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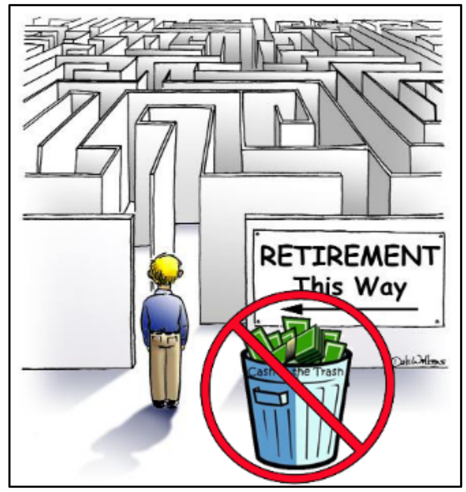
"Cash is trash" and other investing myths

Navigating the Retirement Maze



"I'm only rich because I know when I'm wrong… I basically have survived by recognizing my mistakes."

– George Soros, billionaire investor and philanthropist (1930 -)

The latest personal finance book to hit the market is "The Index Card: Why Personal Finance Doesn't Have to Be Complicated." It is based on the author's premise that all that one needs to know about personal finance can be written on a 3x5 index card. Which begs the question why he needed to write a book to explain it, but I guess it's hard to make money selling an index card.

I agree with the assertion that the key concepts are fairly straightforward. Where I tend to disagree with the author's simplicity thesis is that emotions and behaviors tend to obscure the average investor's ability to implement wise financial practices. Add in media noise, and it isn't surprising that most people freeze up like a deer in the headlights when it comes to managing their financial lives. Today I'll cover a few misconceptions about investing, with mistakes that people make in personal financial management to follow in a later column. (To adequately address all of them would take a book. Or a really large index card.)

Cash is trash

A portfolio consisting mostly of cash for the long term will guarantee you one thing: that you'll lose out to inflation. However, cash has an important role in your investment mix. Any funds for planned expenditures over the next year or two should not be invested in the stock market. Cash covers shorter term monetary needs with next to no risk because it isn't volatile and is highly liquid. Plus, in times of significant down markets, cash is the "dry powder" with which one can purchase beaten down asset classes, instead of having to sell other portfolio losers. Also, one should always have an "emergency reserve" in cash in the event of job loss, unexpected large expenses, or other financial crises.

Volatility is bad

Many financial academics equate volatility with risk. A more useful definition of risk is the possibility of permanent loss of capital. This can result from may different situations: being underinsured, needing to sell an asset when it is at a loss, owning overly risky assets for your financial situation, sending your child to a high-priced college that is inappropriate for them, poor claiming strategies for pensions or Social Security, or not being tax-aware when it comes to asset and estate planning. Permanent capital losses will undermine your ability to retire on your desired schedule and put yourself at long-term financial risk. Volatility, on the other hand, is found in all markets. Remove market volatility, and you remove the possibility of upside investment potential. The key is to manage volatility to your advantage, which is a function of the price at which you purchase investments, choosing the appropriate ones, the length of time you hold them, and owning an adequately diversified asset mix.

Financial news improves investing

Here is a bit of advice that will save you both time and anxiety: Ignore CNBC, the Wall Street Journal, and all daily business media. The best investment strategy, once you have decided on the appropriate asset class allocations for your portfolio, is to do little other than continue to fund these investments and rebalance them periodically. Financial news, which is mostly paid for by brokerage advertisers who make their money from trading commissions, appeal to their audience by highlighting short-term events and market moves. By the time you read or view financial news, institutional investors have already acted upon it. So spare yourself the time and anguish of trying to stay up on the market, and instead ignore it. The business and market events of a day or a week have negligible impact on long-term market performance.

Stock picking is key

Numerous studies have shown that over 90 percent of a portfolio's performance is due to asset allocation, not the performance of individual investments. Most mutual fund managers have hot streaks, particularly when the markets happen to coincide with their preferred investment strategy, but outperformance usually "mean reverts" back to the average over time. Standard & Poor's issues an annual report measuring the consistency of outperformance among mutual funds, and always shows that very few managers can beat the markets consistently. Yes, some have winning streaks, but if you have 7,000 fund managers flip a coin eight times, I can almost guarantee that at least 20 of them will toss eight heads. There are some asset classes in illiquid and little followed markets where investment manager knowledge and research can be rewarded. For the majority of asset classes, though, very few actively managed funds beat index funds over the long term.

The key to your own outperformance? Here's your personal "index card": 1) Determine your appropriate asset class allocations; 2) Invest in low-cost index funds or exchange traded funds (ETFs); 3) Spend less than you earn, and invest the excess for the long term. Pretty radical, huh?

Our brains are investment engines

One final myth to debunk. Physiologically, our brains are not that different from those of our Cro-Magnon ancestors, who survived natural selection (and thus contributed to today's gene pool) by overcoming threats of starvation, attack, and exposure. Investment wasn't exactly one of their valued skills. It has been shown that most investment decisions are not made with the analytic part of our brain, but with the limbic system, the part of the brain responsible for emotions. Humans are also subject to a number of inherent behavioral biases – including confirmation, loss aversion, anchoring, endowment, recency, overconfidence – that effectively reduce our ability to think rationally when it comes to investing.

So when it comes to investing, keep it simple: trade and manage your portfolio infrequently; save and invest more; filter out outside media noise. And while you're at it, eat healthy. Exercise and meditate. Read a good book. These things will improve your life much more than obsessing over the markets and your investments.

George Gagliardi is a financial advisor with Coromandel Wealth Management in Lexington, and helps clients develop and implement investment, tax, and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor.