Performance Matters

7 Steps Toward More Effective Investing

BURNEY WEALTH MANAGEMENT

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Introduction:

Why I Wrote This

Few of my parent's generation invested in stocks. Most worked for companies that provided pensions and socked their savings away in banks. During my generation pensions were replaced by 401(k) plans and overnight, regular people had to become effective investors. As expected, many failed and now those "thrown into the deep end" souls are retiring with inadequate resources. The purpose of this book is to address that.

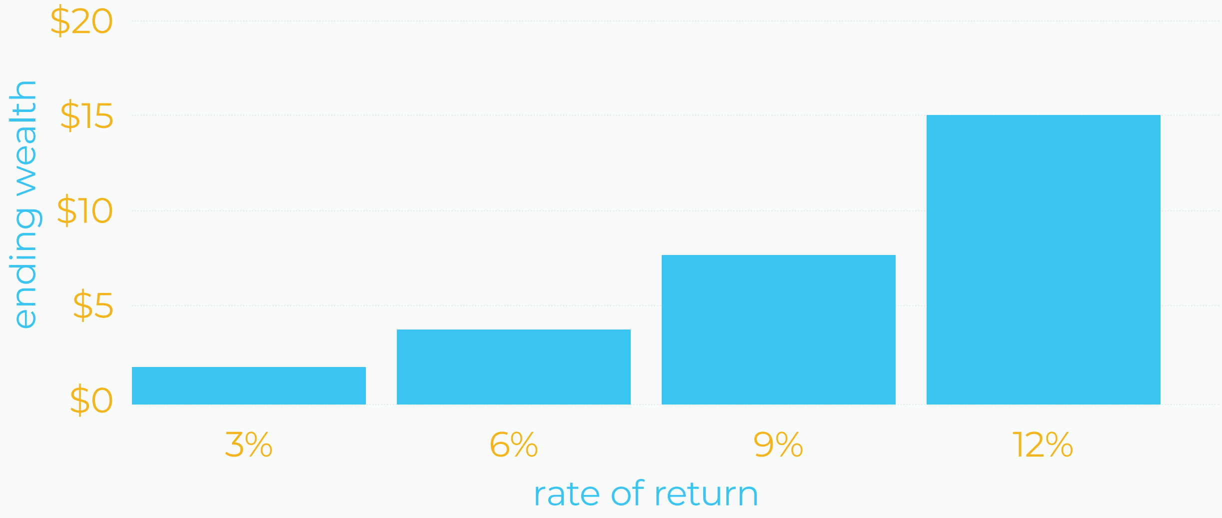
Lowell D. Pratt, CFA
President
Burney Company

1. Compounding - "Mankind's Greatest Invention"

Attributed to Albert Einstein, but evidently not actually his quote. Doesn't mean it's not a brilliant concept! Most investors don't appreciate how impactful seemingly small differences in return can be. Returns of 3%, 6%, 9% and 12% were available once upon a time to investors who invested in CDs, Bonds, a Stock/Bond mix and Stocks respectively. For each additional 3% points of return over 25 years, ending wealth effectively doubles, or said another way, earning 3% less each year over 25 years halves ending wealth.

$1 grows to $2.03 in 25 years at 3%. At 6%, $1 grows to $4.05, $7.91 at 9% and $15.18 at 12%. So, what do you want in 25 years, $2.03, $4.05, $7.91 or $15.18? From the $15.18 potential, many investors choose to halve their ending wealth by mixing Stocks and Bonds. Some choose to halve it again by investing in just Bonds and many more halve it yet again. Mysterious...

In 25 years, $1 grows to...



