Lloyd Wealth Management, LLC

Yale Expert Has Good Advice For Investors

Professional athletes have the best coaches, trainers and facilities. They also have the time to become proficient in their sport. Most of us play sports occasionally and don't have the wherewithal to achieve the same success.

Investing is no different. While you cannot invest the same way as David F. Swensen, Chief Investment Officer for Yale University does, his new book "Unconventional Success: A Fundamental Approach to Personal Investment" will help you become a better investor if you follow the guiding principles and avoid costly mistakes.

The lessons in this book help investors understand why they need to be skeptical about their ability to actively manage their own portfolios. Today we focus on several key components of building and maintaining a portfolio, Swensen-style.

1. Diversify your portfolio using core asset classes. These are the building blocks for creating portfolios to meet your broad investment objectives. The six classes include domestic equities, foreign developed market equities and emerging market equities, which drive portfolio returns. Additional diversification includes U.S. Treasury bonds, which can help provide protection from financial catastrophe, and U.S. Treasury Inflation Protected Securities, which can provide assurance against inflation-induced asset erosion. Real estate exposure, in which risk and returns fall between both those of bonds and equities, contribute additional diversification to a portfolio.

"What I worry about is the ability of the average investor to understand what is behind the curtain and choose those investments that are sensible and avoid those that aren't." says Swensen. "So, ultimately I came up with this plain vanilla, very basic approach to managing portfolios."

Any number of portfolio allocations can satisfy the requirements of diversification and equity orientation. In his book, Swensen offers the following example:

Domestic Equities 30 percent
Foreign Developed Equities 15 percent
Emerging Market Equities 5 percent
Real Estate 20 percent
U.S. Treasury Bonds 15 percent
U.S. Inflation-Protected Securities 15 percent

Note: This is an example only and should not be considered specific for any individual. Please consult your advisor for an allocation appropriate for you and your risk tolerance.

2. Rebalance your portfolio systematically. This requires behavior at odds with traditional thinking, by trimming winners and bolstering losers under normal market conditions.

In Bear markets, rebalancing requires investors to buy depressed assets to maintain the risk and return profile of the desired portfolio. This is easier said than done.

In reducing over-weighted asset classes, investors may hesitate if they contain highly appreciated assets that would incur tax liabilities if sold. Alternatively, adding new monies to under-weighted asset classes, or rebalancing in tax-deferred accounts (such as retirement) may help investors achieve the desired asset allocation.

Most important, each asset class exposure should range from a minimum of five percent of assets to a maximum of 30 percent.

How often should you rebalance your portfolio? “Realistically, it would be good if people could take a look at their portfolios once a quarter. I think that if it was as infrequently as once a year, it would be OK, but less than ideal,” says Swensen. “This is a very, very important thing for most people. I think probably most don’t give the time, energy and attention that they should to their financial assets.”

Rebalancing forces investors to act against the crowd. In periods of excess volatility, investors may enjoy the opportunity to buy low and sell high.

3. What about investment alternatives? “The big difference between institutional portfolios, like Yale’s, and individual portfolios has to do with the access to high quality active management opportunities,” notes Swensen. “Most of the alternatives require high quality, superior active management. Individuals necessarily have to avoid those areas because they do not have the access or the ability to choose,” he adds.

4. Chasing performance: Most investors overemphasize strong performance numbers based on the recent past, notes Swensen. Many focus *only* on historical returns, ignoring high quality managers who display integrity, thoroughness and discipline in their decision-making. Thus, investors might position themselves for future disappointment.

“As more money chases a rapidly appreciating sector, the resulting price increases might sow the seeds of the trend’s eventual demise,” says Swensen. “The problem with trend following is the fact that it works only as long as it works. Market forces ultimately reverse a trend, speculators rush for the exit, leaving all but the most nimble with disappointing results.”

Swensen cites a recent 10-year study by Morningstar. In every instance, the actual returns investors got fell short of the reported returns. “The reason being that investors would invest after a period of strong performance, before a period of weak performance,” he explains.

5. Getting on track: If you now feel you need to make more changes to your portfolio, how should you proceed?

Here’s where Swenson offers some of his best advice. He advocates taking a gradual approach to getting to the right place. “Radical moves are fraught in part because … you put yourself in a position of second-guessing what it is that you did. You tend to keep on measuring what would have happened, maybe not precisely but mentally, had you not made that radical change,” says Swenson.

“Gradualism is good from the perspective of having the ability to maintain the sensible policies that you are trying to implement. The second important factor has to do with transaction costs. You don’t want to pay a big exit fee, nor incur unnecessary tax liabilities. Take a gradual approach from where you are to where you want to be."

Sound advice from one of the all-time best investors.

Please contact us with any questions regarding this article and how it effects the management of your portfolio.

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