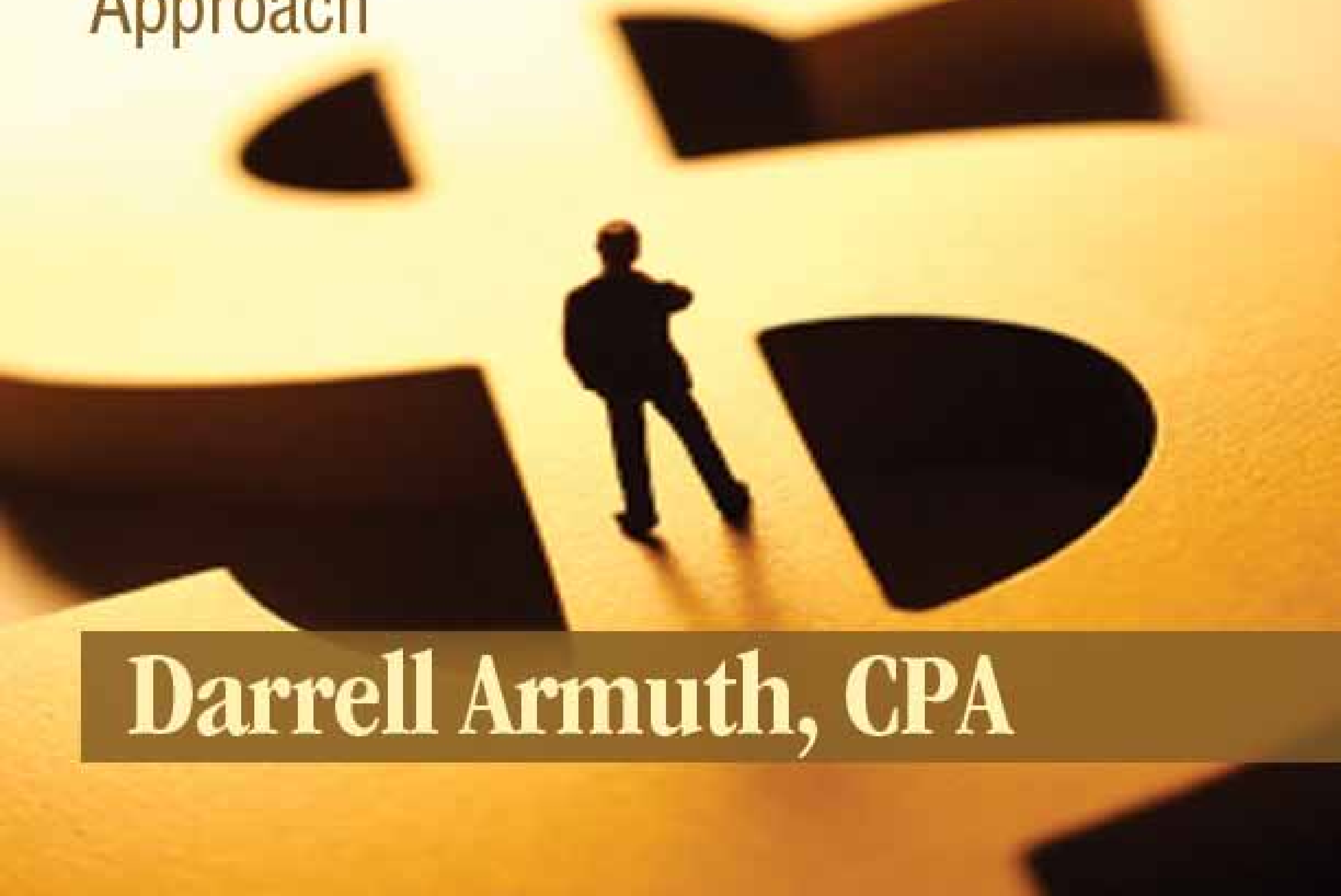
A Case for Sensible Investing

The SensiblePortfolios Approach



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SensiblePortfolios

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“Just the facts, ma’am”

Detective Sergeant Joe Friday from the 1960s TV series Dragnet wanted “just the facts, ma’am” as he sought to solve a crime. He was all business, and didn’t want irrelevant information to cloud the facts he needed.