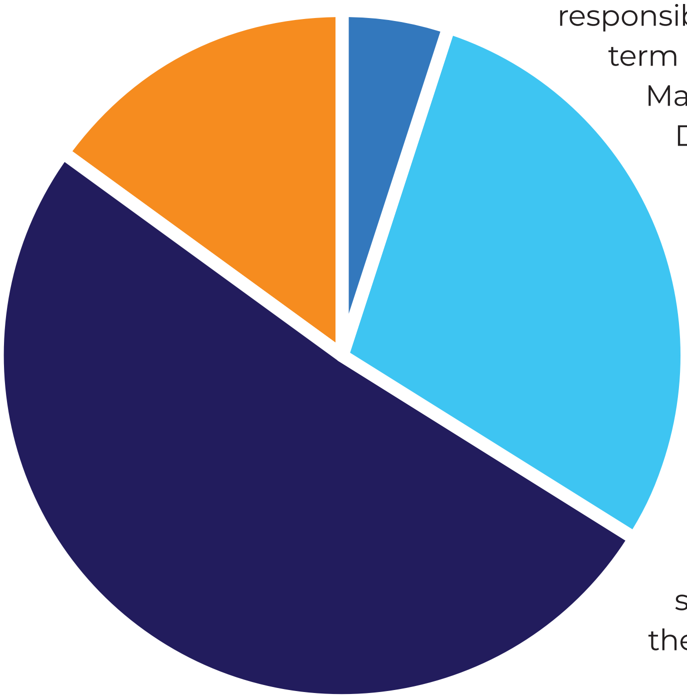
$15.18 can be achieved with 12% returns over 25 years.

2. Matching Beats Diworsification

When I started my career, Peter Lynch was the great professional investor of the day. His spectacular performance at the helm of Fidelity's Magellan mutual fund was legendary (and almost as good as our founder Jack Burney's return for the same period). He wrote a couple books when he retired and coined the term "Diworsification" which basically made the previously mentioned compounding case. Why take a perfectly good portfolio of stocks and ruin it by adding bonds or some other lower returning asset?

Lynch's argument was basically that stock markets periodically have panics, but in short order bounce back and move onto ever higher levels. Unless an investor needs to pull funds during a panic, or chooses to do so (covered below), these pullbacks are just noise that savvy investors can elect to ignore. Investors who do this create the $15.18 end result and everyone else "Diworsifies" their return to something less.

When I studied Finance at VA Tech, Corporate Finance and Investments were separate courses. In the latter, we learned things like the Efficient Market Hypothesis and the importance of portfolio diversification. However, in the former we learned about Matching. Short-term debts/responsibilities should be covered by matching short-term investments and long-term debts/responsibilities should be matched to long-term investments. Lynch argued that the Matching principle was better than Diworsification.



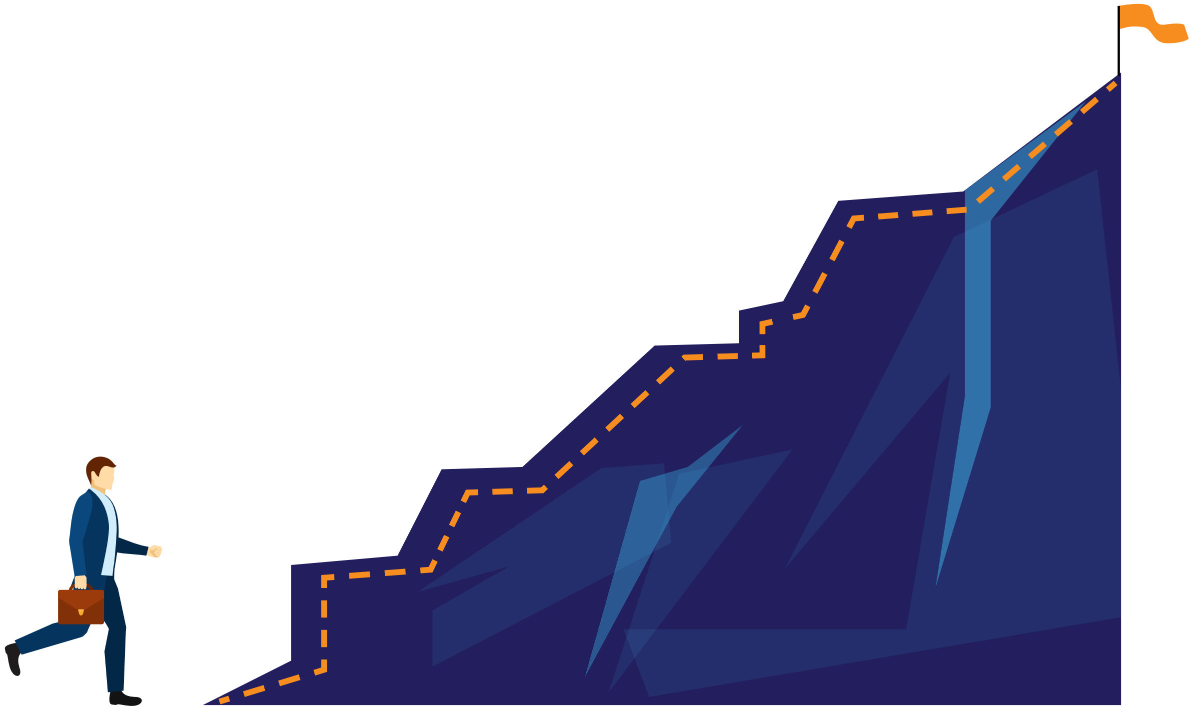
Lynch wrote an entire book on this subject, but in a nutshell this is his argument: Mid-career professionals investing for retirement or retirees building legacies for their children and grandchildren both have long-term horizons. Stocks are their best matching investment. Unconventional, but the choice made by most of the clients I've spent decades working with, hence their earning the $15.18 end result.

