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WHAT DO YOU BELIEVE?

Part III

I noticed the marketing blitz for the movie “Lions for Lambs” was in full swing in Los Angeles during a recent trip. Always the one looking for inspiration, I stared at the billboard for a few minutes. The movie is a political thriller starring Robert Redford, Meryl Streep and Tom Cruise. I wondered, first, who was the tallest of these three award-winning actors (Redford at 5’9”). Then I noticed the tag line for the movie. The "hook" to see “Lions for Lambs” was the motivation for Part III of the original commentary written in December 1999.

"If you stand for nothing, you will fall for anything" – Alexander Hamilton

We east coast types, more easily believe Hollywood screenwriters are hard pressed to come up with original ideas. (“Dukes of Hazzard” on the big screen?). The tag line for the movie is a paraphrase from a quote credited to Alexander Hamilton, the first Secretary of the Treasury. The brief sentiment is an important observation about investing today. The myriad choices available to investors do not insure better outcomes; in fact, too many alternatives may result in lower long-term returns.

“Too much of a good thing can be wonderful.” – Mae West

I doubt Mae West was referring to mutual funds when she stated her philosophy toward choices. The number of investment alternatives available today is nothing short of overwhelming. Morningstar, one official record keeper of mutual fund data, currently monitors almost 25,000 funds across 66 categories. Why is this explosion of choice a bad thing? After all, we absolutely love choice in this country. Unlike the abundant choices available at your local grocery store which offer something for every taste, most mutual funds fail to outperform their respective benchmarks. More choices certainly do not mean a better outcome for investors.

"Please sir, may I have some more." – Oliver Twist

Oliver’s plea sums up the attitude of many toward portfolio diversification. The availability of choice often influences portfolio structure more than the suitability of choice. Our industry adds to the clatter as we are prone to associate sophisticated with complicated. The hidden risk is many strategies have much higher correlation of short-term returns to each other than investors realize. This suggests there are far fewer *real* choices than investors might think. The result is overconfidence the portfolio is adequately protected from short-term volatility.

“Jeannie, get back in the bottle this instant!” – Capt. Tony Nelson

Just because some choice is good doesn’t mean more choices are better. Choosing the wrong mustard for your hot dog means one bad meal. Buying the wrong investment can be devastating to long term goals. The risk today is a dizzying array of options which results in poorly designed portfolios and confused clients, unsure how each piece fits into the whole. Unfortunately, the creative minds in financial product development have no interest in putting the genie back in the bottle.

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"Never mind" – Emily Litella

Gilda Radner's "Saturday Night Live" character used to say "never mind" when she realized she was talking about the wrong topic. The first step in minimizing bad decisions is realizing that the potential for making a mistake goes up when more alternatives are available. Of course, there are newer strategies that offer true diversification benefits not available to investors until now. Consequently, rejecting all new options can be a costly mistake as well. The key is considering changes to the portfolio structure with deliberation and circumspection.

"It is not the return on my investment that I am concerned about, it's the return of my investment." – Will Rogers

The concept of diversifying portfolios is based on minimizing short-term swings in market value through a combination of strategies with differing patterns of return. In other words, the focus is on risk allocation first and asset allocation second. Think of it this way. Even if you were hungry, you would probably not walk through a buffet line and heap only mashed potatoes and French fries on your plate. The same discriminating taste should be applied to portfolio structure. What is a seemingly different strategy at first smell may produce a pattern of returns highly correlated to what is already in the portfolio.

"Lions and tigers and bears. Oh, my!" – Dorothy Gale

I have yet to meet anyone who has convinced me the business of providing financial counsel is easier today than yesterday. I doubt anyone ever will. Meeting client return expectations in a world of low interest rates has become exceedingly difficult. Our industry has responded as it always does - with more products than we can reasonably process. It is important to realize this abundance is of little value unless the portfolio construction process is guided by a clear set of beliefs. Like Dorothy, who sensed danger on her way to Emerald City, investors face perils on the yellow brick road to their financial goals. However, the enormous challenge we face as advisors is also an opportunity for some. A more demanding environment will eliminate those in the business who don't have the commitment, the conviction and the confidence in their beliefs.

It is essential clients have a clear and concise roadmap of the right portfolio strategy for meeting their financial goals. Portfolio structure also need not be complicated. Well diversified portfolios can be both sophisticated and straightforward in design. The guiding principle is your philosophy, which should be written down and reviewed regularly with clients. Advisors who remind their clients often of the philosophy behind their portfolio choices will be less likely to have relationships at risk. More clients will demand this conviction and clarity from their advisors, and your beliefs, not just the number of choices you can offer, will add more value than ever before.

So, what do *you* believe?

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