Joe Friday would appreciate this book. It’s “just the facts” on how to make investing transparent and easy to understand.

Like any good mystery, investing can be difficult to understand,, complex and, well, *mysterious* to the everyday investor. But this complexity is often only smoke and mirrors, full of seemingly logical but misleading clues, spread by the guardians of Wall Street to knock you off-course. Instead of helping you build your wealth; overly complex investing advice can generate confusion and turn your nest egg into a victim of excess costs. Investing doesn’t have to be complicated. Like Joe Friday, you should:

- **Ignore the distractions —** Don’t be fooled by the red herrings of investing that glut the popular financial press and the 24 hour cable news cycle. Focus on just the facts you need to build a solid investment portfolio.

- **Remain patient, objective and disciplined —** Be willing to stick to your carefully crafted strategy, to see your way through to the end.

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The rest of this booklet guides you through the essentials you need to build a sensible case for investing:

Part I — Begin With the Building Blocks: Harness the efficiency of mutual funds in general, and passively managed, low-cost index funds in particular.

Part II — Use the Right Tools for the Job: Apply the principles of asset allocation, diversification and periodic rebalancing to building and maintaining your sensible portfolio.

No matter how often the financial press implies you can beat the market through clever trading, there's no crystal ball to help you divine the market's future … but there are plenty of costs involved in trying. That's why I believe that the most practical way to invest is by sticking to the sensible blueprints — just the facts — presented in this booklet.

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Part I: Begin With the Building Blocks

Chapter One
Mutual Funds: The Investment Product of Choice

Mutual funds were created in the 1920s as an affordable way for investors like you to come together and hire the services of a professional money manager to invest your pooled assets. Individually, you may only have so much to invest. But collectively, with other investors like yourself, you can become a powerful investment force!

So it makes sense that today mutual funds have become the core building blocks for most retail investors' portfolios (including those offered at SensiblePortfolios). Their popularity is warranted for a number of reasons:

- Mutual funds come in a variety of flavors to suit your needs and tastes. As an investment vehicle, they can hold any number of assets, including stocks, bonds, real estate, and commodities.

- They let you invest a modest amount of money to own a small, but well-balanced "slice" of a larger portfolio pie.

- The costs of owning a mutual fund — its ongoing **operating expenses** — can be relatively affordable when spread across a wider pool of assets. (More on expenses in a moment.)

- Your fund’s custodian will send you periodic reports, regulated by the Federal government to ensure consistent disclosure, so you can see how your investment is doing.

- You can usually easily add to or withdraw from the money you’ve invested.

There’s a lot to be said for mutual funds in general. But … there are more than of 8,000 of them from which to choose. How do you know where to begin? Fortunately, you can narrow your search dramatically, by considering two key concepts:

