The Ten Most Common Mistakes Affluent Investors Make And How to Avoid Them

BY JAMES P. OWEN

How I Made My Fortune

It was really quite simple.

I bought an apple for 5¢,

spent the evening polishing it,

and sold it the next day for 10¢.

With this I bought two apples,

spent the evening polishing them

and sold them for 20¢.

And so it went until I

had amassed $1.60.

It was then my wife's father

died and left us $1 million.

Anonymous Entrepreneur

Table of Contents

Getting Rich Slowly — But Surely

THE TWO BASIC RULES FOR AFFLUENT INVESTORS:
RULE #1 — AVOID MISTAKES
RULE #2— DON'T FORGET RULE #1

Each year, hundreds of books, magazine articles and newspaper columns offer personal investment advice — nearly all of it aimed at the "do-it-yourself" investor looking for hot tips or the small mutual fund buyer seeking this week's top-performing fund.

However, very little is written for the *affluent investor* who invests on a much larger scale, and thus faces many of the same issues concerning professional money management as large institutional investors. This booklet was written to fill that gap.

How This Booklet Will Help You

This booklet won't tell you how to double your money in six months. What it will do is help you deliberately and consistently build your wealth over time — to get rich slowly, but surely.

Based on extensive interviews with some of America's most successful financial advisers, this booklet lays out the basic building blocks of an effective, proven strategy that is so simple, it never occurs to most investors: Don't focus on trying to beat the market or outperform other investors, factors you can't control. Instead, focus on *avoiding mistakes* — the one thing you *can* control.

By avoiding mistakes, you benefit from two powerful forces you have on your side: Time, which lets you build wealth slowly and steadily, without taking unnecessary risks; and the Power of Compound Interest, which gives your portfolio an enormous boost over time — especially in the latter stages of your program.

Never forget, as an affluent investor you have a huge advantage. You can invest on a large enough scale to produce impressive dollar gains, just by consistently earning above-average returns, year after year.

This booklet also gives you a perspective on the correct way to look at the critical issues and helps you identify the right questions to ask the professionals. By "demystifying" the process of hiring and firing money managers, this booklet helps you avoid being hoodwinked by industry jargon and bogged down by information overload.

Above all, it shows you how to sidestep the classic pitfalls that trap many affluent investors. Learn how to avoid these big mistakes, and in the long run, you will *win at investing*.

JAMES P. OWEN
Santa Barbara, California

> "YOU CAN GET POOR A LOT FASTER THAN YOU CAN GET RICH."
>
> BOB MILLER

TREATING INVESTMENTS LIKE A PART-TIME JOB — NOT A BUSINESS

"WHEN A MAN TELLS YOU THAT HE GOT RICH THROUGH HARD WORK, ASK HIM: WHOSE?"
DON MARQUIS

For someone with, say, $100,000 or $200,000 to put toward the future, investing doesn't have to be a very high priority. Perusing back issues of *Money* Magazine, consulting the Morningstar ratings and picking a couple of middle-of-the-road mutual funds may be all the effort required. Whatever the choice, whatever the result, investing won't likely do much to change that person's lifestyle.

But if you're an affluent investor, it's an entirely different ballgame. You probably have an enviable annual income, a sizeable investment portfolio and a comfortable lifestyle you'd like more time to enjoy ...someday. How well your investments perform will determine when and how you're able to retire, how big an estate you can build and whether you ever get to do the things on your personal wish list.

Small investors, oddly enough, often are more serious and focused about investing than wealthy ones. When market researcher Russ Prince recently studied the investing habits of affluent and not-so-affluent investors, he found a sharp dichotomy between the two groups. When asked how they selected mutual funds, the less-well-to-do group said investment performance was the single most important thing. For wealthy investors choosing investment advisers, however, performance was ranked only the *ninth* most-important consideration, behind such factors as discretion, reputation and quality of presentation.

No doubt many affluent investors feel they're so busy making money they can't devote much attention to investing it.

Consciously or unconsciously, they also may believe that they don't really need to think or worry about it that much. After all, anyone who can command earnings of $300,000, $400,000 or $500,000 a year already has achieved success far beyond the expectations of most Americans.

But highly successful people who are casual or haphazard about investing probably are oblivious to the amount of money it takes to maintain their accustomed lifestyles after retiring. And the truth can be shocking. Take one example: A 49-year-old executive with a $400,000 annual income and a $1 million portfolio. To retire at 65 without dramatic downscaling, he has to grow that $1 million to $6 million in assets within a decade and a half!

No matter what your situation, if you're investing assets of $1 million, $2 million, $5 million or more, you have a great deal at stake. Not only do you have more to lose, you have much more to gain by improving the performance of your investments. A mere 1% or 2% increase in average annual return, sustained over time, can boost the ultimate value of your portfolio by hundreds of thousands, even millions of dollars.

At this level, investing *must be* a business. The capital you're investing is comparable to the capitalization of many small companies. What's more, the principles of success are the same for investing as for any other business. As the CEO of your own investment "company," you need to make sure your assets are managed in a systematic, disciplined way. That means having:

- **A business plan that covers both the short and long term**
  Successful businesses have a one-year, five-year and ten-year plan. Your time horizon may be longer, extending through retirement and perhaps even beyond. Once you have a plan, you also need to monitor how well the plan is working and adjust it in light of your results and changing conditions. Like any good business plan, a sound investment plan isn't just a document; it's really a *process*.

