DAILY REPORT
AT ISSUE

Those who beat the market in the short term do so because of luck, not skill.

ROBERT C. PORT is an attorney with Cohen, Goldstein, Port & Gottlieb in Atlanta, where he practices business and securities litigation. He can be reached at rport@cgpglaw.com.

Court taught me all about investing

LEARN FROM THE MISTAKES of my past clients in seven easy lessons that will lead you to success

AS PART OF MY litigation practice, I represent investors harmed by the misconduct of their stockbroker, investment advisor or financial planner. Some of these cases can be brought in court; most are required to be arbitrated before the National Association of Securities Dealers, New York Stock Exchange or a similar forum. In either venue, however, many of these cases have common themes that teach important lessons about investing.

Wall Street doesn't have a crystal ball

The financial industry spends millions of dollars convincing the investing public that it can predict the future price movements of stocks. We all know that predicting the future is impossible, but when Wall Street breaks out its technical charts and graphs, and its highly paid analysts discussing P/E ratios, EBIDTA, relative strength, quantitative analysis, momentum plays, valuation, trading strategies, market timing and the like, it sounds as if they have discovered a window on the future. But the reality is that price movements of stocks are unpredictable and random, because stock prices react to news, which by definition is unpredictable and random. The resignation or indictment of a CEO, a product recall, an "earnings disappointment," the failure of a new product to generate significant sales, or an international crisis all will affect stock prices.

These types of events can rarely be anticipated. Therefore, contrary to what Wall Street's very effective marketing would have you believe, those who beat the market in the short term do so because of luck, not skill. Academic research has shown that there is a very low probability—less than 3 percent—that any one broker, money manager or investment newsletter can pick investments that consistently outperform benchmark market averages over 10 years or more. Those odds are about the same as throwing snake eyes at a Vegas craps table. What is the probability that with the money you have to invest today, you can identify the lucky broker, financial advisor or mutual fund that will consistently roll snake eyes and beat the market for the next 10 or 20 years? Very slight.

Lesson learned: Avoid actively managed investments; stock picking and market timing are losers' games.

One size doesn't fit all

When you shop for clothes or shoes, there are a variety of sizes and styles because each of us is physically different and each of us has an individual fashion style (or lack of style). Investing choices should also be tailored to fit you as an individual. Just as a tailor or shoe salesman measures you before determining what clothes or shoes will fit, a conscientious advisor will measure you to determine what types of investments are suitable for you, and how those investments should be allocated in your portfolio to meet your goals and risk tolerance. The advisor should ask about your investing time horizon, liquidity needs, income and savings rate, net worth, tax bracket, and investment experience and knowledge. Most importantly, the advisor needs to understand what level of risk gives you discomfort. Can you tolerate a decline of 20 percent in your portfolio without panicking, or do you need to construct a portfolio that, based on historical data, is likely to fluctuate up or down only 5 percent a year?

As a rule of thumb, more aggressive, risk-tolerant investors should be more heavily weighted in small-capitalization, value equities, while conservative, risk-adverse investors should be more concentrated in bonds and large-capitalization blue-chip securities. An advisor who takes the time to understand your needs and risk tolerance will recommend diversifying and allocating assets among various types of investments to fit your goals and risk profile. Studies show that more than 90 percent of your investment returns depend on how your assets are allo-

cated among different investment classes, while only about 2 percent is due to the specific stocks, bonds and other investments you choose to buy.

Lesson learned: An advisor should spend the time to learn your particular circumstances, and tailor investments to fit your particular risk tolerance profile. Run, don't walk, from any advisor who tries to sell you something without first learning about you and your risk tolerance, who has the same solution for everyone, or who recommends putting all your assets into a single type of investment.

Wage war on fees, expenses and commissions

Over long periods—10 to 20 years—well-diversified portfolios have returned approximately 10 percent a year. Fees, expenses and commissions, imposed year after year, substantially reduce the long-term net investment return. The average expense ratio for actively managed mutual funds is approximately 1.5 percent. Similar or higher charges are assessed in managed accounts or wrap accounts, where the investor is charged a fixed percentage of the portfolio rather than commissions on each trade. Because of the miracle of compounding, even a small difference in expenses charged against your investments can make a significant difference in the long-term investment results.