3. Embrace Volatility

Stocks are volatile, bonds are more stable, so which is better? Knee-jerk answer is of course that since volatility is obviously bad, bonds are better, but what if volatility is actually good?

Aswath Damodaran is recognized as today's valuation guru, so if interested in more depth, read his work. For now, accept that riskier (defined as more volatile in the short run) assets are priced to produce greater return via the mechanism of Discounting. Discount models use forecasted future expected cash flows (dividends or income) to calculate the value today of those cash flows. $1.10 a year from now is worth $1 today if the discount rate is 10%. If the discount rate is 20%, it's worth less than $1 today and if 5% it's worth more. The fact that stocks are riskier (more short-term volatile) than bonds means it receives a larger discount rate, and that translates to higher return. Since higher return is better than a lower return, in this regard stock volatility is actually good.

And oh by the way, stocks are not actually more volatile than bonds! Stocks are of course in the short run, and are also in the mid run, but it's not the case in the long run. As periods increase from daily, to monthly, to annually, to 5- or 10-year or longer, volatility differences between Stocks and Bonds diminish and eventually disappear. 10-years and longer is the point where this occurs, so every investor with a 10-year plus time horizon can view volatility per the Matching principle as being roughly equivalent. Those who buy this argument capture their $15.18 opportunity without incurring additional risk, since the time horizon matching volatility is equivalent.



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4. Don't Chase Size and Style

In the 1980s, Nobel laureate Bill Sharpe solved an important finance riddle. According to the Efficient Market Hypothesis, all publicly available information about a stock is incorporated in the price of a stock. As a result, stock-picking is wasted effort and every investor should instead focus on diversification to hit the Efficient Frontier (a point of maximum return for a given level of risk). Said another way, for any given level of risk, every professional investor should capture the same return for a given period.

Every MBA program taught this, and many of those students went on to become professional portfolio managers, yet they routinely created vastly different period returns. How could that be? Some argued the foundation of everything taught was flawed. Sharpe proved that wasn't the case, but rather that two critically important variables were missing from the equation - Size and Style. By including those two variables, Sharpe proved the stock market was highly efficient.

In any given year, there can be double-digit differences in return between Large-Cap and Small-Cap stocks or between Value and Growth stocks or both at the same time. In fact, the market has extended, usually multi-year phases persistently favoring one end of the market or another. Fundamentally driven mean-reversion causes these phases to eventually end which typically triggers an opposite phase to begin. This is the stock market's Size and Style Cycles.