- **Quantifiable goals against which to measure results**
  It's not enough simply to say "I want to preserve my capital and make a decent return." Take that approach and down the road, you may be unpleasantly surprised to find that your assets haven't grown enough to meet your requirements. You need to start with your *life goals* — whether they be to retire at 60, maximize income during your children's college years or build wealth for future generations.

This helps you determine your *investment goals* — how much money you'll need, when you'll need it and what rate of savings and investment return will get you there.

- **A strategy for attaining your goals**
  This is where goals meet reality. When you look at investment alternatives that might help you achieve your goals, you face tough questions. You may want an average annual return of 15%, but is that realistic given the historical returns from stocks and bonds? And, are you willing to assume the level of risk that comes with targeting that return? If not, your goals and strategies must be adjusted. Perhaps you'll need to save more — or lower your goals.

- **The right professionals to do the job**
  To most affluent investors, having professional investment management is a given. The question is, who? Some wealthy individuals take the path of least resistance, passively standing by while a local bank trust department, family tax adviser or former fraternity brother makes the real decisions. If you're serious about investing, it's worth the effort to find an investment adviser upon whose expertise and judgment you can rely.

Many people who have earned a great deal of money fail to apply the principles of their professional success to their own investments; they're often too busy or too focused on their careers. But if you have substantial assets, you can't afford to be anything but businesslike in the way you invest them.

"FINANCIAL SUCCESS IS NEVER HAVING TO BALANCE YOUR CHECKBOOK."

BENJAMIN GRAHAM

NOT HAVING AN ASSET ALLOCATION STRATEGY

"ONE THOUSAND DOLLARS LEFT TO EARN INTEREST AT 8% A YEAR WILL GROW TO $43 QUADRILLION IN 400 YEARS, BUT THE FIRST HUNDRED YEARS ARE THE HARDEST."

SIDNEY HOMER

Much of the investment advice in books and magazine articles focuses on investment selection — how to pick specific stocks, bonds or mutual funds. Individual investors tend to put more emphasis on this aspect of the investment process than any other.

Yet, studies show that over 90% of a portfolio's return depends on *asset allocation* — how the portfolio is divided among different investment classes, such as stocks, bonds and cash equivalents. Knowing this, large institutional investors devote substantial resources to creating, fine-tuning and adapting their asset allocation policies.

In contrast, many affluent individuals make the mistake of not having an asset allocation policy at all. Instead, they back into asset allocation decisions based on unspoken assumptions, unexamined feelings or untested information:

- "Bonds are the safest investment."
- "This isn't the right time for stocks."
- "Emerging markets are where the real opportunities are."

Anyone who lets this sort of thinking shape his or her investment approach is vulnerable to missed opportunities at best, and costly errors at worst.

Every serious investor should have an asset allocation policy — a strategic, long-term framework laying out a mix of investments with the balance of risk and return that's right for the individual. And this policy should be in place *before* any investment managers are hired.

If you have substantial assets, your portfolio deserves more than a quick, off-the-rack solution. You need an asset allocation strategy thoughtfully tailored to your goals, needs and personality.

> "The safest way to double your money is to fold it over once and put it in your pocket."
>
> Kin Hubbard

While some investment vehicles incorporate a preset asset allocation mix, often based on the investor's age or stage in life, no one asset mix is right for everyone in a given age bracket. For example, investors approaching retirement age often shift automatically toward fixed-income investments — forgetting many people live 25 or more years past retirement and need to keep growing their assets in order to maintain their lifestyles. By the same token, someone uncomfortable with even modest risk may be temperamentally unsuited to equity investments at any age.

When you develop an allocation strategy, it's vital to start with the right questions, as well as a solid perspective on the historical risk and return characteristics of the various asset classes. Look at several investment scenarios and evaluate how well each mix fits your needs, depending on your:

Time horizon
Over the past 70 years, stocks have outperformed bonds by a wide margin, but stocks also have had greater variability in their year-to-year returns. The longer your time horizon, the more you can afford to ride out the equity market's ups and downs in pursuit of those higher returns.

Income requirements
Are you investing primarily for the future? Or, do you need some current income from your portfolio? How you answer these questions will greatly affect the way your portfolio should be structured.

Tolerance for risk
How would you react if your portfolio suddenly dropped 10% in a bear market? What about 20% or more? If, by realistically anticipating your emotional reactions during tough times, you can come to terms with risk *before* you face it, you'll be better able to resist making rash moves during the market's inevitable downturns.

Expectations for return
Your targeted returns should be realistic in light of historical performance trends, the current market environment, as well of course, as your attitude about risk.

Like your overall investment plan, your asset allocation strategy should not be set in stone. It's wise for you and your investment advisers to revisit asset allocation issues periodically. If your goals or the investment climate have shifted in any meaningful way, you may need to make some adjustments.

Like anything that tries to look into the future, an asset allocation strategy can't guarantee results. Although history tends to repeat itself, the only thing certain is that investment cycles will occur. But having a sound, well-thought-out asset allocation strategy is essential if you want to reach your long-term goals.

