ESSENTIAL IDEAS FOR INVESTORS:

DO NOT PART WITH YOUR MONEY WITHOUT THEM!

This article provides guidelines on how to sensibly manage your savings.

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If you are reading this article, you are likely to be an executive in a large corporation; you are also likely to be well-compensated for your efforts. Because you are well-educated, you know the importance of saving for retirement, although not necessarily how to make good investment decisions. You may let your employer decide for you in which pension funds your money should be allocated, you may be accumulating money in a bank deposit, or you may be delegating all of your investment decisions to an advisor without worrying too much about what he does — all of which are bad ideas. Hence this article.

Consider the ideas we will discuss as a very brief primer on how to sensibly manage your savings. This is not a comprehensive guide to all the factors you should consider and all the actions you should be taking; it is only a good start. This article aims to raise your awareness of several important issues you may not even think about when making investment decisions and will hopefully turn you into a better investor.

Yes, managing your own savings seems like a scary task. Financial markets seem to get increasingly sophisticated — there are thousands of financial products to choose from, pundits are always disagreeing about what the future may bring, and the list goes on. I will not claim in this article that managing your money is trivial. But I will claim that: a few simple ideas can, and should, go a long way and that you should be able to grasp them with little difficulty. On the flip side, to implement these essential ideas, you must be able to suppress the confusing noise generated by the finance industry and fight (and beat!) the emotional investor within, neither of which may be easy.

Several times a year I run (as an open-enrollment program, a course in the
MBA, in the Global Executive MBA, and in some executive-education programs) some 5–10 sessions that aim to give participants a broad and comprehensive guide to sensibly manage their savings. In the first session, I always say a variation of the following: "Over the next n sessions I will say nothing that you will not be able to understand, but I will say many things you will find hard to accept and even harder to implement." That is the first lesson to be learned: Understanding what you have to do is not difficult; implementing it is likely to be.

Trying to manage your savings in a sensible way is, in fact, not too different from trying to stay fit. We all know, more or less, what we have to do in the latter case. Exercise regularly both aerobically and anaerobically, eat plenty of vegetables and fruits, stay away from 500-calorie muffins — you get the picture. We can argue about the details, but stick to common sense advice and you will do just fine. The same goes for investing.

Unfortunately, when trying to get fit, many people ignore the tried and true and fall for "miracle diets." Eat all you want, whenever you want, sit on a couch and watch TV... and lose 10 pounds a week. Right! Most people know that such claims are not true, but they buy the books and give it a try anyway. Why? Because the sales pitch is invariably a good one, and, more importantly, it is far easier to try the "miracle diet" than to exercise regularly and eat properly. In fact, these two reasons go a long way toward explaining the popularity of books that are not worth the paper they are printed on and that are ultimately bad for you. Again, same with investing.

Contrary to what the financial industry and even the conventional wisdom would have you believe, a simple approach to managing your savings can and does work, which is why in this article we will explore a few essential ideas that you should always keep in mind. Obviously, there is not enough space here to go into all of the relevant issues, or deeply into the few we will discuss, but hopefully you will get an idea of some of the factors that really matter.

**Wired the wrong way (I) — Overconfidence**

"The fault, dear Brutus, is not in our stars, but in ourselves." William Shakespeare, *Julius Caesar*, 1623.

We chase performance, we follow the madness of the crowd, we fall for growth stories... and the list goes on. It is sad but true: We are simply not wired to be good investors. A wealth of evidence in the emerging and growing field of behavioral finance clearly establishes the following: 1. Human beings are affected by cognitive biases; 2. These biases have a negative impact on our investment decisions; and 3. It is possible to overcome these limitations and become better investors.

By way of example, consider the issue of overconfidence. Psychologists have long established that in areas such as finance, men are more overconfident than women; behavioral economists, in turn, predict that such a cognitive bias would lead men to trade more often than women, thus lowering their returns. A fascinating study involving almost 38,000 trading accounts shows that men trade 45 percent more than women and, more interestingly, that such overtrading leads men to earn almost 1 percent less per year than women. Single men, who presumably are even more overconfident than married men, earn almost 1.5 percent less per year than single women.

