Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor Series #7

Investing 101 - Forwards and Backwards

Ed Hynes, CFA
July 12, 2005

Everyone has been told a thousand times how they "should" invest. But for many people managing their investments is a daunting task. It is difficult to understand and honestly, pretty boring. So let's have some fun and turn your portfolio into a summer detective mystery.

To be a good detective you need to understand events looking forward and backwards. Let's start by briefly looking at the investment process going forward.

1. **Asset Allocation**. This is where an investor decides how they will divide their money among various asset classes, such as stocks, bonds and cash.

2. **Choosing Risk in Each Asset Class**. Within each asset class investors decide what risks to take. For instance what risk do they want in the stock market? Do they want board exposure to the market or just to certain sectors such as technology?

3. **Investment Strategies**. For each risk identified in step 2, investors need to choose an investment strategy to take that risk. For our purposes today this is primarily a question of deciding between active and passive investment strategies. Active investment strategies attempt to beat the market while passive strategies aim to perform in line with the market.

4. **Purchase Investments**. The final step is to purchase individual stocks/bonds or other investments which fit your investment strategies at a reasonable cost.

Now for the fun as we become detectives in "CSI Wall Street." Let's start with an example where your job is to figure out the investment strategies of two, 50 year old men. Your only evidence is their brokerage statements or what they did in step 4.

We see that "Investor A" owns about 20 energy and bio-tech stocks. He also owns five mutual funds, all of which use active investment strategies. All of "A's" assets are in stocks, he has no cash or bonds. Expenses and fees cost him about 1.75% a year.

"Investor P" on the other hand owns two Exchange-Traded Funds (ETFs). Both are broad-based and one tracks the stock market and the other the bond market. We see that

“P” holds cash in a money market for emergencies, and of his remaining money about 70% is in stocks and 30% in bonds. Expenses and fees cost “P” about 0.50% a year.

The first thing our detective realizes is that “Investor A” gets his name from using Active investment strategies and “Investor P” from using Passive strategies.

Since “A” uses multiple active investment strategies, we know he thinks he is one of the chosen few that can beat the market. We see his stock selection is tilted toward the hot energy and bio-tech sectors. He then increases his risk by choosing individual stocks in these sectors. We guess he thinks if he picks the best stocks in the best sectors he is going to get rich.

It is clear that “Investor A” never learned to save for a rainy day as he has no cash for emergencies. Maybe he’ll be lucky, but most of us will need a rainy-day fund someday. He also doesn’t know or care about the benefits of portfolio diversification as he has no bonds.

“Investor P” is a model investor according to our detective. His asset allocation looks reasonable for a 50 year-old. He has set aside money for emergencies and his remaining assets are split 70% stocks and 30% bonds. He realizes that asset allocation is the most important decision when it comes to long-term returns and that diversification is very important.

Within each asset class, i.e. stocks and bonds, he is well diversified, as both ETFs are broad-based and own many different stocks or bonds.

With his passive strategy, “Investor P” will probably trail the market by a very small amount, but it is highly unlikely he will fall short by a significant amount. “Investor A’s” risks are almost the mirror image. He may beat the market from time to time, but it is highly likely that over the long-term he will under-perform “Investor P” by a large amount.

Now pull out your portfolio and play detective. What do your holdings tell you about the decisions you have made?

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. *This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.*