> "Thrift cannot be too highly commended. Teach all those with whom you come in contact to be saving. You never know when you may need their savings to finance one of your ventures."
>
> Don Marquis

Trying to Time the Market

"A study of economics usually reveals that the best time to buy anything is last year."
Marty Allen

Like the fountain of youth and the pot of gold at the end of the rainbow, a successful market-timing strategy is something that people have always dreamed of finding. Although most have given up on the first two, plenty of people still search for the secret of buying low and selling high.

And why wouldn't they? In theory, at least, market-timing is a wonderful idea: Be fully invested during rising markets, and move to safe cash equivalents when prices fall. No other investment strategy has more powerful or universal appeal.

The problem is it's virtually impossible to pull this off consistently. Almost all who try ultimately fail, and with good reason: Market-timers have the odds overwhelmingly stacked against them.

To start with, aspiring market-timers should consider the market's overall, long-term trend, which has been decidedly upward. Since the turn of the century, the market has risen approximately 70% of the time. That means if you exit the market betting it will go down, you have a 7-in-10 chance of being wrong.

Another lesson of history is that stocks make most of their gains in short, dramatic spurts. Consequently, the price you pay for being out of the market at the wrong time is enormous. Between 1926 and 1993, according to a study by the University of Michigan for Towneley Capital Management, 99% of the stock market's gains occurred during the best 48 months — less than 6% of the total time period.

The Michigan study shows a $1 investment kept in the market for the entire 68-year span would have grown to $637.30. But for the investor who missed just 12 of the best 48 months, the return drops to $65. And someone unlucky enough to miss all 48 peak months would gain just $1.60 on the dollar, after nearly seven decades of investment!

It's interesting to note, historically, the market's biggest gains have tended to follow right on the heels of bear markets. So anyone who is on the sidelines waiting for a market recovery has to jump back in at precisely the right time or risk missing the upswing.

It's easy to see why market-timing has failed even the smartest professional money managers. Based on his research, Nobel Prize-winning Economist William F. Sharpe concluded, "...a manager who attempts to time the market must be right roughly three times out of four, merely to match the overall performance of those competitors who don't."

Sharpe points out that market-timers who mistakenly predict a bear market have more than one problem. Not only do they miss out on positive returns, they pay transaction costs for making the wrong moves. And even if they guess right, they're stuck paying taxes on their trading profits. Add it all up and it's easy to see why buy-and-hold investors have a clear advantage over those who try to outmaneuver the market.

It's only human nature to want to time the market, and many investors will continue to try, despite all evidence they will never succeed. But on Wall Street and among institutional investors, the consensus is clear: *It is time — not timing — that makes you successful in the market.*

"The idea that all wealth is acquired through stealing is popular in prisons and at Harvard."

George Gilder
Wealth & Poverty

Letting Emotions Drive Investment Decisions

"There are only two emotions on Wall Street: Fear and Greed."

Anon

Most of us encounter strong emotions when dealing with money issues — and understandably so. Not only can money have a lot to do with our feelings of success, security and self-worth, it can have a huge, tangible impact on our lives. Money can give us experiences, freedom and the ability to choose the kind of life we want.

The trouble comes when emotions are the unseen driver of investment behavior, distorting perceptions and sparking reactive, short-term decisions that end up being counterproductive.

For instance, irrational fear is usually the force behind a classic investment mistake: Directing your manager to sell all your stocks *after* the market takes a plunge. Those with cooler heads and a longer view know this actually may be the time to commit more money to equities.

Emotions also may keep investors boxed into unrealistic investment frameworks. Some, hindered by a Depression-era mentality, put all their money into bonds. By investing so conservatively, they let inflation eat away at their principal.

Others, propelled by ego or an unquenchable desire to "get rich quick," search out super-aggressive growth managers, ignoring the fact higher returns almost always mean higher risks. In between are all shades of investors who let their feelings guide their actions, often without even realizing it.

If you truly want to take control of your financial destiny, you must make sure emotional reactions such as anger, impatience, denial, procrastination and panic don't lead you astray. How do you guard against that? By having a logical, well-thought-out investment game-plan; one you genuinely believe in and to which you are willing to commit, long-term.

Once you've developed a sound plan, you've already gone through the process of understanding the market's historical patterns, setting realistic goals and crafting a strategy that takes market cycles into account. You also have gained the perspective you need to avoid dangerous, knee-jerk reactions when the market takes a nosedive. Having tempered destructive emotions, you'll have the confidence and the patience to stick with your original plan.

"Money doesn't always buy happiness. People with ten million dollars are no happier than people with nine million dollars."

Hobart Rowan

This is not to say that investing should be mechanical and devoid of all emotion. Certain types of emotions are valid — even critical — in shaping your investment plans: What you want money to do in your life, how wealth ranks in your scheme of things, how you feel about risk — all these questions deserve thoughtful exploration.

In short, emotions *do* have a place in investing — so long as they don't occupy the driver's seat!

Ignoring The Biggest Risk of All

"I've got all the money I'll ever need if I die by 4 o'clock."

Henny Youngman

Ask affluent investors to name their biggest investment risk and most will tell you it's the chance of losing principal. But for all except the very wealthiest of us, loss of principal isn't the biggest risk. Much scarier is the risk we won't accumulate enough capital and we'll outlive our money.