We think we know more than we really know, and the more we act on that wrong belief, the more we decrease our returns through excessive trading. This is, in fact, consistent with a wealth of evidence showing that the returns of investors in mutual funds are lower than the returns of the funds themselves. Morningstar reports on its site both the returns of thousands of funds as well as the returns of the investors in those funds (what Morningstar calls “investor return”). Almost invariably, the latter is lower than the former; that is, in their attempt to buy and sell the funds at the right times, active investors end up lowering their returns substantially relative to those of passive investors.

Thinking that you know more than you really know, and acting on that belief,
is bound to hurt the performance of your portfolio. Even thinking that someone you know knows more than everyone else can hurt the performance of your portfolio just as much. We tend to think that our (or some pundit's) view about the evolution of a currency, or the path of interest rates, or the performance of equities, can help to enhance our returns, but the sad truth is that there is a mountain of evidence that shows otherwise.²

If this sounds hard to believe, there you have it — overconfidence! But in any case, the evidence is overwhelmingly clear: Despite our belief to the contrary, we have no ability to enhance our returns by attempting to foresee the future. I could go on and on with this but I will take a shortcut. This is what John Bogle, the venerable founder of Vanguard, has said about those who believe they can pick the right times to be in and out of the market: 'After nearly 50 years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently.'³ I rest my case.

Wired the wrong way (II) — Other cognitive biases
Overconfidence is not, of course, our only cognitive bias; behavioral economists have identified many others. To illustrate, consider the following scenario. Suppose you plan to play tennis on Saturday, and you can choose between an outdoor court and an adjacent indoor court. The former is free and the latter costs $40 an hour. You would much rather play outdoors, but the weather forecast calls for rain, so you pay a nonrefundable $40 to play one hour indoors. As luck would have it, Saturday turns out to be a beautiful day, and it just so happens that nobody is playing on the outdoor court. Where do you play, indoors or outdoors? (Before you keep reading, think! Where would you really play?)

When asked this question, many people answer that they would play indoors; they think that doing otherwise is like throwing $40 away. They already paid for the court and they cannot get their money back, so they might as well use what they paid for and play indoors. But think about it. The $40 is a sunk cost, an expense incurred that cannot be recovered; hence, the only relevant comparison is where it is more enjoyable to play. The rational decision is to play outdoors, and yet many people would choose to play indoors.

If you are wondering whether this has anything to do with investing, yes it does. How many times have you heard someone saying something like: 'It is not a good time to sell these shares now; I paid $20 a share a year ago, and since they are now trading at $15, I will wait at least until they get back to $20 and then sell?' But think about it. The $20 per share paid is again a sunk cost, an expense incurred that cannot be recovered; it should play no role whatsoever on whether or not the shares are held or sold. And yet many people are reluctant to sell at a loss; that implies facing regret, and we naturally want to avoid regret. Rationality calls for ignoring the price paid for the shares; emotions point in the opposite (and wrong) direction.

Finally, consider the following scenario. Your daughter is graduating next year and you promised a round-the-world trip when she does. You already have the $5,000 the trip will cost and decide to protect that money by depositing it in the bank for one year at 3 percent. At the same time, you buy a new car; you turn in your old one, get the new one, and have to put $5,000 on top, which you decide to pay in 12 monthly installments with a loan from the dealer that has an implicit annual rate of 7 percent.

Obviously, there is something wrong with this picture. Borrowing money at 7 percent and at the same time lending money at 3 percent does not sound like good business. And yet many people do similar things, which behavioral economists refer to as "mental accounting." In other words, many people have separate accounts for different purposes, despite the fact that in many cases consolidation would be beneficial. In our example, it makes sense to use the $5,000 saved for the trip to pay for the new car rather than depositing those funds at 3 percent and at the same time borrow-
ing money at 7 percent. In fact, one of the first things I ask clients who want to review their portfolio with me is whether they have any credit card debt. If they do, the first investment decision should be to pay that debt off; it is difficult to find investments that yield the 20 percent or more that credit card companies charge for financing purchases.

We could go on, but hopefully you get the picture: We are simply not wired to be good investors. For this reason, the growing field of behavioral finance has many lessons for us all. You would be wise to pick up a short book or two so you can learn what your limitations are as an investor and how to overcome them. In these and similar books you will learn what cognitive biases you may suffer from, what the impact is on your investment decisions, and how you can try to overcome them. That is a necessary (although not sufficient) condition for successful investing.

