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New Year's Resolutions for Investors

Whether building your dream house or crafting an investment portfolio that will last a lifetime, the likelihood of realizing your vision without a well thought out plan is at best remote. There are simply far too many decisions, choices and potential distractions. I can hear the mantra of Benjamin Franklin now: "*if you fail to plan, you are planning to fail.*"

Your life: your plan

It's human nature to be competitive. We inevitably compare ourselves to friends, family members, co-workers and strangers by how much we make, how much we give, what we drive, and a host of other measures. From an investment perspective, however, this can be a very dangerous trap – each of us have a uniquely different vision for the future (both dreams and fears), so each of us need a custom bespoke plan to deal with that future.

Any sort of planning necessitates trade-offs. If your heart is set on creating a home office, you may have to be willing to forego the guest bedroom. If you want both, you may need to accept a smaller yard. Most of us understand and accept these trade-offs, except when it comes to investing, where we think in terms of absolutes (we want to have our investment cake and eat it too!). In the real wealth management world, it is no different. We must accept trade-offs. If you want to maximize gain—you must accept added volatility (volatility is the price investors must pay if they are to be rewarded with outsized profits.) If you want to minimize portfolio risk, you need to come to terms with the idea that you'll need to forego some potential portfolio return in order to ensure that degree of protection. Investors can't have both.

Your individual end goal dictates your plan. The plan is everything as it will keep you on track and prevent you from becoming distracted—whether that be on aisle seven at Home Depot or amidst a periodic market selloff.

Investments must align with plans

Your goal dictates your plan. Your plan dictates what you buy and not the other way around. If the blueprint for your house demands 12-foot ceilings, then the universe of window and door options available to you is going to be dictated by that plan. If your house plan calls for a safe room, it will need an especially strong door. It's your plan (features and style of the home) that dictates the appropriate fixtures.

The same holds true for your portfolio.

To keep it simple, consider a universe of two investment choices—a five-year Treasury Bond (considered among the safest assets in the world) or shares of common stock in the world's largest public company–Apple Inc. If your investment plan calls for a high degree of safety, most of your investments will need to be conservative in nature and thus dominated by Treasuries. Conversely, if growth is your primary consideration, most of your portfolio will need to be more aggressive (and more volatile) and thus dominated by Apple stock.

Your long-term plan dictates what you buy in the short run. And as anyone who has ever built their own home can attest – switching plans can be very costly. Switching investment plans mid-cycle is not only costly it can be highly counterproductive to achieving your long-term needs and wants.

Comparing apples and oranges

We instinctively want to track how we are doing compared to everyone else, and some use benchmark indices to do that. Intellectually, we all know that it's unfair to compare the cost and specifications of a multi-million-dollar mansion to a starter home, yet emotionally that is precisely what many investors do with their portfolio. For example, if your financial plan calls for a mandate to minimize risk through high-grade bonds or to scour the globe to prudently invest in attractively valued stocks, then comparing either strategy to the performance of the NASDAQ index (an index primarily comprised of growth oriented technology companies) might be a poor fit for comparison purposes.

Another popular US index is the venerable Dow Jones Industrial Average (DJIA). While the DJIA may be good for history books (it is the most celebrated and historic of all indices, dating all the way back to 1885) the index as an investment tool is relatively meaningless for modern times. Representing a mere 30 stocks, the index can hardly be considered a true representation of a country with more than 3000 public companies of meaningful size. Also, the DJIA is a price-weighted index—meaning a company's share price is the determining factor of its weighting within the index (normally, a stock's weighting is determined by either its size or its earnings). For example, Goldman Sachs (GS) currently makes up 8.3% of the DJIA; GS has a market capitalization (market cap) of $95 billion with a current share price of $240. In contrast, General Electric (GE) is nearly three times as large with a market cap of $280 billion—but makes up only 1.10% of the index because its share price is only $30. Thus, GS has 8x the weighting of GE due to no other reason other than share price alone. As a result, GS has accounted for nearly 500 points of the DJIA recent 1000 point move in the latter parts of 2016. While exciting, the abnormal contribution exhibits weakness in the index's price-weighting methodology.

The S&P 500® is an improvement over the DJIA as it not only represents more stocks (500 vs. 30) but also weights stocks by size (larger companies with larger market caps have a larger position in the index) and not price. Moreover, sophisticated investors can estimate earnings/share of all 500 companies (say $135 in 2018) and then assign a valuation multiple (a forward-looking Price/Earnings multiple of say 18x) to come up with a projected index price level target ($135 x 18 = 2430 by the end of 2017). However, there are flaws in this index as well – most notably the fact that it contains only Large Cap companies, and thus eliminates two-thirds of the potential investments within the U.S. (consider an investor that could only invest into US Large Caps in 2005 would have missed Apple's 2000% return as the company only sported a market cap of $13 billion in 2004—far below the Larger Caps that dominated the S&P 500).

Other indices (e.g., the Russell 3000 and S&P 1500) expand their scope to capture the entire U.S., yet still far short of a comprehensive index by excluding overseas markets. Given that nearly half of all equity opportunities reside in other areas such as Europe/UK (which makes up 23% of the globe), Emerging Markets (11%), and Japan

(9%), a more appropriate benchmark is needed to measure and quantify the total universe of equity opportunities.

Enter the MSCI All Country World Index (ACWI) which captures nearly all of the globe by measuring the market performance of 2500 large and mid-sized companies in 24 Developed countries and 21 Emerging Markets. Why do we mention this now? We certainly are aware that the investment world is inundated with acronyms and that the last thing you need is commit "ACWI" to memory. But if your investment mandate is to scour the globe for growing companies at attractive valuations, then one needs to properly assess the global equity markets and ACWI should be your benchmark of choice.

While no one here is calling for a top in the S&P 500, recent conversations remind us of the late 1990s. Then, investors only wanted Large Cap Growth NASDAQ stocks even though there were many attractive companies residing in the Value side of the ledger. And we all know what ensued. Today, the dominant conversation is US vs. International with many investors shunning attractive companies overseas. Thoughts of future tax breaks, deregulation, and infrastructure spending have pushed stocks upward. But now, with valuations of the average US stock in the 98th percentile of history (99 being expensive, 1 being cheap), investors would be wise to dust off their 2009 financial plan and rebalance their portfolio all while heeding Sir Winston Churchill's great advice, "*Those who fail to learn from the past are doomed to repeat it*."

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