- **Mutual fund costs** — Why they matter so much

- **Investment styles** — Passive versus active

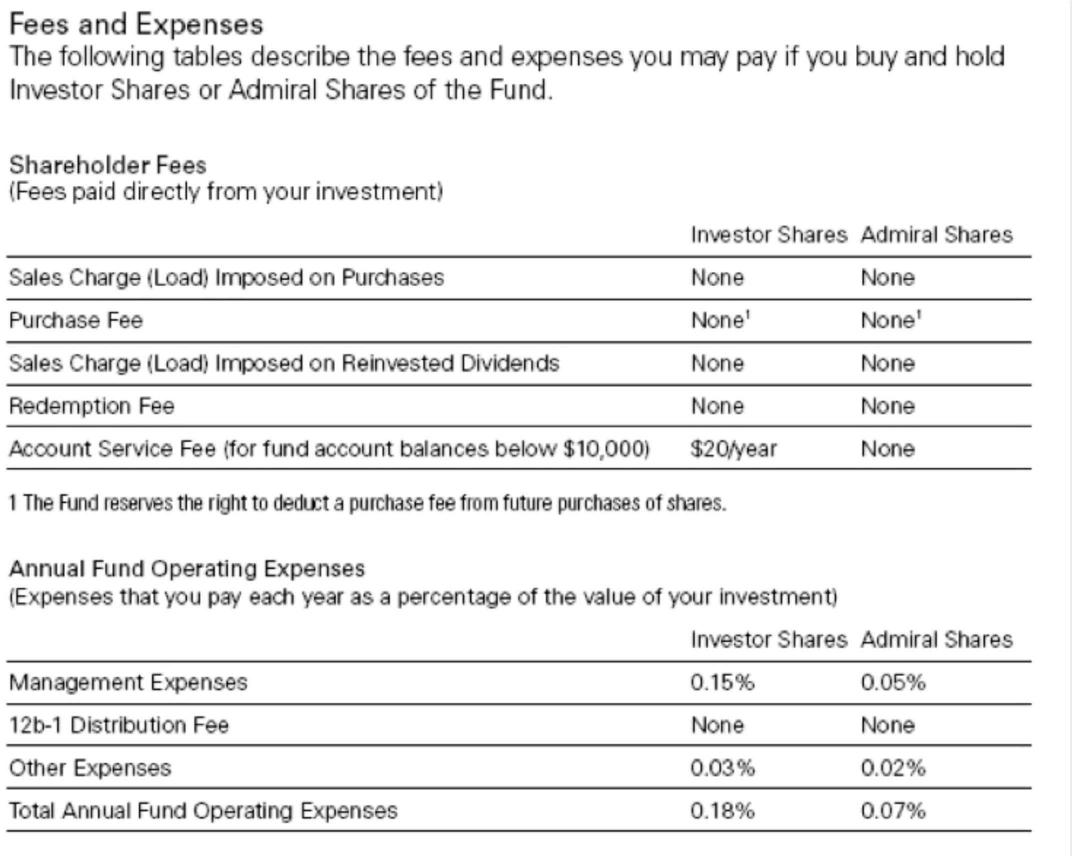
Mutual Fund Operating Expenses

Mutual funds are operated by mutual fund companies who are paid an annual management fee for their services. And those costs depend on the operator. The total cost paid to operate a mutual fund is called its expense ratio. The **expense ratio** is expressed as a percentage of the assets under management. For example, if the expense ratio of Mutual Fund A is 1 percent, then the cost of operating Mutual Fund A is 1 percent of the pooled assets held by the fund.

How do the fund companies decide what to charge? Like any business, the expense ratio of a mutual fund is usually as high as the market will bear. That means the expense ratios of many mutual funds can be quite high; it’s a situation of buyer beware!
By Federal law, operating expenses, including expense ratios, must be disclosed in the

fund's **prospectus**. But too often, investors don't bother to read the prospectus, and you don't see this cost come out of your account in any easily recognizable way. Because it's built into the share price, you may actually be paying a high expense ratio without knowing it.

Figure One displays the fees and expenses disclosed in the April 29, 2010 Vanguard 500 Index Fund Investor Shares (VFINX) summary prospectus. As one of the largest, lowest-cost mutual funds available, it's not always an appropriate comparison "benchmark" for other funds you may be considering, but it is a good place to start your deliberations on low costs:



Fees and Expenses

The following tables describe the fees and expenses you may pay if you buy and hold Investor Shares or Admiral Shares of the Fund.

Shareholder Fees
(Fees paid directly from your investment)

	Investor Shares	Admiral Shares
Sales Charge (Load) Imposed on Purchases	None	None
Purchase Fee	None[1]	None[1]
Sales Charge (Load) Imposed on Reinvested Dividends	None	None
Redemption Fee	None	None
Account Service Fee (for fund account balances below $10,000)	$20/year	None

1 The Fund reserves the right to deduct a purchase fee from future purchases of shares.

Annual Fund Operating Expenses
(Expenses that you pay each year as a percentage of the value of your investment)

	Investor Shares	Admiral Shares
Management Expenses	0.15%	0.05%
12b-1 Distribution Fee	None	None
Other Expenses	0.03%	0.02%
Total Annual Fund Operating Expenses	0.18%	0.07%

Figure One: It can pay to read a mutual fund's prospectus. The lower a fund's fees and expenses are, the more of your earnings you get to keep for yourself. Source: https://personal.vanguard.com

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Mutual Fund Loads

There are other costs besides the expense ratio. You might have to pay commissions to financial salespeople such as a stock broker, insurance agent or banker. This commission is called a "load," and it's another fee that weighs against your potential net return. "Load" mutual funds cost you a commission – sometimes up front and sometimes when you sell it. "No-load" funds don't offer an up-front payment to the salesperson.