The Size and Style Cycles are the market's most dangerous dynamics. Why? Because investors (especially individuals) habitually chase past excess returns. When Growth stocks are outperforming, investors rotate toward Growth oblivious to the fact the market will soon rotate and favor Value. Repeating this over and over again through time with both Size and Style is a main explanation for how individual investors collectively capture only about half the market's available return.

5. Market Timing - The Great Return Destroyer

Timing the stock market by selling out to avoid downdrafts and buying back in to capture upside is the most appealing and intuitive of all strategies. It also consistently fails. As my son Andy says (head of investments now in our shop), to make this work you must be right twice. Once to get out in time and then again to get back in. No one does this well enough over time to equal the return of buy and hold.

Too quick on the trigger and you're constantly going to cash after every little market blip. Normal market gyrations grind this approach up quickly. Wait too long and much of the damage is already done, as major selloffs occur rapidly and unexpectedly. These investors may feel good for a short time should the market continue to decline, but then the market recovers just as rapidly and unexpectedly. Getting back in soon enough almost never occurs. In fact, most selling occurs near the bottom at the end of a sell off (called the final capitulation) and most of those investors don't return until stocks have fully recovered.

In the end, they typically lock in a 20-30% loss (sometimes worse). I've worked with many different kinds of investors over the years. Market Timers are the only ones I can't help.

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6. Alternatives Can Make A Difference

Not every non-equity investment has lower expected return than stocks and some non-equity investments are better diversifiers than others.

Today, the Privates (Equity, Credit, Real Estate) all have attractive expected returns despite their high fees and are good diversifiers via a trick they get to employ. They value their investments based on recent arms-length transactions in their respective markets. These transactions don't have sudden, radical changes in valuations like the stock market. As a result, Privates act as portfolio stabilizers.

The Privates' Public counterparts (Stock, Bonds, REITS) can be good diversifiers in normal markets, but during selloffs their diversifying benefit often breaks down. To be a good diversifier, an asset class needs to have a low (or better negative) correlation. In panics, many asset class correlations move toward 1.0 with stocks, meaning they provide little to no diversification benefit when it's needed most. Managed Futures are the great exception as they often perform best during selloffs.

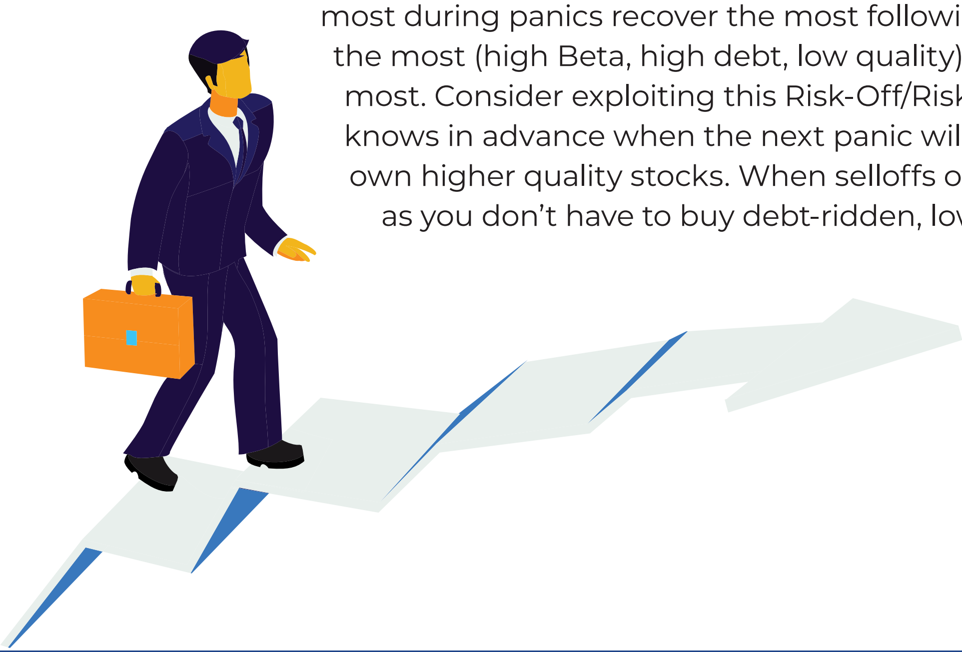
7. Panics Can Be Opportunities

Stock market sell-offs occur with regularity in response to an endless variety of news and events. Frequently, they are short-lived and quickly forgotten (except by those who sold in response). Oftentimes they'll morph into deeper and more protracted downdrafts and some of those turn into outright panics. VIX is known as the Investor Fear Gauge. A quiet VIX reading is below 20, at 30 the market is unsettled, above 40 it's in a panic.

On October 19, 1987, the Black Monday panic occurred. The trigger was program trading (new then) that destabilized the stock market by flooding it with computer-driven sell orders the Friday before. Monday morning, everybody (human and otherwise) massively sold. The sky was falling and the world as we knew it was ending. VIX hit 160! Late that morning, my boss Ted Rosenberg called a meeting to organize our response. I was a trader then and along with the buying and selling Ted wanted done in client portfolios, his last order as I walked out of his office was to place his personal accounts in 20% margin. I was incredulous and asked him to repeat the order. He did so and brusquely told me to just do it as he returned to his most important job of the day—talking clients off their ledges.

By the end of the year, stocks had fully recovered and Ted made around 50% on the stocks bought that day. One guess what Ted did the next market panic, and the next and all the ones after that. Ted lived Warren Buffett's, "Be fearful when others are greedy and greedy when others are fearful." Each time he let his margin diminish to zero with normal selling over time so he had fresh powder for the next opportunity. And the next opportunity always comes.

There's another opportunity during panics to consider. Stocks that sell off the most during panics recover the most following a panic. Riskier stocks sell off the most (high Beta, high debt, low quality) and subsequently recover the most. Consider exploiting this Risk-Off/Risk-On pattern. Since one never knows in advance when the next panic will occur, during normal periods own higher quality stocks. When selloffs occur, rotate selectively Risk-On, as you don't have to buy debt-ridden, low quality stocks to capture the recovery's excess return. Solid quality but higher Beta stocks will do the job nicely. The excess relative return potential during recoveries is an order of magnitude greater than during normal times, so you'll be well rewarded.



Conclusion: Remember the Seven

Effective investing can be complicated, but it doesn't have to be. When you're looking to try a different, more effective investment strategy, remember the seven:

1. Compounding - "Mankind's Greatest Invention"
2. Matching Beats Diworsification
3. Embrace Volatility
4. Don't Chase Size and Style
5. Market Timing - The Great Return Destroyer
6. Alternatives Can Make A Difference
7. Panics Can Be Opportunities.

Epilogue:

In the text of this book, I mention my two dear friends and mentors: Jack Burney and Ted Rosenberg. They were both extraordinary men who shaped The Burney Company, and me, during the decades they spent here in their second careers.

Their first careers were as military officers—they each retired with 30 years of service (Jack was a brigadier general leading armored cavalry troops; Ted was a full colonel in logistics). As a former Army reservist myself, I respected and admired their leadership. They instilled in us what we refer to as a “West Point” culture, common in the military, but often lacking in the business world. West Point culture is a combination of integrity, service and work ethic. More than anything else, this culture explains our firm’s success and longevity.

They were also genuinely interesting people who we all enjoyed working for (and later with), and whose company we enjoyed. Jack’s wife, Mary Burney, was an artist and another incredible person we all admired.

She drew the cartoon on this page in the early-to-mid 1980s. In the drawing, Jack is giving Ted a lesson on the use of “leverage” after Jack bounced a check written to Ted. “Hutton” refers to “EF Hutton,” a prominent broker-dealer at the time. The cartoon hangs in one of our conference rooms as a reminder of their influence to this day.

Want to learn more?

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