

April 10, 2007

Dear clients,

Last quarter I left off with a “*To be continued ...*” regarding the Efficient Market Theory (EMT) and specifically how we utilize its concepts to our collective advantage. This quarter I want to demystify the whole process of investment portfolio construction by telling you what I do when constructing and maintaining portfolios. For those of us who subscribe to the concepts of the EMT, portfolio construction is a rather straightforward process with three key components:

1. Determine an appropriate mix of investments that will best reconcile with our particular goals and objectives and risk tolerance levels. I frequently say what may be exactly right for a long-term investor is totally wrong for a short-term saver and vice versa. It’s really pretty easy in that the longer-term our time horizon, the more likely we will be to maximum our returns by tilting our portfolio in favor of stocks over less volatile choices. Yet the shorter our time horizon, the more investing in stocks becomes a gamble rather than a strategically sound decision because even a very broadly diversified mix of stocks will lose value in just about one of every three twelve month periods.
2. Once the appropriate mix is determined, our next step is to create a portfolio that is as broadly diversified as possible. The EMT applies here because it suggests that a more concentrated portfolio will outperform a broadly diversified portfolio only as often as pure chance would have it. In other words, good old fashioned luck now becomes a huge determinant of success for those who choose to not diversify their portfolios as much as possible. Let’s toss a little common sense into the equation and suggest that when it comes to managing your life savings, most people, if possible, would prefer to minimize the impact of the luck component (unless of course it could all be good ☺).
3. Costs, costs, costs. There are so many potential different costs associated with investing that entire chapters of books are dedicated to explaining them. Let me keep it really simple. Once we have settled upon a good mix of investments, that is broadly diversified, we just use the lowest cost investments to create our portfolio because every extra nickel we pay above and beyond the lower cost alternative will reduce our investment returns by exactly that amount. Put another way, higher costs don’t buy better returns they do the exact opposite!

So now let’s get back to how the EMT ties into all of this. If we no longer have to spend enormous energy or pay an “advisor” a lot of money to try and figure out or tell us the unknowable (where financial markets are headed in the short run), we are now free to spend our precious time making decisions that truly will impact our level of future investment success. And just as importantly, these good decisions we are making now will also manifest themselves in another way by giving us sleep-at-night comfort and confidence to know that we are being smart with our money and keeping some very powerful free market forces always on our side. I guess what makes the EMT so confounding for many is that on the surface it appears to fly in the face of the old maxim that the harder you work at something the more you should be rewarded. Reading the Wall Street Journal cover-to-cover every day may be interesting for some but I guarantee you it’s not a prerequisite for becoming a very successful investor!

Be well all,