If you have an income of $250,000 or more a year, a good-sized investment portfolio and a comfortable lifestyle, you may feel financially secure. These days, though, being at all complacent about the future is a mistake. To maintain your accustomed standard of living through your retirement years, you may need a far bigger pool of capital than you think.

Survey after survey shows that when it comes to retirement planning, most Americans are in serious need of a reality check. We tend to:

Underestimate how much income we'll need
Although your mortgage may be paid off and your children through school, other types of expenses — health care, medical insurance, travel and taxes — are likely to rise. Many people think they can retire comfortably on 60% or 70% of their previous income, but 80% or 90% is more realistic.

Forget how long our money might have to last
Life spans are growing longer with each generation, which means you could be drawing on your retirement savings for 20, 25 or 30 years, and not just the 15 years often assumed to be the norm. Even today, with the first baby boomers just turning 50, the fastest-growing segment of the U.S. population is 85 and older.

Assume we'll stay healthy
With rising medical costs and declining insurance benefits, one serious illness can mean a huge financial setback. The cost of chronic ill health can be devastating. The Brookings Institute calculates that by the year 2020, the cost of a year in a nursing home will exceed $150,000. And it's estimated at least one in five of today's workers will eventually need long-term care.

Save much less than we should
The U.S. savings rate has dropped from 11% of income in the 1950s to less than 5% today — about one-third the rate usually recommended for retirement saving.

So how much money do you really need to retire? For the affluent who want to maintain their lifestyles, the figures are staggering. A 45-year-old earning $250,000 today will need $2.5 million in investable assets to retire in 20 years without scaling back on his or her standard of living — and that's before inflation. Figure on an inflation rate of 3.5% and the sum rises to $5 million.

The upshot is unless you're in the same financial league as Bill Gates, Warren Buffet or Gordon Getty, you need to plan for steady growth of your assets — not just preservation of capital and a decent return on your money.

Ironically, some investors try to gain security by putting their assets into "safe" investments such as CDs, T-bills or bonds. Those with such a conservative asset allocation mix may *feel* protected, but that's strictly an illusion. Within 20 years, these assets will lose one-half their purchasing power, assuming the cost of living rises only 3.5% a year. With inflation gnawing away at their security, seemingly risk-averse investors have really only traded one risk for another — the risk of outliving their money.

If you don't get high enough investment returns to build the retirement capital you'll need, you only have a few alternatives: Pump up your earnings, save enough to offset the low yield on your investments, or keep working until you're 70 or 75. One thing is certain: Keeping most of your assets in CDs or bonds could prove to be the riskiest course you can take.

Expecting Any Manager's Investment Approach to Work All the Time

"WALL STREET GURU: SOMEONE WITH A HIGH DEGREE OF SELF-DELUSION AND A STRONG BULL MARKET."

JOHN KENNETH GALBRAITH

In every field of human endeavor, a handful of especially gifted people always stand out from the crowd; investment management is no exception. A few industry giants, such as Warren Buffet, John Templeton, Peter Lynch and John Neff have proved it *is* possible to beat the stock market by a solid margin over time.

These investment superstars have at least two things in common: Each has a distinct, well-articulated philosophy about how money is made in the market. Equally important, each has the conviction to stick with that philosophy through thick and thin.

Completely attuned to their own special brand of opportunity, these celebrated managers cut through the noise, confusion and conventional wisdom to unearth truly outstanding investments. They believe in and apply their disciplines confidently and consistently, no matter what signals the market may give. That constancy is the ultimate secret of their success.

But even these renowned managers, with their documented records of exceptional performance, endure periods when their approaches don't work. When that happens to one of these managers, it's not because he's suddenly "lost his touch" or "turned dumb overnight." It's because the market doesn't favor his particular approach at that point in time.

The market isn't a machine that moves in regular, predictable patterns. It's an ever-changing mosaic that can be approached successfully in many different ways. If one approach were clearly superior, everyone would quickly embrace it, and it would inevitably lose its advantage.

Experienced managers know it is critical that they adhere to their chosen investment approach — and by doing so, they are sure to encounter times that severely test their mettle.

While management philosophies differ in many ways, nearly every approach is a variation on one of two fundamental "styles" — *growth* investing and *value* investing. Each style has its pluses and minuses.

Growth managers focus on companies with superior prospects for earnings and expansion.

These are often exciting, innovative companies with leadership positions in their markets — companies whose stocks can soar if conditions are right. The problem is recognized growth stocks typically are priced at a premium and can quickly drop in value if they don't meet the market's high expectations. So it's not surprising growth managers make big gains when they do well, but also sustain big drops during difficult times.

Value managers, in contrast, favor companies that are selling below their intrinsic worth.

These may be companies that are in a temporary slump, possess hidden assets or are in mature industries unappreciated by Wall Street. Value investing can offer the advantage of limited downside risk; some value stocks are priced low enough that they are unlikely to sustain a sharp decline, even if the overall market drops. The disadvantage is the investor may have to wait a seemingly interminable period of time for the market to recognize that value.

In comparison to growth managers, value managers don't experience the same highs, but typically do much better during down markets.

Market analysts have tracked results of these two styles over the years and their findings should interest every investor:

- **No one style offers a clear performance advantage**
  For all the differences in growth and value styles, and all the short-term volatility of their results, their long-term performance has been remarkably similar.

Styles work in extended, unpredictable cycles

No style does well all the time. In fact, one may prevail for two to five years before market conditions change and the other holds sway. Historically, growth and value styles have performed in definite and opposing cycles. But as with any kind of market-timing, it is virtually impossible to predict when a style will move in or out of favor.

Style usually determines short-term performance

This link is so strong that when the market favors a given style, all competent managers practicing that style will do well, and some will do exceptionally well. By the same token, when a style is out of favor, virtually all managers who adhere to that style will suffer to some degree. Whenever a manager's performance diverges sharply from that of the overall market, investment style is usually the explanation.

With the insight that *style drives performance*, one can safely assume that which manager you choose is much less important than which style you choose. Next to asset allocation, the style choice may be an investor's most important decision.

So what is an affluent investor to do? The dilemma is the style question has no right or wrong answer. It's really a matter of what gives you the comfort level you want.

On the one hand, you can pick one style and stay with it. Some investors simply aren't comfortable with the volatility of growth stocks; others don't have the patience for value stocks. And it's true that, historically, the ups and downs of each style's performance have evened out over the long term. But if you go with only one investment style, you'll need the fortitude to stay with it during long periods when it is out of favor. You also will need to diversify in other ways.

> "I've learned that when a man with money meets a man with experience, the man with the experience ends up with the money and the man with the money ends up with the experience."
>
> *As quoted in* Forbes *Magazine*

> "If Karl, instead of writing a lot about Capital, had made a lot of Capital, it would have been much better."
>
> Karl Marx's Mother

Your alternative is to diversify between growth and value styles to spread your risk and increase the stability of returns. Institutional investors often take style diversification to an extreme, spreading assets across the gamut of style subcategories and niche approaches. The pension fund of a large U.S. corporation may have as many as 20 distinct investment styles in its portfolio.

That level of diversification simply isn't practical for individuals. Indeed, *overdiversifying* can create a whole new set of problems, including higher expenses, more complicated oversight, fragmenting of returns and loss of focus on your investment objectives.

Another danger is that your "diversified" stable of managers may actually be similar in style. In that case, you get only the illusion of diversification without the benefits.

For affluent investors who want equity style diversification, a common-sense approach might be to have just three or four managers — one value, one growth, an international manager and perhaps a small-cap or other specialty manager to round out the mix. The right combination isn't the one suggested by research studies or statistics. It's the one that feels most comfortable to you.

When you recognize that style drives performance and that you can't expect any manager to shine all the time, the whole job of working with investment managers — indeed, the whole process of advancing toward your investment goals — becomes much easier.

Hiring Managers Solely By the Numbers

"MORE MONEY HAS BEEN LOST SEARCHING FOR YIELD THAN AT THE POINT OF A GUN."
RAY DEVOE

If you want to know how *not* to hire an investment adviser, take a lesson from the way small investors typically select mutual funds: They pore over the Morningstar ratings, *Forbes* Honor Roll and *Business Week* lists, and choose from the top-performing funds. Then, with the nation's hottest funds in their portfolios, they go on to earn impressive returns, right?

Wrong. The fact is investors who buy into top-performing mutual funds often don't make much money, and may even lose. Long known to the industry, this syndrome repeatedly has been brushed under the rug. But recent studies have brought it into new light.

Morningstar itself was commissioned by Zweig Mutual Funds to study how much investors profited from investing in growth stock funds. Their findings: Although a group of 219 funds earned an average of 12.5% annually over a five-year period, those who invested in the funds *actually suffered losses* averaging 2.2% annually over the same period.

How is this possible? Because small investors typically jump onto the bandwagon *after* a fund has already made a big upward move and then jump back out when returns slump. Not only do they miss most of the fund's gains, they take the brunt of its losses.

Other studies have examined the long-term performance of funds on the *Forbes* Honor Roll, which highlights funds that ostensibly have performed consistently through good times and bad. Princeton University Professor Burton Malkiel found that someone purchasing all the *Forbes* Honor Roll funds each year since 1974 wouldn't have even matched the performance of the S&P 500. John Bogle, former chairman of the Vanguard Group, documented similar conclusions. In his book, *Bogle on Mutual Funds*, he reported that between 1974 and 1992, Honor Roll funds returned 11.2% annually as opposed to 12.5% for the average stock fund and 13.1% for the Wilshire 5000 Index.

Yet it makes perfectly good sense that such investments would prove disappointing. To put it simply, *the past isn't prologue*. As even the magazines and research firms who publish fund ratings will acknowledge, past performance is no predictor of future success. Other things being equal, this year's top-performing fund is no more likely to get stellar results next year than a fund that did poorly.

It all goes back to the laws of probability and the cyclical nature of the market. At any given time, a few of the 5,000 mutual funds available today will have truly spectacular results. Their success stems, to a large degree, from how well their investment strategies and styles fit current market conditions. Studies suggest that market movements account for as much as 80% of the performance of most funds.

Over time, however, equity funds typically earn a return close to that of the stock averages (less management fees and trading costs). And it's almost impossible to predict which hot-performing funds will continue their winning streak and which will drift back toward the return of the average fund (what statisticians term "regression toward the mean").