Just like the expense ratio, the sales commission is not completely invisible. It must be disclosed in the fund's prospectus (as must a few other expenses, such as something known as a "12b-1" fee, which is financial-ese for additional sales commissions). But, unless the mutual fund is specifically promoted as a "no-load" fund, the person selling it will probably be receiving a commission. And even if the fund is no-load, that 12b-1 fee may be costing you a commission by another name.

In other words, when it comes to mutual fund costs, the Federal government offers some protections in the form of required disclosures. But at the end of the day, the burden is on you, the investor, to understand all the costs involved. If the information is not clearly and accessibly presented, insist on additional information until you are comfortable with precisely what you're buying, and how much you are paying. After all, if you were spending thousands of dollars on a car, a home or a similar major purchase, you would do your research. Why wouldn't you do the same when buying an investment?

Are You Getting What You Pay For?

When you're buying "things" it's typical for there to be some relationship between how much you pay and the quality of what you're buying. You wouldn't find it alarming to

discover that the asking price for a mansion in Hollywood is considerably higher than a pleasant, but more modest home in Reno. In investing, the relationship between price and quality does NOT hold true. And this is critical to remember. Bottom line…

There is a great deal of academic evidence indicating that higher expense ratios tend to hurt rather than help your investment experience.

Morningstar, among the most well-known and respected mutual fund performance reporting companies, has commented, “Expense ratios are the best predictors of performance — way better than historical returns… For the investor, there isn’t much logic to costs. Higher expenses don’t get you better management. If it did you’d expect higher-cost funds to outperform their lower-cost peers — when in fact just the opposite has happened.” [1]

If you could spend less money to buy the same thing, which would you choose?

Critical Lesson:
Seek low-cost mutual funds.

[1] Russel Kinnel, *“Expenses Trend Down, But Total Fees Keep Rising,”* Morningstar Fund Investor (April 2005).

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Chapter Two
Choosing Passive Versus Active Management

Along with costs, another key factor is how your money will be managed by the mutual fund you're considering. After eliminating the complexities, there are two basic management styles: **passive or active**. I view these two styles as the passive tortoise and the active hare.

Why Chase the Active Management Hare?

The hare represents the active money managers who try to "beat the market" by using their crystal ball. They seek to generate impressive returns based on their in-depth (and highly paid) analyses and forecasts of when to buy or sell certain company's stocks, or when to get in or out of the market and/or its various sectors.

Perhaps because the hare is fast and flashy, it also tends to generate the most media attention. If you pick up a financial journal or surf the web, it's easy to find "news" based upon active management prognostications. The overwhelming quantity of it all appears substantive, worth heeding. If "everyone" is buying or selling something, it feels like they must know something you don't, and that makes it tempting to follow the leader.

Beware!!! This active style of investing has two serious drawbacks:

"Everyone's" crystal balls are murky — Markets are generally efficient — too efficient to win the proverbial race by trying to outguess them. Whether it's good news or bad, as soon as something is known by that aforementioned herd of "everybody," guess what? The market knows it too. That's because, the market pretty much is everybody. Thus,

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prices effectively adjust immediately in response to any new information, which means, by the time you (or your actively managed mutual funds) are trying to buy or sell to capitalize on the news, it's too late. The race already has been run.

Crystal ball investing is expensive — Even if you or your actively managed fund could occasionally manage to be ahead of the game by placing some smart bets, it's important to realize that every attempt costs you money. Every time you or your fund makes a trade, a broker charges a fee for the transaction; whether it's a good move or a bad one. This means you have to make enough successfully timed trades to overcome the costs of your successful bets, as well as all the unprofitable ones.

Fix Your Future on the Slow and Steady Course

The tortoise, on the other hand, represents the passive management style. The tortoise doesn't own a crystal ball. He knows that, over time, the markets have generally headed upward rather than downward — at least for those who have stayed the course.

