

Quality Asset Management

Grow Your Wealth with Peace of Mind

Is Your Money Invested Responsibly?

By Gil Hanoch, July 20, 2004

Whether you are trying to pick the right stocks at the right time or buy indexes and hold on to them for many years - you want to invest responsibly.

Whether you are looking for aggressive investments or preserving your money for current income - you want to invest responsibly.

This article presents a few things to consider when reviewing the way your money is invested. Needs may vary for different investors. Please consult an investment advisor and a tax specialist about your individual needs.

1. **Diversification:** Are your investments diversified among a large number of stocks of different sizes, industries and countries? Individual stocks can lose all their value if a company shuts down. It is less likely that thousands of stocks all over the world will be wiped out at the same time. Adding stocks with low correlation to your existing holdings can reduce your risks, while increasing the overall returns. This makes it one of the most important investment considerations.

It is important to diversify globally for any required level of risk or returns. As little as 5% invested in different size companies in international and emerging markets, can improve the long-term returns of your US portfolio, while reducing the overall risk. Beware that the risk will start going up, as the relative portion of the international investments grows compared to the US portion.

Bonds are important for reducing the risk of your investments, as they have low correlation with stocks, and have lower risks and returns over the long run. Note that bonds are not a risk free investment, and they might underperform inflation or even lose value at certain times. This makes diversification of bonds very important.

2. **Fees:** Investments involve paying many types of fees to various people. Some are clear and some are hidden very well. If you are using an investment advisor or a broker for managing your investments, it is your right to get a list of all the fees you are paying, in full detail. Some of the most common fees include:
 - ❑ **Transaction cost:** The fee you pay for every purchase or sale of a stock or a mutual fund. Some brokers charge 20(!) times more than others. This fee also depends on the number of transactions made. Try to calculate your annual fees as a percentage of your account value.
 - ❑ **Spread:** The difference between the buying and selling price of a stock. This is one of the most overlooked costs. The easiest way to reduce this cost is to trade less. Another way is to use mutual funds that can obtain highly discounted prices by trading large amounts. This is most significant in small stocks, where spreads average 3%-4%.
 - ❑ **Expense Ratio:** Percentage of your investments charged by mutual fund companies. This number will usually vary between 0.1% for low

cost index funds and over 2% for expensive actively managed mutual funds.

- Asset Turnover: Percentage of mutual fund holdings that are sold on average every year. This is not a direct fee, but it affects your taxable gains. Lower turnover means more time for compounding of gains before paying the taxes.
 - Account management fees: Yearly fixed amount or percentage of the account value that is charged by your broker.
 - Investment Advisory fees: Percentage of your money charged by investment advisors. Usually varies between 1% and 3%.
3. **Risk:** Do your investments reflect the risks you can afford to take? Here are a few guidelines that should apply to any investor:
- At all times, you should keep enough money to live off for 3-6 months, in case you lose your job or other sources of income.
 - If you will need your money in the next 3 to 5 years, keep it outside the stock market. For investments that are not highly diversified globally, this period becomes longer.
 - Construct a portfolio that is not likely to go down to levels that will keep you up at night. Worse than the stress it could cause is the risk of selling right after the portfolio went through a long down cycle. Note that one stock may never go up, but a portfolio that is highly diversified globally is more likely to go back up.
4. **Taxes:** Taxes can take a large bite out of your gains. The higher your tax bracket, the more important these considerations are for you.
- Depending on your needs, consider putting the volatile investments that generate high taxable gains in your retirement accounts. You will enjoy deferral of higher taxes, and higher expected returns in your long-term accounts, compounding the effect of tax-deferral.
 - Minimize short-term sales of stocks (within one year). The rate of taxes on gains will drop from your regular tax bracket to the long-term gains taxes (currently 15%).
 - Buy tax-managed mutual funds. These are mutual funds that minimize short-term gains.
 - Compare the yield on municipal bonds with taxable bonds (after considering taxes), and if better, buy some of them for your taxable accounts.
5. **Number of transactions:** There are many reasons to minimize the number of transactions. Here are a few:
- Transactions cost money. You pay twice: transaction cost, and the spread between the buying price and the selling price.
 - Sales of stocks result in capital gains (in taxable accounts). If sold within one year, the taxes can be double or more. If held for many years, the gains compound over and over before being taxed. This can drop your effective annual taxes dramatically.
 - Whenever you sell a stock in order to buy another one, you might think that the other stock is likely to appreciate in value more than the original stock. You are paying a very big price to make this move (transaction costs, price spread & taxes). Statistics show that most

money managers are not able to beat the market return (S&P 500). Make sure you are one of those who are able to consistently predict the market faster than others by a wide margin that makes up for all the costs.

6. **Rebalancing:** Whenever your portfolio is out of balance by a certain percentage, sell and buy stocks/mutual funds to balance the percentage of each of them back to your target allocation. One option is to choose 25% deviation of any holding from its target, so a 4% allocation of the portfolio growing to 5% or dropping to 3% would call for rebalancing. A good practice would be to check the portfolio once a quarter. It is best to check the need for rebalancing no less than once a year.

Following is the main reason to rebalance: Certain holdings tend to change in value at a different pace than others. A common phenomenon is that riskier holdings tend to grow more for the long run. This causes more of your portfolio to be invested at high-risk stocks, causing your whole portfolio to become riskier. Whatever asset allocation you chose, you do not want it to become riskier without your explicit control.

It is important not to rebalance holdings to the original allocation when transaction costs end up being a significant percentage of the sale or purchase amount. Rebalancing requires careful judgment.

7. **Investment Plan:** Whether you work on your own, or hire an investment advisor, you should always operate based on a written plan (sometimes called investment policy). This is another one of the most important things to do, for the following reasons:

- It makes you think things through. You go through your financial situation, time horizon, risk tolerance, and carefully build a portfolio to reflect these factors. You cannot afford to invest your life's savings without a well thought out plan.
- The plan serves as a reference document for rebalancing actions. You should not redefine the allocation whenever you rebalance, unless something in your situation changed in a way that should affect the portfolio.
- A very important reason: it will help you avoid selling a part of a diversified portfolio after the market goes down and buying after it went up. The buy-high sell-low problem is one of the biggest reasons that investors give up so much of the returns that are there for them to take.

Make sure to update the investment plan whenever any factor in determining the investment portfolio changes.

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