio of index funds is assured of the reliable investment performance of free and efficient financial markets. An index fund invested in an asset class will always earn the returns of that asset class. Thus, indexing is an investment strategy that delivers what it promises to investors.

In comparison, the returns of active funds are erratic and less reliable than index funds, some-

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times outperforming the market and sometimes underperforming it. These variations in performance are caused by the market's unpredictability. They can also result from style drift, when the fund manager modifies the fund's asset class mix.

Both U.S. and international financial markets are becoming more efficient, which indicates that investors and money managers who engage in stock picking and time picking must take greater and greater risks to beat the market. The more educated investors can gain from the efficiency of markets, the more that active money managers need to defend their investment strategies to try to beat the market.

A Simple and Understandable Investment Strategy

Because indexers recognize they cannot beat the market, they focus on building wealth over the long run by holding efficient, globally diversified portfolios. Passive investors stay with their investments and rebalance only when necessary in comparison to active investors who constantly seek ways to beat the market, spending a lot of valuable time reading investment newsletters, reports, magazines, and other media-driven publications.

An Easier Way to Track Investment Performance

Tracking the performance of index fund portfolios against their respective benchmarks is simple, since the return earned by an index fund reflects the return of the comparable index. On the other hand, the performance of active funds is more difficult to track against benchmarks. Although many funds are compared to the S&P 500, it is not an accurate comparison.

Increased Leverage and Compounding of Investment Wealth

Indexers can leverage their funds and thus more efficiently compound investment wealth. Since index funds carry no cash reserves, indexers are invested 100% in the market at all times. Indexers are also better able to leverage their funds because they can hang onto the money invested that an active investor would need to pay the commissions and high annual expenses and taxes associated with active mutual funds. Seemingly small amounts of money continually compounds through the years and helps to accelerate the accumulation of wealth for indexers.

Invest like Institutional Investors

Large institutional investors such as corporate pension plans and educational endowment funds that invest billions of dollars, can certainly afford to hire any money manager in the world. Yet, they continue to index a significant portion of their investments. Individual investors can follow the example of these institutions and reap the same benefits by investing in DFA funds.

12.4 Solutions

The 12-Step Program explained in this book has been written for investors who are engaged in any active investing practices, including stock picking, time picking, manager picking or style picking. The intention is to transform the active investors of yesterday into indexers of today through education and motivation.

This program has provided research and education about the advantages of indexing over active investing. The information that has been presented shows clearly why index funds are best for achieving investors' goals.

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12.5 Summary

With index funds, the stress and pressure of investing melts away, allowing the investor to receive the market returns of a diversified portfolio that is matched to risk capacity, all at a very low cost. Stepping off the emotional roller coaster of active investing, a recovering or reformed active investor experiences a new peace of mind. Instead of panicking, an indexer can calmly invest without fear or tension.

Just like with the original 12-step program, the first step is to admit you're powerless and your life has become unmanageable. In this case, the admission of powerlessness is over the market. By surrendering to the program, a walk through the 12 steps leads investors to the light of intelligent risk management and a realization that active investing is a losing game. When investors reach this pinnacle of investing insight, they are well on their way to entering what we like to call "Tradeless Nirvana" (see page 242).

Congratulations on completing the 12-Step Program! It's now time to take action, so you can invest and relax.

12.6 Review Questions

1. Which is not a fundamental principle of prudent investing?

   a. stock picking
   b. the need to build efficient portfolios
   c. the importance of long-term investments
   d. passive investing with index funds
   e. diversification of assets and time.

2. Why should a portfolio be rebalanced?

   a. to keep risk exposure matched with risk capacity
   b. market changes may change the balance of the portfolio
   c an investor's financial situation or investment goals may change
   d. because all the day traders think it's a good idea
   e. a, b, and c

3. The most efficient way to invest is:

   a. pick your 5-10 favorite stocks and trade on these as frequently as possible
   b. buy the stocks that have performed the best over the last six months
   c. join an investment club
   d. invest in a globally diversified portfolio of index funds and invest for the long run
   e. invest only in Treasury bills and Certificates of Deposit

4. As opposed to relaxing, active investors:

   a. monitor the financial media
   b. worry about market declines
   c. search for the next market gain
   d. search for the next hot stock
   e. all of the above