What you can and cannot control

"The list of things that are beyond our understanding and control is nearly endless. While we cannot control the outcome, we can control our strategy. We can try to prepare intelligently for this unknown future." Ben Stein and Phil de Muth, The Little Book of Bulletproof Investing, 2010.

At this point you may be wondering whether you can build a portfolio without trying to foresee how the assets in it are going to perform. Well, not only can you, but you should. First, remember that the evidence showing that we have little ability to forecast the future and enhance our returns is overwhelming; second, notice that whatever the future may bring you cannot control; and third, when investing there are some critical variables that you do control, which are the ones that you should focus on.

Consider first what you do control:
1. how much you save;
2. what you invest in;
3. how long you will remain invested; and
4. how high the fees (and taxes) of your portfolio are.

Consider, on the other hand, what you do not control: just one thing, the return of the assets in which you invest. (True, you do not control the tax rates you face, but you do control how much you expose yourself to those rates.) Should you not focus on the first list rather than on the single-item second list? Should you not focus on a portfolio that performs reasonably well regardless of what the future may bring instead of on one built based on what you think is going to happen next?

For obvious reasons, I will not get into here how much you can or should save. And I will wave my hand on the issue of taxes, which is so critically dependent on the country from which you are reading this. Therefore, I will focus on the other three items on the list of factors you do control — that is, what you invest in, for how long you remain invested, and how high the fees are that you pay. I will do so within a broader list of the things you should focus on and always keep in mind if you want to sensibly manage your savings.

First things first — Your holding period and your asset allocation

When I have a new client who wants to build or review a portfolio with me, I start by asking a few questions. One of my first questions is: “Do you know, from the top of your head, what the breakdown is between equities, bonds, and other assets in your portfolio?” Often people look back at me and their eyes say, “Am I even supposed to know that?” And I look back at them and my eyes say, “You bet you are!”

It is a well-established result in portfolio management that one of the most important investment decisions is your asset allocation, also called the strategic decision — that is, the proportion that each major asset class (stocks, bonds, and other assets) has in your portfolio. Therefore, not only should you know what your asset allocation is, but you should also have a target for it. We have no space here to discuss how to set that target, but remember: You need to build your portfolio from the general (the asset allocation) to the specific (the stocks, bonds, or funds in your portfolio).

In fact, most people do this the other way around. They buy shares in a company they like, then a corporate bond they
read about in the paper, and then add a fund recommended by a colleague, and little by little they build a portfolio that has an asset allocation that is merely the end result of decisions taken without ever looking at the big picture. You should go exactly the other way around: Start by determining the best asset allocation for you and then determine what you are going to buy to implement that particular breakdown between stocks, bonds, and the other assets in your portfolio.

When determining your asset allocation, there are two critical variables to consider: your ability to tolerate losses and your holding period. Of these two, let me highlight one thing about the latter: It is simply not possible to have an appropriate portfolio if you do not consider for how long you intend to hold it. A portfolio that may be perfectly appropriate for the short term may be entirely inappropriate for the long term, and the other way around. Hence you need to know for how long you will (or intend to) remain invested.

That is, by the way, one of those first questions I always ask clients: “For how long do you intend to hold the portfolio?” The more or less standard reply is “I never thought about that.” But you should. Think about your goals, the holding period implied by those goals, and an asset allocation consistent with both — and do it in that order.

One final point: As already mentioned, your asset allocation should also take into account your ability to tolerate losses. Although a deeper discussion of this issue is beyond the scope of this article, here is one thing you should always keep in mind: The higher the return you expect from your portfolio, the higher the short-term losses you should be prepared to bear.

Active versus passive management and fees
So you first need to decide the (goals and) holding period of your portfolio, and then determine an asset allocation appropriate for that holding period. What is next? This brings me to two other questions I typically ask clients on a first meeting: “What is the breakdown between actively managed and passively managed products in your portfolio?” and “What is the annual cost of your portfolio?”

Before we discuss these two factors, I should mention the implicit assumption behind them: All (or most) of your portfolio is invested in funds rather than in individual securities. Most (non-finance) professionals do not have the time or the knowledge to build a globally diversified portfolio of individual securities. For this and many other reasons, you should focus on financial products that provide you with built-in diversification; if you do, then the issues of active/passive management and fees become relevant.

