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Fifteen Rules for the Prudent Investor

Overview: This paper discusses fifteen investment principles, all of which can be part of an overall prudent approach that includes building a globally diversified portfolio of passively managed asset class investments and adhering to a carefully formed, disciplined strategy regardless of market events.

When it comes to investing, we agree with Charles Ellis, author of *Winning the Loser's Game*, when he said, "Advice doesn't have to be complicated to be good." On that note, following are 15 additional guiding principles divided into four distinct categories for the prudent investor. Incorporating these relatively simple tenets into an investment strategy can go a long way toward helping investors achieve their financial goals.

Section I: On Investing

These investment ideas remain valid regardless of market fluctuations. They help an investor recognize the benefits of adhering to a disciplined plan.

1. Have a plan, and stick with it

Successful investing requires a well-developed plan as well as the discipline to stick with that plan in the face of adversity. While not many would take a trip to a place they have never been without a road map or directions, countless individuals invest without a comprehensive plan. And, unfortunately, emotions caused by the market and the financial media — greed and envy in bull markets, and fear and panic in bear markets — often persuade investors to stray from their well-developed plans.

2. The importance of assessing risk tolerance

Investors should not take more risk than they have the ability, willingness or need to take. Many plans fail because investors take an inappropriate amount of risk. Then, when the risks show up (perhaps unexpectedly), the plan may be abandoned, either out of necessity or because panic sets in.

When establishing an asset allocation, investors should consider at least the following: 1) their investment horizon, 2) the stability of their income, 3) their ability to deal with the stomach acid created by bear markets and 4) the rate of return they need to achieve their goal.

3. Understanding the true value of information

Before acting on seemingly valuable information, it is essential to consider whether that information is already incorporated into prices. The basis of the Efficient Market Hypothesis is that the market

incorporates everything knowable about a stock into current prices. Therefore, only *incremental* insight would be of any value, and capturing *incremental* insight is very difficult, if not impossible. Securities analysts are competing with so many other smart and highly motivated people researching the same stocks. This tough competition makes it difficult to gain a competitive advantage.

Imagine an art auction at which there is only one expert among a group of amateurs. In that circumstance, it might be possible to find a bargain. On the other hand, if the group consists of mostly experts, it is unlikely that anyone will find bargain prices. The same is true of stocks.

No matter how valuable the information may sound to investors, if they heard it on CNBC, read it in *Barron's*, or their broker told them about it, it is virtually certain that the information is already known by the market and thus of no value to them — it is not *incremental* insight.

4. Remaining aware of how expenses affect a portfolio
Equity investing is a positive-sum game; expenses make *outperforming* the market a negative-sum game (for example, like roulette). For one investor to outperform the market, another must underperform. Passive investors (for example, indexers) earn the market rate of return less generally low costs.

Active investors also collectively earn the same market rate of return, but generally incur higher costs to do so. If one active investor outperforms the market, another must underperform. The result is that, in aggregate, active investing is a negative-sum game — one in which the collective returns are below those of both the market and passive investors. Prudent investors don't play negative-sum games.

5. Choosing to work with an advisor who will act as a fiduciary
The National Association of Securities Dealers (NASD), which regulates brokerage firms and their employees, requires only that brokers adhere to the suitability rule. This rule states that a product or service must meet only the standard of being suitable for an investor — it does not have to be in an investor's best interest. For example, a brokerage firm is not required to obtain "best execution" pricing for trades. Firms can sell a similarly suitable fund that has higher expenses but provides the broker with additional commissions or satisfies sales production quotas (such as selling a proprietary fund instead of a competitor's fund).

While Registered Investment Advisor firms must meet the suitability standard, as a Registered Investment Advisor under the Investment Advisers Act of 1940, they also have a *fiduciary* obligation. They must act with the utmost good faith in their clients' best interests. The fiduciary duty standard is a much higher standard than that of suitability. It is generally considered the highest legal duty that one party can have to another.

In fact, one of an advisor's most important roles may well be to ensure that investors adhere to their well-developed plan when markets fluctuate. Numerous academic studies, including a landmark series by University of California professors Brad Barber and Terrance Odean, have found that individual investors who frequently react to the noise of the market can expect their behavior to detract from their expected returns, even before the costs of the trades.

6. Let the bubbles burst where they may, but don't try to predict when and where
From time to time markets become irrational — bubbles do occur (for example, the dot.com bubble). However, investors should never attempt to profit from a bubble because, while bubbles always eventually burst, not many have been able to successfully predict when the drop might occur.

Section II: On Individual Stocks

In this section, we touch on why investors are advised to avoid trying to "beat the market" by investing in individual stocks.