So if you're an affluent investor, what does all this tell you about hiring an investment adviser? First and foremost, you don't do it from performance rankings, but neither do you throw the numbers away. Performance *is* important, but it has to be put into context. Also, you should give as much weight to *qualitative* factors as you do performance. If you heed the typical mistakes of small investors, you'll never hire a manager based on numbers alone because there's a better way:

- **Decide what investment style you're looking for**
  Because style is the driving force behind performance, starting with the style decision is essential to your overall investment results. It also helps you operate with more realistic expectations. If you know you're hiring a growth manager and growth stocks plunge in value the next quarter, you won't be so shaken when your manager's performance drops too.

Look at past performance of managers who adhere to that style

That's the only way you can get valid comparisons of performance. Then you can use those numbers to eliminate managers from consideration. Successful managers abound, so why consider one who hasn't done well?

For managers on the short list, insist on a long-term record

Seven to ten years is probably a good *minimum*. It takes about that long to see how a manager has performed under varying market conditions. So what about a new, up-and-coming firm with an intriguing story to tell? If you feel comfortable with the firm and its approach, you might want to take a small risk on an unproven manager just to make things more interesting. But put the serious money with established firms that have proven themselves over several market cycles.

Research the qualitative factors that shape future performance

In evaluating successful managers, you're looking for *repeatability.* You want to know what's been behind the firm's success, and the likelihood that it can replicate that success:

- Are the portfolio managers who built the firm's track record still making the investment decisions?
- Does the firm have a sound investment philosophy, and is that philosophy carried through in its portfolios?
- Is the investment process well-defined and consistently applied?
- How stable is the organization? Has it been gaining or losing major clients? If so, why?
- How fast is the firm growing, and does it have the resources to keep pace with the associated demands?
- Were the manager's strong returns the result of skill or luck?

Let personal chemistry guide you to a final decision

When you hire a manager to invest substantial sums of money, you're entering into an important personal relationship. That's much different from simply buying a mutual fund. Like a good marriage, a successful manager/client relationship is one founded on trust, clear communication, a strong sense of rapport and a high level of comfort. These intangible qualities are crucial to help you stay with a manager through the tough times you're bound to encounter sooner or later.

> "If you would know what the Lord God thinks of money, you have only to look at those to whom He gives it."
>
> Dorothy Parker
> *The Paris Review Interviews*
> First Series 1958

To make good hiring decisions, you need a logical approach, the willingness to spend some time at it and the perspective to weigh factors carefully. You can take the mystery out of the process once you have the insight to know what not to do.

GETTING CAUGHT UP IN THE RELATIVE PERFORMANCE GAME

"IT'S BETTER TO BE APPROXIMATELY RIGHT THAN PRECISELY WRONG."

ANON

Traditionally, large tax-exempt investors — corporate pension funds, foundations, endowments and Taft-Hartley funds — have measured performance of the managers they've hired against market indexes such as the S&P 500, the Russell 2000 and the Wilshire 5000. Not surprisingly, many individuals assume they ought to measure their investment results the same way.

Indeed, it's always gratifying to learn your portfolio has outpaced the S&P 500, or your bond fund was up 8% when the Lehman Brothers Government/Corporate Bond Index showed 7% returns. But while this stimulates good feelings and cocktail-party chatter, it is really quite irrelevant to an affluent individual.

Much more important to know is how well your investment program is doing *in relation to your personal goals*. Your results may look great against market benchmarks, but still fall short of the asset growth you've targeted. Rely too much on relative performance measures and you may be lagging your goals without realizing it. But that's not the only downside to the relative performance game.

When you get caught up in tracking how well your investments are doing relative to everyone else's, you can easily become fixated on short-term results. Poring over performance comparisons also breeds anxiety because there's always *someone* you're not keeping up with. And if you try to "fix" things by firing an underperforming manager and hiring one with better numbers, you'll probably end up making a classic mistake: "buying managers high" and "selling them low."

The real problem is that individuals who get into the relative performance game want to play it only part of the time. They want to beat the indexes when the market's going up, but they don't want to lose *any* money when the market tumbles. Unfortunately, you can't have it both ways.

For large institutions, an emphasis on relative performance is understandable. It's only natural that a numbers-oriented corporate treasurer, accountable to senior management and a board of directors, would want lots of data to support his decisions and to show he's done at least as good a job as his peers, whatever the results. Someone in that position can honestly tell his CEO, "You'll be *delighted* with our investment results this year. The market's off 18%, but our portfolio is down only 15%."

For affluent individuals who know intuitively the difficulty of recouping a loss, negative returns can never be good news. For instance, if your annual return objective is 10% and your portfolio loses 5% in year one, you'll have to earn 27.4% in year two to stay on track. Lose 10% and in year two you'll have to get a 34.4% return!

If you're an affluent investor, it's critical that you stay on top of your investment performance. But make sure you do it the right way:

- **Measure performance of your total portfolio against your targeted goals**
  Good relative performance won't pay the mortgage or college tuition when the market is down. If you have a $1 million portfolio and want it to grow to $3 million over the next 15 years, you need to know, in quantified terms, exactly how you're tracking against your required rate of return. If you have multiple managers, it's important to know each manager's results, but much more important to know how your portfolio is doing overall.

