

SIX STEPS TO THE NINETY-NINTH PERCENTILE OF INVESTMENT SUCCESS

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This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

In this *Brief*, we are temporarily departing from tradition and offering a “guest editorial” by Nick Murray, a prolific writer and respected observer of the wealth management industry. The following excerpt from his February 2006 newsletter is reprinted with his permission, and falls under the category “we couldn’t have said it better ourselves”.

The great truths of successful investing are immutable and timeless — and therefore never spoken about in the mainstream media, from which nearly all Americans get nearly their entire daily economic and market input.

There is, as we have often noted, a sound (if necessarily evil) business reason for this. If the media told the immutable truth, it would end up constantly repeating itself, whereupon people would soon stop reading/watching it, and it would go out of business. It therefore doesn’t cover the truth. It covers the news, and attempts to get people stirred up about the dominant news “event” of any given 24-hour news cycle. (“Is it time to sell Japan? Will oil hit \$100? What six funds went up the most in January?”)

It is therefore the function of an excellent advisor to preach truth to the news. And the greatest of all investing truths is that the primary determinant of real-life returns isn’t investment “performance” but investor behavior — that the critical variable isn’t what your funds do. It’s what you do.

What are the predominant beliefs and behaviors that will cause a client household to achieve better lifetime returns than virtually all of its peers? What values and strategies will, in time, carry that household to the ninety-ninth percentile of real-life returns? ...

My goal was, as nearly as possible, to denominate this talk in strategies which anyone can execute.... Highly successful investing isn’t a no-brainer — far from it — but the parts of the brain involved in ninety-ninth percentile success are very different from what the culture suggests they are.

I fairly quickly got it down to six variables, three of which I call values, and the other three behaviors. This distinction is, I hope, helpful, but it’s certainly not critical. If you just want to see these six characteristics as the six cylinders you know you have to be firing on all the time, you’ll be fine.

The first three variables — the “values” — are as follows:

1.FAITH. This is the first characteristic of all successful long-term investors. It is impossible to invest successfully in a future of which one is fundamentally afraid. Thus, the great enemy of investment success isn’t ignorance, but fear. All human experience goes to teach us faith in the future, and especially faith in the American economy and its markets. The problem arises when media suggests that some economic or market setback is new and different: terrible in an unprecedented way, and therefore a disaster you’d better jump clear of. Oddly, the more inconsequential the disaster (viz. Katrina/Rita), the greater the volume of fear mongering, yet faith in the future is always rewarded in time. The day I was born in 1943, the S&P Index closed at 11.7. As I write, it’s 1270 — which ignores dividends. As I compose this essay, I’m

commanding more computer power than existed in the earth in 1950. These are not mere factoids; I'm counting my beads of faith. I cannot be frightened out of my long-term portfolio, and therefore cannot fail to achieve superior real-life returns.

2. PATIENCE. I'm 62, and my bride will be the same age in another month. We don't smoke. Thus, even if we attain only average joint life expectancy, one of us has 30 years to live. *That's a very long investing time horizon.* We're therefore not much interested in what our portfolio is doing this quarter, this year, or even over the next five years, because we're asking that portfolio to provide security for us in 2016, 2026, and 2036...and perhaps beyond that. (Moreover, we don't want to leave our children and grandchildren wallpaper.) We have a great deal of patience, and again that patience has been extremely well rewarded over time. We're not interested in "what's working now;" but we're vitally concerned with *what's always worked.*

3. DISCIPLINE. The need to pay oneself first — funding your long-term plan before (and, if necessary, instead of) re-modeling the kitchen or grabbing that great deal on a boat — is a discipline. Continuing to fund that plan month in and month out — as opposed to "Maybe we better hold up for a while until this market stops going down" — is a discipline. But without those or similar disciplines, faith and patience — and everything else — are abstractions, as evanescent as New Year's diet resolutions. Discipline is, in that sense, the iron wire upon which all these other beads are strung.

And the three portfolio behaviors which, launched from the platform of the three values above, will carry an investor into the ninety-ninth percentile are:

4. ASSET ALLOCATION. In their landmark study, Brinson et. al. demonstrated (to my complete satisfaction, anyway) that more than 93% of long-term institutional portfolio returns came from which asset class you were in; the other 7% came from selection and timing. But the media, and the culture at large, find no "news" in this. So they stand the truth on its head, and natter about what stocks, sectors and funds are hot, and whether it's time to jump into tech. (The ancient Greeks said Socrates was doing something very much like this, and made him drink hemlock.) Asset allocation is and will always be the dominant variable in portfolio (as opposed to investor) returns. And a huge part of what happens to an investor household over time is driven by its adherence to the dictum *be an owner, not a loaner.*

5. DIVERSIFICATION. Second only to asset allocation, diversification is the next critical portfolio behavior. Getting diversified and staying diversified keeps you from betting the ranch on a fad at a market top, and from hiding out in cash at a bottom. It is the personification, in our world, of Aesop's tortoise: it's slow, it's steady...and it always wins the race. *Diversification is the conscious decision never to be able to make a killing, in return for the priceless blessing of never getting killed.*

6. REBALANCING. Sometimes your portfolio gets lopsidedly exposed to something — usually because that something has gone up spectacularly, and not much else has. The typical American response is to sell out of the "laggards" and chase the dream — kind of like electing to be the hare in Aesop's fable. This is because most Americans are (unconsciously) speculators instead of investors: they chase price trends instead of seeking neglected values. (A speculator not only doesn't know that price and value are inversely related; he will get really mad if you try to tell him.) Rebalancing takes some profits off the line and redeploys them in (relatively) undervalued areas. (Dollar-cost averaging is, in that sense, almost real-time rebalancing.)

Are these values and disciplines really so distinct from each other? Of course not: they're constantly flowing into each other. Where does discipline leave off and diversification begin? I'm sure I don't know, nor care. Heck, diversification *is* discipline...just as it's an expression of patience. Don't worry about it. Just run for election on these six platforms. You and your clients will be happy and successful...in time.

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