7. Owning individual stocks and sector funds is more akin to speculating than investing
The market only compensates investors for risks that cannot be diversified away — like the risk of investing in stocks versus bonds, or corporate bonds versus Treasury bonds. Investors should not expect the market to compensate them for risk that can easily be diversified away (the unique risks related to owning just one stock or one sector fund). Thus, owning one large-cap growth stock has the same expected return as owning an index fund of large-cap growth stocks, but it obviously entails far greater risk. Prudent investors only accept risk for which they are compensated in the form of higher expected returns.

8. Costs accompany each strategy
To outperform the market, an investor has to first identify a mispriced security and then be able to exploit any mispricing *after* the expenses of the effort. Strategies have no costs, but implementing them does. Countless investors have tried to exploit what they believed were mispricings (and perhaps even were), but found that the trading and other costs of implementing their strategies exceeded the potential benefits.

9. It is wise to avoid investment products with "club" appeal
We feel that hedge funds and private equity (including venture capital) fall into the same category, one that appeals to investors by offering them the possibility of achieving superior returns while appearing to extend invitations to an elite group of investors. Recently, however, both the hedge fund and private equity industries have lowered their minimums significantly. In addition, many of these vehicles turn out to be more expensive than they are expansive for an investor's portfolio.

Generally, investors should not invest in a security without fully understanding the nature of all of its risks. In addition, they should avoid investing in an investment product purely for the sake of its inherent complexity or exclusive nature. Such products are designed to be sold, not bought; the complexity is likely to be designed in favor of the issuer/seller, not the buyer.

Section III: On Diversification

In this section, we address the subject of diversification and the essential role it plays in portfolio construction.

10. The safest port in a sea of uncertainty is diversification across many asset classes
A well-diversified portfolio would typically include allocations to the asset classes of large-cap and small-cap, value and growth, real estate, international developed markets, emerging markets, commodities, and the appropriate amount of fixed income (bonds).

For example, it is not possible to diversify properly using only the S&P 500 Index. Although there would be a large number of holdings, there would not be enough diversification by asset class. Although an investor would receive ownership in 500 companies by investing in the S&P 500, many of them belong to the same asset class. Therefore, investors need to look further than a single index to achieve appropriate diversification.

11. Diversification is always working
Sometimes, investors like the results of diversification in their portfolios, and sometimes they don't. Most investors are familiar with the benefits of diversification. Done properly, diversification reduces risk without reducing expected returns.

However, once investors diversify beyond popular indices (such as the S&P 500), they must accept the fact that they can expect to be faced with periods, even long ones, when a popular benchmark index, reported by the media on a daily basis, outperforms their portfolio.

The noise of the media may then test their ability to adhere to their investment strategy. Nothing will have changed (diversification will still be the right strategy), yet many investors will make the mistake of confusing strategy with outcome (a strategy is either right or wrong before we know the outcome) and abandon their plan.

Section IV: Observations on Life and Investing

This section includes some observations that apply generally in life and specifically to investing.

12. Don't treat the highly improbable as impossible or the highly likely as certain
Stocks have provided higher returns than bonds over almost all periods of 20 years or longer, at least in the U.S. So investors assume that, if their horizon is long enough, this will certainly continue to be the case. The result is they take more risk than they should. Stocks, like any risky asset, are risky no matter what the length of the investment horizon.

13. The only thing worse than having to pay taxes is not having to pay them
Investors who hold a large amount of stock with a low cost basis often refuse to sell because of the tax bill. Unfortunately, large fortunes have been lost because of this error.

Instead, the dominant decision-making factor should be the present asset allocation of the current holdings versus the desired asset allocation that the investor has defined for his or her portfolio within a carefully designed investment policy.

Other considerations, such as tax implications within taxable accounts, have less impact but should be included in the decision-making process.

14. The four most dangerous words are as follows: "This time it's different."
Placing faith in the phrase, "this time it's different," has caused the investment plans of many individuals to end up in the proverbial trash heap. Getting caught up in the mania of the "new thing" is one reason why the following phrase has become a cliché: "The surest way to create a small fortune is to start out with a large one."

15. Good advice does not have to be expensive; but bad advice often costs dearly
Most people wouldn't choose the cheapest doctor, the cheapest attorney or the cheapest CPA. Costs do matter; but it is the value added relative to the cost of the advice that ultimately matters.

Conclusion

The above principles can provide investors with resolve to stay the course regardless of market events. For investors, designing and adhering to an investment strategy that addresses their long-term financial goals and their overall ability, need and willingness to take risk is a prudent approach that can serve them well through good times and bad.

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