THE COMPASS CHRONICLE

Highlighting important wealth management issues — *Summer 2008*

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A client-focused wealth management firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our wealth management services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Gift Planning

In This Issue . . .

A Disciplined Approach To Investing

Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing. As much as anything else, successful investing requires something perhaps even more rare: the ability to identify and overcome one's own psychological weaknesses.

– Warren Buffet
[Warren Buffet is a highly regarded investor and chairman of Berkshire Hathaway]

Emotionally-based investment decisions tend to lead an investor away from the old Wall Street adage of *buy low, sell high.* Instead, during periods of market turmoil and weakness, investors who let their emotions dictate their actions respond by selling their riskier positions after the market has already sold off, thereby missing the inevitable rebound. In addition, selling out of an asset class, while thought to be a means of reducing risk, actually increases a portfolio's risk due to its reduced diversification (see page 3 for an article on the concept of diversification).

As Warren Buffet suggests, investors are challenged in making sound investment decisions by their own emotions. In fact, a study conducted by Dalbar, which provides research on the financial services industry, found that the average investor dramatically underperforms broad stock and bond indices. As Dalbar stated,

> investors continue to chase investment returns to the detriment of their pocket books. Motivated by fear and greed, investors pour money into equity [stock] funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than [the rate of] inflation.

A slew of psychological challenges face each investor. We review some of the more prevalent challenges below and then review how COMPASS Wealth Management manages client portfolios to avoid these psychological investment traps.

Rearview Mirror Investing

This is my unscientific, but descriptive phrase of what behavioral finance calls "anchoring" and "recency bias". Too many investors expect that what has most recently occurred will continue to occur. For example, in the late 1990's, many investors expected the dot-com and Internet-related stocks would continue their parabolic ascent, though many such companies were likely years away from turning a profit. Investors were, in effect, looking in the "rearview mirror" and optimistically expecting that past stock appreciation, though consistent with a bubble, would continue indefinitely.

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One consequence of investors extrapolating the market's contemporary experience into the future is that they tend to overweight the asset classes, sectors, and individual securities that have performed well, rather than looking prospectively and making a sound judgment as to what will outperform in the future.

Confirmation Bias

Confirmation bias was also evident during the dot-com bubble. Related to anchoring, confirmation bias is placing greater weight on information that supports what you already believe (or want to believe), as well as discounting information that does not support your view. Many investors were easily taken by the prospects of dot-com stocks, rather than critically evaluating their prospects based on realistic growth and valuation metrics.

Return Asymmetry

One of the more interesting perspectives that some investors have is that they would like to enjoy the upside of stock investing, but are unwilling to accept the potential downside of such investing. Unfortunately, to obtain the greater returns offered by stocks, you need to accept the greater risks that accompany them—security returns are not asymmetric! We can use tools to alter the asymmetric returns of securities, such as placing stop loss orders on stocks or exchange-traded funds, but these tools do not alter the traits of the underlying securities.

Loss Aversion

No one prefers to lose money and, not surprisingly, investors avoid losses like the plague. Yet losses are part of the normal investing experience, though you obviously expect your gains to occur more frequently and with greater magnitude than your losses. Many investors habitually focus more on their money-losing holdings than on their holdings that have performed well. Certainly you should review underperforming holdings, but many investors are unable to distinguish between a bad decision and a bad outcome. Often a reasoned decision was made initially, but a bad outcome may still result. Such is the life of an investor!

THE COMPASS APPROACH

COMPASS Wealth Management's approach runs counter to an emotionally reactive one. Our disciplined approach is devoid of emotions.

Risk Evaluation

Our process begins by first evaluating risk, or how much volatility a client is willing to subject their portfolio to, from two different perspectives. The first is from a client's perspective and attempts to determine from an emotional or psychological level their willingness to undertake risk in order to achieve returns. The second perspective on risk is our own—given a client's circumstances, how much risk do we think they should be willing to bear from an objective standpoint. We examine any differences between the two views on risk and, in discussions with our client, incorporate the client's risk tolerance and our assessment of their risk capacity into our recommendation for their portfolio structure.

Portfolio Structure

Once we have determined where on the return-risk continuum a client lies, we create a portfolio structure that is appropriate for their needs. This structure is specific to their individual goals, investment time horizon, and risk tolerance and capacity. This customized approach can incorporate a client's multiple financial goals and objectives, whether it is having sufficient assets for retirement, saving for a child's college education, etc.

Depending on the market environment, we may adjust a client's exposure to various underlying asset types within preestablished ranges to take advantage of market opportunities. However, our disciplined strategy maintains diversification in order to control risk. Our belief is that by consistently following a disciplined process, clients have the best opportunity to create the wealth necessary to meet their financial goals.

Investment Policy Statement

All of these factors are then included in an investment policy statement, which outlines a client's financial circumstances and recommends a specific portfolio structure based on their needs. This document acts as a road map that is adjusted over time as a client's circumstances change.

The investment policy statement incorporates our recommendations for establishing an appropriate asset allocation and diversification strategy. We regularly review the asset allocation of our clients' portfolios and rebalance them whenever necessary to maintain alignment with long-term targets. This rebalancing process reduces exposure to asset classes or sectors that have performed above trend line and increases the weighting of recent laggards (consistent with the *buy low, sell high* adage referenced earlier).

SUMMARY

Our approach of crafting an appropriate portfolio structure for each client's needs and our policy of regularly rebalancing each portfolio to maintain diversification limits the deleterious impact that emotions can play in preventing successful investment decisions.