Investment Philosophy - Passive Investment Management

I practice passive investment management. Passive investing involves building portfolios that are comprised of various distinct asset classes. The asset classes are weighted in a manner to achieve a desired relationship between risk and return. Funds that passively capture the returns of the desired asset classes are placed in the portfolio. The funds that are used to build passive portfolios are typically index mutual funds or exchange traded funds.

I generally do not advise clients on the purchase of any securities other than those just listed, but sometimes clients come to NHF with other securities already in their portfolio. In that case, I do advise clients on whether or not they should keep those securities. Additionally, I *do* advise clients on the purchase of employer stock offered through various employee benefits plans.

Passive investment management is characterized by low portfolio expenses (i.e. the funds inside the portfolio have low internal costs), minimal trading costs (due to infrequent trading activity), and relative tax efficiency (because the funds inside the portfolio are tax efficient and turnover inside the portfolio is minimal).

In contrast, active management involves a single manager or managers who employ some method, strategy or technique to construct a portfolio that is intended to generate returns that are greater than the broader market or a designated benchmark. Academic research indicates most active managers underperform the market.

What are the factors that matter in achieving investment success?

For most people, investing shouldn't be complicated. Research has shown that in the long-term, it is nearly impossible to choose investments that will beat a comparable market index after expenses. Attempting to figure out which investment will beat the market, in advance, is not worth the time and expense. It just doesn't pay off in the long run. A better strategy for investors is to accept the fact that markets will return what they are going to return, and focus on the things that you can control. In the next few sections, I have listed the primary considerations of my investing philosophy.

Costs Matter

Market returns come and go, but costs are forever. Keeping your investing costs low is one of the best ways to maximize your long-term portfolio value. Vanguard has a good set of tools at their website to show the impact of costs over time. There are many different kinds of costs associated with investing. Some, like trading commissions and taxes, are visible, while others, like mutual fund expense ratios and bid-ask spreads, are hidden.

Taxes are one of the biggest costs of investing. It is important to be very careful when choosing investments in a taxable account. Even infrequent trading can significantly decrease long-term returns. When possible, investments that generate taxable distributions should be placed in tax-protected accounts. Taxable accounts should contain low-turnover investments that can be held forever, such as total market index funds.

Asset Allocation Matters

The mix of different asset classes, (stocks, bonds, and cash), in your portfolio, is the primary determinant of portfolio risk and return over time. The first step in any good investment plan is to figure out the asset allocation that makes sense for each investor based on their risk tolerance, goals & time horizon. Once the asset allocation decision is made, investments can be selected to meet the chosen risk profile.

Risk and return are related. Risk is typically defined in the investing world as the probability that an investment will go down in value. Investors unwilling to accept risk must be willing to accept low returns. In order to have a chance at high returns, an investor must invest in risky investments.

Investing in “safe” investments also carries risk; specifically purchasing power risk. A safe investment with low returns may not be able to keep pace with inflation, which means that over time the portfolio may be worth less and less on an inflation-adjusted basis.

On the other hand, once financial goals have been achieved, it may not be necessary to take on much risk, even if the investor has a high risk tolerance. Therefore, another part of the asset allocation decision involves making sure to take on only the risk necessary to achieve the investor’s goals.

Additional Factors That Influence Portfolio Returns

Academic research (note 1) by Nobel Laureate Eugene Fama, and Kenneth French shows that certain factors are persistent over time in improving portfolio performance. These factors, market (stocks vs bonds), company size (small vs large cap), and relative price (value vs growth) have been demonstrated increase returns over the long run. These are known as the *Equity Premium, Small Cap Premium*, and *Value Premium*. Over the long run these factors matter.

Diversification Matters

Within each broad asset class, there are many investment options. Bonds can be further segmented by time horizon (duration) and credit quality. Stocks can be further segmented by company size, valuation, and location (domestic vs. foreign). In any given year, it is likely that some of these segments will perform better and some will perform worse. However, because we can’t predict when each segment will outperform, it is beneficial to construct a portfolio which contains many different asset classes. This way, whichever asset class ends up outperforming is guaranteed to be in the portfolio. Owning all or many of the investments in a given asset class is known as diversification, and it is best accomplished by investing in low-cost index funds or exchange traded funds rather than individual stocks and bonds.

Asset Location Matters

It is important to consider all accounts associated with a household and implement the household asset allocation across all accounts. This is simple when there are just one or two accounts, but many households have 6-12 separate accounts, each with different tax treatment and available investments. For example, a household might have two Roth IRAs, two retirement accounts with current employers, two Rollover IRAs from previous employers, several college savings accounts, and/or a few taxable accounts including bank accounts holding large cash balances. In order to minimize taxes, it makes sense to place investments that will generate taxable income (such as taxable bonds and high-dividend stocks) into tax-protected accounts if possible. Since distributions from Roth IRAs are free from tax, it makes sense to place the investments with the highest expected rate of return in these accounts. Though not always possible, ideally taxable accounts should contain only tax-efficient investments like low-turnover broad market index funds and tax-exempt bonds.

Rebalancing Matters

After the portfolio is constructed, different investments will experience different returns in any given year. Rebalancing is the process by which additional funds are moved from the over performing to the underperforming investment in order to get back to the desired asset allocation. Rebalancing can be done using new investments (if in the accumulation phase), using distributions such as dividends and interest, or by selling an outperforming investment. This enforces a "buy low and sell high" process. There are many different strategies for rebalancing. When possible, I try to use a strategy that includes elements of "opportunistic rebalancing" which is based on a research paper by Gobind Daryanani from 2008, and has been further validated with subsequent research. This strategy performs rebalancing as needed when threshold around a target asset allocation are crossed.

Discipline Matters

When the markets rise and fall, it is tempting to change your investing plan based on recent market performance. It can help to have a written investment plan that outlines the strategy for a portfolio. This investment plan, often called an "Investing Policy Statement" or IPS, typically includes a target asset allocation and a rebalancing strategy, and can include a plan for cash flows in and out of the portfolio. During times of market volatility, the IPS can help prevent an investor from acting against his or her own best interests.

Unfortunately, without a plan in place, many investors buy and sell at exactly the wrong times. When the market is going up, it can feel like it will continue to go up forever. When the market is falling, it can feel like it will never recover. This is known as recency bias - in other words, believing that recent events will continue indefinitely into the future. The emotions of fear and greed are powerful forces that drive many investing decisions. Better investing outcomes are achieved when decisions are based on a plan rather than emotions.