Let us consider the breakdown between active and passive management first. Actively managed funds have the goal of outperforming a stated benchmark, which is an index of a country, region, or sector (to name a few possibilities). Passively managed funds, in turn, have the goal of simply replicating the performance of the stated benchmark. Needless to say, these two goals are very different, and outperforming a benchmark sounds a lot more exciting than just replicating it. However, before you rush to stuff your portfolio with actively managed funds, consider the following two issues.

First, most active managers fail to beat their benchmark. To illustrate, for the 20-year period through December 2010, 72 percent of active managers that invested in U.S. stocks and 81 percent of those that invested in U.S. bonds underperformed their benchmark; the results were similar for active managers that invested in international stocks for the 15-year period through December 2010. This is, in fact, another area in which the evidence is quite overwhelming: More often than not, active managers fail to achieve their goal.

Worse still, the evidence shows that the best-performing managers, over 10–15-year periods, tend to go through shorter periods in which they are among the worst performers. To illustrate, of the
top-performing large-cap managers over the 10-year period through December 2009, 96 percent spent a three-year period in the bottom quartile and 46 percent spent a three-year period in the bottom decile. And guess what? Most investors bail out of the funds during the bad periods, miss the rebounds, and inevitably find that their performance badly lags behind that of the best-performing funds; their inability to stick with the good managers through thick and thin is the culprit.

In fact, these reversals in performance (that is, the tendency of active fund managers to alternate good and bad periods) turn the choice of actively managed funds into a guessing game of who is going to perform well over the period you intend to remain invested. But that is a losing game for you to play; if you like gambling, I would recommend Vegas, a place where the odds of every game are known and fun too! Trying to guess who is going to be the best active manager is not that fun, the odds are worse than in Vegas, and you can surely find much better things to do with your time.

Passive managers, on the other hand, have a much easier job than active managers: Tracking a benchmark is largely a technical task and can be properly done without much difficulty. Therefore, although the goal of active managers sounds much more exciting to investors than that of passive managers, the latter are far more successful than the former at achieving their goal. And that is not all; there is another critical difference between them, which brings us to the second factor that should stop you from rushing to stuff your portfolio with actively managed funds: costs.

I never hesitate to say that the cost of investing is the most underrated of all financial variables. Yes, the annual fees of most portfolios are small compared to the returns investors typically expect to get, but neglecting their importance is a huge mistake. We do not have the space here to go over all of the relevant costs of investing, but in the space we do have I will highlight four points.

First, both actively managed and passively managed funds charge annual fees. Second, the fees of the former are far higher than those of the latter. To illustrate, there are passively managed funds that aim to track the performance of the S&P 500 and charge annual fees lower than 10 basis points (100 basis points equals 1 percent), and there are many actively managed funds that charge well over 10 times that amount for attempting and, more often than not, failing to outperform the S&P 500. As a very rough guideline, actively managed funds charge annual fees at least five to six times higher than passively managed funds. (They also have higher trading and other costs not explicitly shown in total expense ratios that further erode investors’ returns.)

Third, if the difference between paying, say, 25 basis points for a passively managed fund and 150 basis points for an actively managed fund, year after year, does not strike you as substantial, just get an Excel file and try to compound $10,000 first at 8.5 percent and then at 9.75 percent over 20 or 30 years; you will be surprised. Remember, every dollar you do not pay in fees is a dollar you keep in your account. If you have a large portfolio and hold it for the long term, little differences of a few basis points in fees will amount to very large differences in the terminal value of your portfolio.

Finally, although it is generally true in most industries that the more you pay, the better is the product or service that you get, in the finance industry it is almost exactly the other way around. In fact, the evidence shows that funds with lower fees provide investors with higher returns and lower risk than funds with higher fees. In other words, the less you pay, the more you get! Nowadays, with little work you should be able to build a portfolio that has fees far lower than 100, and even 50, basis points per year.