5. By maintaining low portfolio turnover, index funds:

   a. maximize realized capital gains
   b. keep capital gains low
   c. minimize realized capital gains
   d. miss out on "hot" stocks
   e. both b and c

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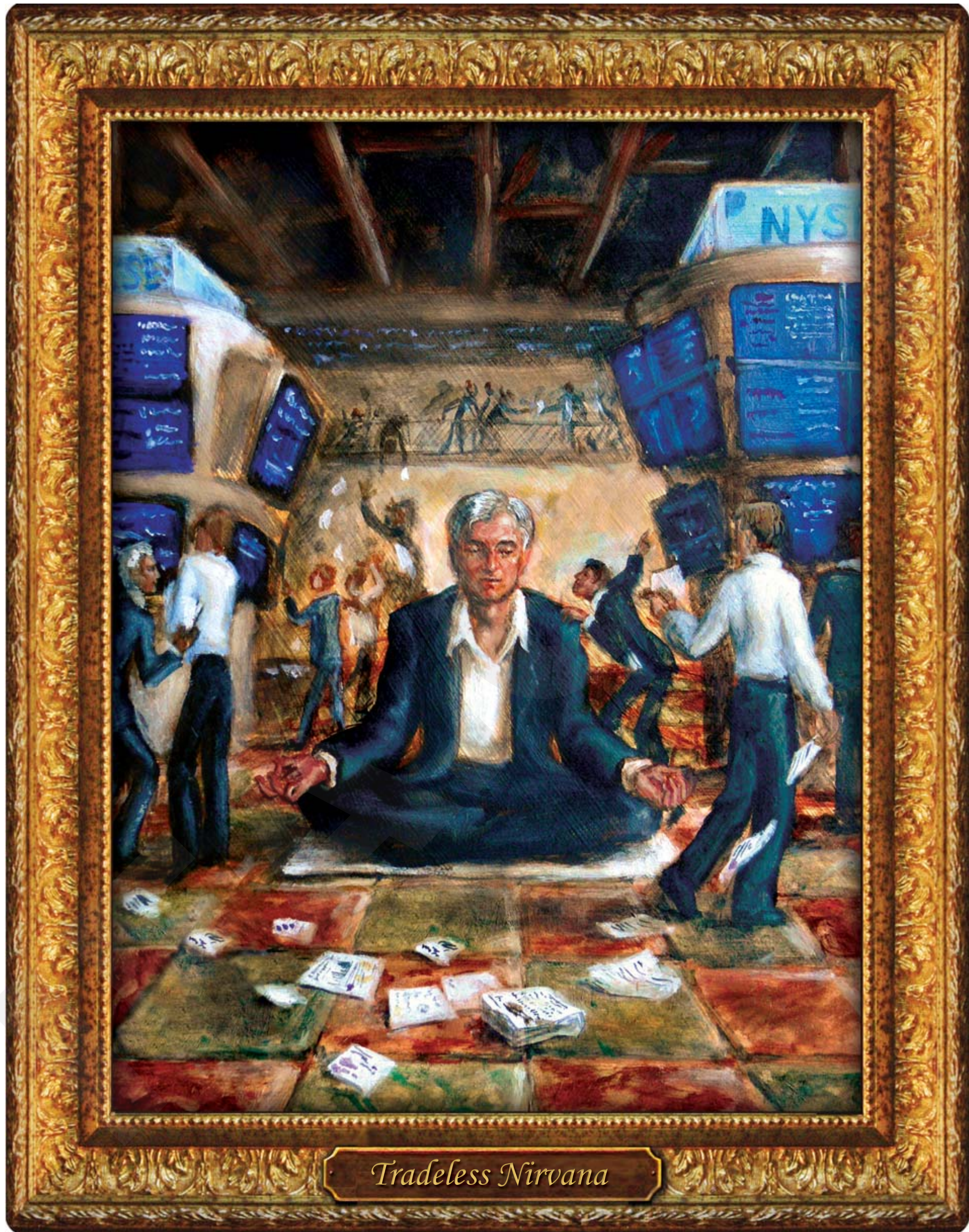

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