- **Always look at after-tax returns**
  When you factor in taxes, a seemingly sound investment can quickly turn sour. A good example is a mutual fund that trumpets high, double-digit returns, but never discloses what share resulted from short-term trading profits vs. long-term capital gains. A good investment adviser will tailor a client's portfolio for tax-efficiency and design investment strategies to maximize after-tax returns.

Don't forget to take inflation and expenses into account

For the affluent individual, total "real" investment return — what you net after inflation, taxes and all expenses — is the one number that really counts. In fact, you should state your investment objectives in precisely those terms.

Compare segments of your portfolio against the appropriate style benchmarks

Market indexes do have their place: Helping you to view managers' performance in a more realistic light. When a manager is out of step with the overall market, but you know he or she is matching other managers with the same style, it gives you the confidence you need to ride out an adverse cycle. By the same token, if you find your managers are performing well against style benchmarks, but your overall returns are below par, that tells you it's time to revisit questions of asset and style allocation. Ideally, you should evaluate each manager's results with a yardstick you've both agreed upon in advance.

Recognize the level of risk associated with your returns

Because higher risks usually accompany higher returns, always judge results on a *risk-adjusted basis*. And remember that achieving consistent, above-average performance will move you steadily toward your goals, while an investment that's showing superior short-term results may not deliver over time. That's why every affluent investor must make a choice: Do you want *consistent* performance or *spectacular* performance? No manager can deliver both. In most cases, consistency is the wiser choice.

All investors need to track progress toward their long-term goals — preferably on a quarterly basis. This discipline functions, first of all, as a reality check. Unless you quantify the progress you're making, you may miscalculate your returns. It's human nature to remember the one or two investments that scored big gains while forgetting those that disappointed.

> "GENTILITY IS WHAT IS LEFT OVER FROM RICH ANCESTORS AFTER THE MONEY IS GONE."
>
> JOHN CIARDI

> "A FOOL AND HIS MONEY ARE INVITED EVERYWHERE."
>
> *Sign outside* WARREN BUFFET'S *office*

Regular investment reviews help you recognize any need for midcourse corrections in your plan. If your investment results are off-track, it may be time to adjust your long-term strategy, or make tactical shifts in response to short-term conditions, or increase your rate of savings — or all the above. A change in your career path or life goals may be another reason to modify your investment program.

Monitoring results is also important for another reason: To help you stay with a long-term program. By continually reassessing and strengthening your investment plan, you build the resolve to stay the course during difficult times. You may even gain the confidence to add to your portfolio, at favorable prices, during those turbulent times when less stalwart investors bail out.

By measuring performance against your personal objectives and not just against the market, you'll know where you're going and how quickly you're getting there. Both pieces of information are vital if you want to reach your goal in time to enjoy it.

NOT KNOWING WHEN TO FIRE A MANAGER

"I NEVER MET A DERIVATIVE I DIDN'T LIKE."

R. CITRON

When it comes to termination, investors frequently err in two ways: By firing managers they should keep and by keeping managers they should really let go. When affluent individuals make either mistake, it's usually because they made a decision "by the numbers." But it doesn't always make sense to fire a manager whose performance has slipped, or to keep one whose results have been good.

Instead of automatically terminating a manager with poor performance, first find out what's *behind* the disappointing results. For instance, a manager may be getting mediocre returns because his investment style is temporarily out of favor. Fire him now and you'll miss the rebound in performance when the style cycle shifts. Or you might have a "defensive" manager sitting on large cash reserves because of a speculative market environment. His near-term performance may suffer, but if you drop him for a more aggressive manager, you're inviting trouble when the market inevitably cools.

Conversely, sometimes a manager should be fired in spite of good performance. If you see warning signs of organizational turmoil, a slackening of investment disciplines or other kinds of trouble ahead, you should be prepared to take action *before* your portfolio suffers. Consider it a "red flag" whenever you see:

- A change in investment style
- Portfolios or results that don't reflect the manager's stated strategy
- An exodus of key professionals
- A big increase or reduction in assets under management
- Repeated violations of a "sell discipline"
- A new portfolio manager on your account
- A wide disparity in performance results from accounts with the same objective
- Continued operational or back-office problems
- The loss of a flagship account
- A rash of legal or regulatory problems
- An abrupt drop-off in client communication
- High turnover of marketing personnel
- A flurry of new product offerings
- A big increase in the number of accounts per manager
- Portfolio managers spending more time marketing than managing money
- The senior partner buying a personal jet or a third vacation home
- The chief investment officer's golf handicap dropping dramatically
- The name on the door changes

Of course, sometimes performance *is* a valid reason for terminating a manager. If a manager has had two or three years of mediocre returns compared to others following the same style, or has consistently underperformed the market for more than three years, or has gotten truly terrible results for a year or two, it may be wise to cut your losses.

There may even be times when you decide to fire a manager who has done a good job, such as when your investment goals have changed. For example, as time goes by your investment focus may shift from long-term growth toward maximum current income, requiring you to move assets from one manager to another.

Generally, it's not a good idea to change managers too frequently or too quickly. It takes time to become comfortable with a manager and it can also take time for managers to prove their worth. You should hire a manager only after careful research and thoughtful deliberation. The decision to fire a manager should be made in exactly the same way.

NOT HAVING AN INVESTMENT MANAGEMENT CONSULTANT

"ADVICE IS WHAT WE ASK FOR WHEN WE ALREADY KNOW THE ANSWER BUT WISH WE DIDN'T."