In short, if you put together (1) the relative success of active and passive managers in achieving their goals and (2) the relative fees they charge, you will arrive at a nearly inevitable conclusion: Most of your portfolio should be invested in passively managed funds. Sure, you can have some small exposure to actively managed funds, but make it small. Choose the low fees of passively managed funds
EXHIBIT 1 Managing Your Own Savings — A Checklist

<table>
<thead>
<tr>
<th>Have I carefully considered ...</th>
<th>If not, ...</th>
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<tr>
<td>... my ability to tolerate losses over different holding periods?</td>
<td>... I may build a portfolio too risky for me and bail out of it at the worst time.</td>
</tr>
<tr>
<td>... my goals — the concrete reasons why I am saving rather than spending?</td>
<td>... I may just be going nowhere fast.</td>
</tr>
<tr>
<td>... my holding period, which will be largely determined by my goals?</td>
<td>... I may end up with a portfolio that is more or less risky than I need.</td>
</tr>
<tr>
<td>... my asset allocation — that is, the proportions of stocks, bonds, and other assets in my portfolio?</td>
<td>... I am ignoring a factor that will determine most of my portfolio's future performance.</td>
</tr>
<tr>
<td>... the maximum fees I am prepared to pay, keeping in mind that 50–75 basis points a year is a reasonable target?</td>
<td>... I am ignoring another factor that will critically determine my portfolio's future performance.</td>
</tr>
<tr>
<td>... the breakdown between passively managed and actively managed funds?</td>
<td>... I may end up paying more fees than I could and should.</td>
</tr>
<tr>
<td>... the specific funds that will be in my portfolio?</td>
<td>... I may end up with more inferior funds than similar ones that are easily available.</td>
</tr>
<tr>
<td>... once or twice a year whether the asset allocation is close to my target?</td>
<td>... the risk and return of my portfolio may not be what I expect.</td>
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over the exciting goal of actively managed funds every day of the week — and twice on Sunday.

Time to wrap up

By way of recap, then, remember the following five important points (and carefully read the checklist in Exhibit 1):

1. Pick up a book or two on behavioral finance and learn about your cognitive biases, the negative impact they have on your investment decisions, and how you can overcome them.

2. When rethinking your portfolio, start by considering your goals, your ability to tolerate losses, and your holding period; without this step, it is nearly impossible to have an appropriate portfolio.

3. Implement an asset allocation that is consistent with step two; this strategic decision is critical and will determine most of your portfolio's performance.

4. Focus on costs, targeting annual fees of no more than 50–75 basis points; this implies that your portfolio will be mostly invested in passively managed funds.

5. Finally, something that lack of space has made impossible to discuss: Rebalance your portfolio periodically. That is, once or twice a year, make sure that your asset allocation remains aligned with the one you determined in step three.

Although the finance industry strives to convince you otherwise, managing your own savings in a sensible way is not outside your reach. It is our bad investor within who whispers in our ear that sophisticated is good and simple is not. John Bogle, the founder of Vanguard, has spent most of his life trying to convince investors that simple approaches work and that focusing on a few important things and ignoring the background noise is what ultimately helps investors to enhance their wealth. And although he is more than 80 years old by now, he is not quite done with his job. You would be wise to pick up his recent book, The Clash of Cultures, or better yet, The Little Book of Common Sense Investing, for a dose of sensible investment advice.
In his recent and instructive book, Carl Richards writes that we:

often resist simple solutions because they require us to change our behavior. And so we spend $40 billion a year on weight-loss programs and products rather than take the simple, do-it-yourself approach: consume fewer calories, burn more calories with exercise, or do both. We’d rather look for the magic bullet: something to save us from the day-to-day grind of simply doing the work that needs doing.11

I could not have said it better. Just in case you still have doubts, or still think that sophisticated must be better than simple, I leave you with the words of a living legend in the world of investing. In his 1994 Letter to the Shareholders of Berkshire Hathaway, Warren Buffett wrote: “Ben Graham taught me 45 years ago that in investing it is not necessary to do extraordinary things to get extraordinary results.” And you can take that to the bank.

NOTES
1Barber, B. and Odean, T., Boys will be boys: Gender, overconfidence, and common stock investing, Quarterly Journal of Economics 116 (2001): 261–292.
6Perhaps I should clarify that the reason for asking these and other questions of clients on a first meeting is obviously not to put them down. On the contrary, it is because a client’s answers to these questions give me a good idea of the issues that need to be discussed on a first meeting. Do not feel bad if you did not know the answer to any of the few questions I mentioned that I ask of clients; the vast majority of individual investors do not know either, or have a very vague idea at best.