ADDING VALUE

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SUMMARY:

This edition of ADDING VALUE addresses investing with a goal. We propose that portfolio construction and risk management should be closely aligned with client goals. This methodology, which we have always practiced, helps to avoid the human behavioral biases that lead to investment failures and traps.

Second Quarter Investment Review and Outlook: Investing with a Goal

There is nothing like a severe bear market to test the strengths and weaknesses of traditional investment theory. Investors certainly had ample opportunity to decide if their portfolios stood the test of time as they watched U. S. equity prices fall by 49% from the peak in March 2000 to the trough in October 2002. Although the carnage of the popped equity bubble may seem long past, one only has to look to the trailing five-year returns for the period ended on June 30, 2004, or look forward to the future returns for the next five years to know that there may be a major adjustment for the "saving-short" American consumer. Even those investors who were well-diversified among many types of investments were unprepared for the full extent of the bear market. Many had implemented strategies in good times with neither clear objectives nor a clear understanding of risks. To grapple with this problem, this quarter's newsletter will discuss the concept of *investing with a goal.*

What is goals-based investing?

Did you, your parents or your grandparents keep money for rent, vacation, groceries, or a rainy day in separate jars? When money was needed for the week to eat, the jar was opened and a trip to the market followed. It turns out that this was not such a bad idea. Taking money out of the rainy day fund occurred much less frequently than money needed from the grocery jar. The best part of this system was that all money was segregated as to use and only what was in the "needed" pot was spent. An interesting observation is that money went into each pot based on the thriftiness of the household manager, or from the viewpoint of the **user**. Every family knew precisely how much they had to spend, because they could count how much they had in the jar.

Over the years, we have become more sophisticated in how we manage money. Many advisers provide presentations using

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

modern portfolio theory, which was the basis of the Nobel Prize in Economics in 1952. Nevertheless, individuals continued to have an impact on the outcomes and implementation of the theories which were not foreseen by the original theorists. Perversely, individuals carried with them biases and opinions from their parents and grandparents; in this way, they retained some control of the cookie jar. In 2002, precisely fifty years later, a Nobel Prize in Economics was awarded to a behavioral theorist who attempted to identify why the original formulas of Modern Portfolio Theory had different outcomes in practice. Recognizing that individuals have certain needs, we have always built client portfolios with a simple, but subtle and powerful, reorientation to the standard methods. **We build a portfolio from the viewpoint of the investor rather than from our viewpoint.**

This newsletter will be divided into two sections. The first will enunciate why investors often fail to achieve their goals. In the second section, we will describe a goals-based investing process that links investment strategy selection to client goals for a higher success ratio.

What is investment achievement?

By our definition and the definition of most of our colleagues and clients, investment achievement is defined as having enough capital to satisfy personal lifestyle needs, wealth transfers and charitable gifts. The life- cycle saving theory is an **intertemporal** model of consumer behavior. This means that decisions that we make about money today affect the choices available to us in the future. Eventually, households must align their spending and saving balances to be compatible with the needs of youth, middle age and ultimately retirement. This simply stated concept of saving money today in order to live comfortably in the future is a lot easier to state than to practice. As in the game Chutes and Ladders, there are pitfalls and surprises along the way.

What are some of the pitfalls and shortcomings of traditional investment management?

As we reviewed our process in constructing client portfolios, a light bulb went on. In life and career, there are just a couple of “aha moments”, when illumination of an idea gives clarity to the whole process. The following points are what we consider to be special trap avoidance issues of traditional management:

- Failing to understand that there is an inconsistency between traditional risk measures and how individual investors experience risk.
- Seeking shortcuts in our attempt to understand the complexity of the investment problem.
- Viewing the world by time intervals rather than events.
- Attempting to quantify a client’s risk tolerance with risk profiling.
- Neglecting to manage behavioral biases.
- Using current macro-economic gibber-gabber or friendly chatter to define our goals.