ERICA JONG

Having read this far, you may be wondering how you or any other busy person is supposed to develop an investment plan, create an asset allocation strategy, select managers, monitor and evaluate results and accomplish all the other things this business of investing entails. It has become a dauntingly complex endeavor and is getting more so all the time.

For many affluent investors, the solution has been to seek the help and expertise of an experienced, knowledgeable investment management consultant. If you're in the market for a consultant, it's important at the outset to understand a consultant's role and to recognize exactly what a consultant can — and cannot — do for you.

For starters, an investment management consultant doesn't manage your assets. Rather, he or she helps you create the *strategic framework* that is essential for the successful management of your assets.

Neither is a consultant the same as a financial planner, who typically offers a broad-brush perspective on a range of money issues, such as insurance matters, budgeting and estate planning. A consultant's background, expertise and advice are focused on one area — investments.

And consultants are quite different from traditional stockbrokers, although some excellent consultants can be found within brokerage firms. A consultant isn't in the business of selling investment products. He or she is in the business of providing independent, objective advice to help your investment program succeed.

Exactly what kind of help does that entail? A good consultant will guide you and work with you in a logical, step-by-step process of developing and executing a sound investment plan. Specifically, an investment management consultant can help you:

- **Analyze the past performance of your investment portfolio** — not just how well individual managers and funds have done, but how well you have done overall.
- **Thoroughly assess your investment needs**, including tax considerations, current income and future capital requirements.
- **Come to grips with your true tolerance for risk.** Until they suffer big losses, people tend to believe they're more risk-tolerant than they really are.
- **Strike a realistic balance between risk and reward** so that your expectations are within the realm of probability, based on historical investment returns.
- **Resolve family issues** from spending habits to inheritance.
- **Address such issues as active vs. passive management** (indexing), domestic vs. international stocks and bonds, number of managers, etc.
- **Test varying asset allocation mixes against your goals** and arrive at a strategic level of diversification among asset classes and investment styles.
- **Simulate the likely best- and worst-case scenarios of any given asset and style allocation mix**, so you're better prepared for the unexpected.
- **Explore the use of futures and options**, short-selling, commodities and hard assets.
- **Determine the quality and duration** of fixed-income investments.
- **Gain control over scattered assets**, consolidating investments and eliminating unsuitable vehicles.
- **Interview and hire suitable managers** based on a set of selection criteria tailored to your personal needs, temperament and biases.

- **Look critically at manager fees or trustee arrangements** and, when appropriate, negotiate more reasonable terms.
- **Measure individual managers' results** as well as total portfolio returns against the right yardsticks.
- **Decide when to fire a manager** who isn't giving you the results or the service you want. (Don't hold your breath waiting for a manager to tell you, "I've done a lousy job; you should fire me").
- **Monitor the entire investment process** — including income flows, savings, cash needs and investment returns — and identify potential trouble spots.
- **Make tactical shifts in your investment plan** when warranted by changing economic conditions.
- **Make major strategic revisions to your plan** if your needs, goals or circumstances change.
- **Keep your emotions in check** during turbulent times.

Finding someone with the experience, the objectivity and the critical judgment it takes to handle all these tasks isn't easy. Like money managers, consultants are found in different varieties and different places. They may work in a small, independent firm or a major Wall Street brokerage house, in a regional brokerage or a large, diversified accounting firm. But hiring a good consultant isn't a matter of going to the right firm, or even the right kind of firm. It's a matter of finding the right person for you.

It may be tempting to take the path of least resistance and look to an old school friend or golfing buddy who is "in the business." Alternatively, some affluent investors rely on a traditional broker, a family attorney or their tax adviser for investment counsel. If you have good people functioning in these roles, you certainly want them on your team. But if you have substantial assets, your investment program should be quarterbacked by a *senior consultant* — someone whose training and experience focuses on one major role — helping you do a better job of *managing your managers*.

A senior consultant is someone who:

- Has a strong investment background — as distinct from a successful sales background — with enough experience to have been through several market cycles
- Demonstrates impressive analytical thinking
- Has a high degree of personal integrity
- Is dedicated to giving you sound, objective advice, rather than selling you something
- Creates the comfort level you need to be completely open and honest about your life goals and investment needs

With this combination of qualities, a senior consultant is able to play the variety of roles the job requires — mentor, confidant, educator, sounding board, referee and advocate, as well as be a source of wise and thoughtful counsel.

Don't expect a consultant to guarantee that you'll always beat the market, or that you won't encounter some reversals along the way. But a consultant *can* help you avoid the big mistakes that affluent investors all too frequently make on their own. Even if a consultant did nothing else,that benefit alone is invaluable. A good consultant can also help you make better choices, achieving incremental returns that, with compounding, will mount into substantial dollar gains over time.

> "ANOTHER ADVANTAGE OF BEING RICH IS THAT ALL YOUR FAULTS ARE CALLED ECCENTRICITIES."
>
> ANON

Of course, no consultant, no matter how dedicated, can or should take over your role as the ultimate decision-maker. That responsibility belongs to you and you alone. But with the right kind of advice, you'll be better equipped to make the critical decisions necessary to reach your goals.

~~~
~~~