For example, the final value of an initial $100,000 equity portfolio earning, on average, 9 percent a year for 10 years with 1.25 percent in annual fees and expenses will be $208,754.58. That same portfolio, with identical returns but with 2 percent in annual expenses, will be worth $193,439.85, or $15,323.73 less.

Additional fees, commissions and expenses, by themselves, can make it difficult to beat the market. As we have seen, the probability is that the broker cannot select investments that beat the market, and the probability of market underperformance is necessarily increased when the advisor tries to do so in a fee-laden or commissioned account.

Lesson learned: Keep the fees and expenses charged to your portfolio as low as possible.

Don't chase last year's or last month's winners

Mutual funds, Wall Street firms and financial newsletters love to tout their recent successes. Investors flock to the fund, firm, newsletter or investment category with the highest recent returns. But what happened in the past is a poor predictor of what will occur in the future. One study suggests that only 12 percent of the top-performing investment managers for a particular year will be among the top-performing managers the following year. The same historical reality that applies to stock picking applies to recent market-beating firms and mutual funds—the fund or firm that did well last year is not likely to repeat that success the next year, and highly unlikely to consistently outpace its peers for long periods.

Lesson learned: Don't chase recent winners.

Be leery of investment 'products'

Wall Street loves to sell "investment products." These come in a variety of forms, including limited partnerships, investment trusts, annuities and mortgage-backed securities.

Some of these products cobble together investment and insurance concepts in a single package, to be sold as something that will supposedly cure one or another investment risk or provide a benefit, such as life insurance or a guaranteed return. Often these products pay the highest commissions to brokers and insurance agents. When I see the phrase "investment product," I expect to find an investment with a variety of fees and expenses, and one that often is too complicated for the average investor to understand. These products are suitable for some people, but are often too costly or complicated to be appropriate for most investors.

Lesson learned: Be leery of "investment products." Look carefully at the fees and expenses for such products, and if the investment is very complicated, ask yourself whether you should risk your hard-earned money in something you don't understand.

Make sure your money lasts as long as you do

In retirement, many baby boomers suddenly will have access to significant lump sums of money, accumulated through savings, pensions, IRAs and 401(k)s. There is a temptation to spend those assets freely, without considering that those funds may have to last 20 to 30 years or more. It is critical for the investor to structure retirement investments, and any withdrawals from retirement funds, so as not to outlive the money. As a general rule, holding the withdrawal rate to 4 percent or less, adjusted for inflation, will help ensure there won't be a shortfall. Of course, each investor must consider life expectancy, the composition of the portfolio, any other sources of funds (such as Social Security) and spending habits.

Lesson learned: The higher the withdrawal rate from your retirement assets, the greater the risk you will outlive your money.

Avoid all the noise and invest in index funds

An index fund seeks to ensure that returns meet a specified benchmark by buying representative amounts of each stock in the index, such as the S&P 500 or the Wilshire 5000. Other index funds focus on a particular industry, such as the telecommunications or the health-care sector, or a particular geographic area, such as the leading publicly traded companies of South America or Japan. You can also buy an index bond fund. These funds don't try to beat the market by active trading. Instead, they mirror the market by investing in the securities comprising the benchmark index. As we have seen, only a small percentage of active money managers beat the market over the long term. Thus, an investment that meets the market year after year is, based on historical data, statistically more likely to provide superior long-term returns than active money management that tries to beat the market. Much of the superior performance of index funds is due to their low expenses, which average .25 percent, or about one-fifth of the expenses charged by actively managed mutual funds. Additionally, most index funds necessarily provide diversification (e.g., owning the 500 companies in the S&P 500, or the 5,000 companies in the Wilshire 5000), and are tax-efficient, since there is no active manager trading for short capital gains.

Lesson learned: Allocate most of your investments among a variety of equity and bond index funds, based upon your particular risk tolerance, goals and financial needs. DR