Limiting Risk Measurement to Investor Goals
In our newsletter last quarter, we discussed risk measurement in depth. We spent some time talking about standard deviation, or portfolio volatility, the most common method of measuring “risk” in the portfolio. Consid-

er, for example, an investment in the S&P 500 between 2000 and 2002. The standard deviation of the S&P 500 over this period was 19%. The total **portfolio loss** over the same period was 38%. Few individuals are able to connect the standard deviation of 19% with the possibility that they could lose over one-third of their wealth! Fewer still can connect the 19% standard deviation with the implications for their capacity to fund their goals. Frankly, we and most individuals don't care what the standard deviation of the portfolio is, we are most concerned about the maximum amount that can be lost.

Taking shortcuts

We live in a society of sound bites. Time is so constrained by the events in our lives that we want to turn on CNBC and be given an immediate answer on what stock to buy today. This tendency is reinforced by the news media who are simply doing their job by giving the customers what they want to hear in the form of the latest hype. One of these aha moments occurred to me in this regard during a panel discussion of journalists led by Jason Zweig, editor of Money magazine, at the 2001 CFA Institute Annual Conference (formerly AIMR). One panelist described the nastiness of the emails and the editorial pressure when she did not give the readership what they wanted to hear- the tech stock propaganda. She finally capitulated on the stage and I paraphrase: "We cannot be held accountable if we are giving our clients what they want to hear." This statement more than any reminds us that these talking heads are not providing objective information.

Events not time intervals

Another limitation of traditional risk measures is that they are specified in terms of time intervals. Standard deviations tend to be annualized. Reference points tend to be trailing- year returns for one, three, five, or ten years. The important point to remember is that trailing-year returns are beginning and end point sensitive. For example, Thornburg Value has a trailing 12-month return of 22.4% for the period beginning on March 30, 2003, and ending on March 30, 2004, and a trailing 12-month return of only 13.1% for the period ended June 30, 2004. How can there be so much change in just three months? The reason is that the March 30, 2003, value was very low, by measuring from that low point, the return for the succeeding twelve-month period is high. In other words, the return calculation is very dependent on the beginning and end points. For an individual, it is important to remember that historical performance averages don't matter, time intervals don't matter; what matters is where you are when the music stops, i.e. when you need the money.

Risk profiling

Risk profiling is used to establish the client's risk tolerance, which is the primary link between the client and the investment recommendation. Two difficulties arise in building an effective risk profiling process. First, the information that clients provide about their attitudes towards risk can be misleading and hard to interpret. Second, it is not easy to integrate risk tolerance estimates with other factors affecting client goals.

Behavioral biases

We are all afflicted with behavioral biases, even professional managers. Since behavioral biases are traits of human nature, no one is immune. Biases can lead to failed investment strategies and should be controlled rather than accommodated. Some of the most damaging biases that we and other researchers have observed include:

- **Overconfidence**- investors overestimate their ability to predict market events.
- **Hindsight bias**- people believe that they predicted an event, when they

didn’t, or they look only at past performance in investment selection.

- **Overreaction**- people are overly influenced by random occurrences.
- **Belief Perseverance**- people are unlikely to change their opinions even when new information is available.
- **Regret avoidance**- investors stick with the wrong approach for longer than they otherwise would to avoid acknowledging a mistake.

Macroeconomic gibber-gabber
People feel comfortable on the side of the majority opinion. Some of the most intelligent individuals seek validation of the pack. This is why individual investors typically get in too late. By the time they have completed their research, listened to the news, and read the newspapers, they have convinced themselves that everybody else is getting rich. They are the only ones not getting rich. When those investors get in, it may be time for others to get out.

Why goals-based approach?

A goals-based approach works by reducing the friction between the practitioner’s trained perspective, which is based on traditional investment principles, and the individual’s perspective, which is determined by goals and psychological make-up. When these perspectives are not well integrated, strategy selection becomes arbitrary. Investors, who have greater flexibility, use their portfolio as a testing ground, trying different approaches and changing strategies based on outlook, emotions, and other behavioral biases, rather than goals.

The biggest challenge to implementing a goals-based approach is twofold:

- It is complicated, because it is complex.
- It is a new way of thinking.

By having a jar, or at least the mental equivalent of one, we can separate our goals into the most appropriate pot. We know that we have to be careful about what we spend from each jar. In a time-tested way, it still remains the only sensible way to manage money.

With the writing of this newsletter, we are celebrating our second year in business. If you like our goals-based approach to investment management, we would welcome any referrals.

Sincerely,

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