

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## **Are You Paid Enough to do Nothing?**

*By Gil Hanoch, August 7, 2005*

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Are your investments having the right impact on your life? This is a critical question that any investor should ask, because investments can make you rich or poor, peaceful or stressed, work hard or get effortless gains.

If you answer any of the following questions with a “yes”, this article is for you:

1. Is the long-term performance of your investments less than 15% per year?
2. Are you spending more than a few hours per year dealing with your investments?
3. Do you ever get nervous about your investments?

This article provides ideas for achieving the goals implied by these questions.

### **Is the long-term performance of your investments less than 15% per year?**

Most investors don't even match the returns of the S&P 500, which averaged less than 11% since 1970. If this is true about you, you are like most investors, including most professionals.

By putting all of your money into one mutual fund in 1970, you could have achieved more than 11%, outperforming most investors in the US! All you had to do is a single transaction, buying a US Large Value Index mutual fund.

If you had diversified your investments into large and small stocks all around the world and held them from 1970 until 2007, you could have crossed the 15% annual returns. This is using a naïve split of the money equally between the following indexes: US Large Value, US Small Value, International Value and Emerging Markets Value<sup>1</sup>, and rebalancing annually.

### **Are you spending more than a few hours per year dealing with your investments?**

Our intuition says that if we study the market well enough, we can perform better than the average. History showed us repeatedly that people cannot consistently get larger gains by choosing certain stocks or timing the transactions. There are many reasons for this, including:

1. Higher costs in many forms:
  - a. Mutual fund fees. Hedge funds are at the extreme end of the spectrum by charging both a percentage of the money managed and a significant percentage of your gains!
  - b. Broker and investment advisor fees.
  - c. Increased trading costs compared to a buy-and-hold strategy in terms of transaction costs, broker fees (bid-ask spread), taxes that are less deferred and short-term gains.

In order to beat the performance of buying and holding index funds, you have to make up for all the extra costs.

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<sup>1</sup> Returns include simulated data before fund inception. See [Performance Data Disclosure](#).

2. We are emotional about investments in many ways.
  - a. We believe in and invest in what we know, even when it's not the best investment. The most heartbreaking cases I've seen were related to investing large amounts in an employer's stock.
  - b. We buy after large increases when stocks are expensive and sell after large declines, when stocks are cheap. This happens because we expect the recent past to continue, instead of studying the long-term behavior of the portfolio.
  - c. The most prevalent mistake I have seen is going after promising investments, not considering the current price. Today's best example is real estate.
3. When concentrating on fewer stocks or countries, you cannot afford to include risky companies, since they are more likely to go bankrupt. This is a big loss since, as a group, they grow faster than average.

By sticking to the simple portfolio of index funds mentioned above, you limit your work to rebalancing.

## Do you ever get nervous about your investments?

Investments can cause stress in many different ways, usually during long and steep declines. You start by asking yourself, "When is my portfolio going to recover?" As time passes, you ask, "Is it going to recover? Can it make up for all the declines, and continue its long-term growth?"

What mistakes can lead to this?

1. **Concentration.** By buying only a few stocks, or stocks that are concentrated in one sector, country or region, you can see your portfolio crash hard and long. A couple of examples are:
  - a. Investment in the Nasdaq in early 2000, led to declines of over 80%. More than 5 years later, we still saw 60% declines!
  - b. Individual stocks got completely wiped out, resulting in 100% irreversible losses of investments.
2. **Individual stock selection and market timing.** As mentioned above, our intuition leads us to believe we can do better by selecting our stocks and timing our transactions. Since it doesn't always work, we get nervous about the negative outcomes.
3. **Lack of history.** If you don't know how your investments reacted to world events in the past, you can't know what they would do in the future. Even if you do know what they did, but you change the composition of your portfolio over time, you change the potential future.

## How can you avoid stress, and even increase your peace of mind over the years?

1. **Diversify!** By buying more companies of some group (e.g., International Large Value), the average expected growth does not change, but the magnitude and length of declines decreases. In fact, when you hold thousands of stocks, you can afford to put a portion in various emerging markets and less mature companies. Your long-term returns increase, and the decline periods shorten, because some of the stocks go up while others go down.
2. **Invest in Index Funds.** There are numerous advantages to this choice:
  - a. Index Funds can help you diversify your money into thousands of companies all around the world.
  - b. With careful selection, you can pay about 0.5% in total mutual fund fees, increasing your returns by 1% or more when compared to actively managed mutual funds.
3. **Learn the history of your portfolio.** We have a long history of the behavior of various indexes, going back as far as 1927. With this amount of history, you can learn how your portfolio behaves in different cases, and see extreme disasters that your portfolio was able to recover. Even long-term history does not guarantee the success in the future, but it can give you a sense of the robustness of your portfolio in the face of major disasters.

4. **Buy and hold.** Other than rebalancing, do not change the construction of your portfolio. After you learned what worked for many decades, stick to it and don't let emotions get in your way.

These actions will keep you calm whether your portfolio goes up or down. When up, you enjoy the growth; when down, you take the opportunity to buy low, and make even more money. As the portfolio grows, your peace of mind increases.

## To summarize

You may achieve returns of 10%-20%, with minimal work. You do that while sleeping really well at night, by knowing that you didn't gamble on specific companies, industries, countries or time of buying and selling.

A few notes about the approach described above:

1. If you can access the Dimensional Funds mutual funds (requires an investment advisor that is certified to use them), you might be able to cross the 15% annual returns in the long run if history is any indication of the future. They might provide the best vehicle for the investing approach described above.
2. The equal allocation described above is a naïve example that shows the ease of achieving high returns. Quality Asset Management constructed a portfolio that would historically achieve returns of over 17%, as simulated since 1970.
3. There are many other considerations, including taxes. There are many ways to invest in ways that minimize taxable gains along the way. This is outside the scope of this article.

If you are getting rewarded with these long-term returns for doing virtually nothing while having peace of mind, you are doing things right.

You can work harder, or with higher risks and still be doing things right. But you should be rewarded with much higher long-term returns, well over 20%, in order to justify the extra work or stress. If the risks are higher, you should consider carefully if you can afford them and want to take them.

Past performance may not be indicative of future results. Simulated data was used for periods prior to the inception of mutual funds (see [Performance Data Disclosure](http://www.qualityasset.com/disclosure.htm) at <http://www.qualityasset.com/disclosure.htm>). Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this article, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Note that services are limited to investment advice and do not include financial planning and/or non-investment related consultation services. You should not assume that any discussion or information contained in this article serves as the receipt of, or as a substitute for, personalized investment advice from Quality Asset Management. If you have any questions regarding the applicability of any specific issue discussed above to your individual situation, you are encouraged to consult with the professional advisor of your choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.