So, the tortoise avoids making investment decisions that are based on active attempts to forecast trends. Instead, he recognizes that the best way to invest in the market is to "be" the market (at least the part of the market that makes sense for you and your risk tolerances, which is a concept I'll explain in Part II).

Whenever returns are earned by "everyone," the tortoise already is there, slow and steady, patiently (sensibly) waiting his turn. By adopting this buy-and-hold strategy, he keeps costs low, using the science of how markets work to his best advantage.

The tortoise may not grab headline news the way the hare does, but if your true goal is to build long-term wealth...

Critical Lesson:
Choose low-cost, passively managed mutual funds.

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Chapter Three
Finding Passively Managed Funds

Hopefully, I've convinced you that patient investing with low-cost, passively managed mutual funds is your key to unlocking the door to a sensible investment strategy.

Identifying a Passively Managed Fund

In contrast to active investing, passive managers make no attempts to predict the future of the market. Instead, they seek to closely replicate the returns of a particular index or similar benchmark.[2] The best passive funds seek to do this with as few costs as possible, since we know that costs only deter from the real dollars you get to keep in the end.

That's it. Simple.

With passively managed funds, nobody's getting paid triple-digit salaries to try (and likely fail) to be more clever than the market. Nor are huge costs being incurred to try to develop fancy and ineffective, forecasting techniques. Despite short-term fluctuations, the markets have by and large moved in an upward direction over time.

Passive investing puts you in the best position to capture and keep as many of those long-term returns as possible. Maybe it's not as exciting to simply stay put during all the market changes, but it's much more sensible.

[2] A "benchmark" is a widely accepted standard against which performance of particular types of investments or particular investment managers can be measured to determine their success compared to others like themselves. Different types of investments or investment managers are compared against different benchmarks. For example, stocks from large, successful U.S. companies are inherently expected to deliver different levels of returns than stocks from small, stressed-out companies in tiny, emerging markets. So each is held to its own standard, or benchmark, to enable apples-to-apples comparisons for each across the various players in the market.

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Index Funds: King of Passive Investing

One good way to identify passively managed funds is to seek out "index mutual funds." As described above, index mutual funds simply track the returns delivered by a particular index without attempting to predict future market movements.

Before the creation of index mutual funds, there were indexes. Charles Dow, founder of *The Wall Street Journal*, created the first index in 1896. The Dow Jones Industrial Average (DJIA), was originally created to track the returns of 12 companies' stocks. Charles Dow created this as a way to measure overall market performance by selecting a dozen companies he felt could represent the market as a whole, by and large. By 1928, the DJIA had grown to track its present-day number of 30 companies.

By the mid-1970s, mutual funds were created to invest in the same companies that comprised an underlying index. In the case of the DJIA, a mutual fund that wanted to track the performance of this index would invest in the 30 companies within the DJIA Index. The most widely tracked and perhaps best-known is the S&P 500 Index.

Over time, more indexes were created to track many different segments of the global stock market, which in turn led to the creation of new index funds to track the new indexes. Today there are more than 1,000 index funds that track a wide list of underlying indexes around the world.

The beauty behind the index fund design is that it doesn't require a lot of management. For the most part, fund managers need only buy or sell stocks to keep the fund sufficiently representative of its underlying index. This allows index funds to keep their costs low — usually substantially lower than actively managed funds that are trying to beat similar benchmarks.

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Index funds' expense ratios can easily be minimized, because they rarely are encumbered by loads, 12b-1 fees or other nonsensical charges hidden in the fine print of their prospectuses.

To quote Warren Buffett:

> ***"Most investors, both institutional and individual,***
> ***will find that the best way to own common stocks***
> ***is through an index fund that charges minimal fees."***

A Variation on the Theme of Index Funds

Without getting too bogged down in the details, there is one additional fund family I'm aware of that is technically not an index fund, but is a good solution for investors seeking passively managed investing. **Dimensional Fund Advisors** (www.dfaus.com) adhere to all the principles described in this booklet. Indeed, in many respects, its leadership have been central pioneers in the field of passive investing.

Instead of passively tracking index benchmarks, Dimensional passively tracks a different set of benchmarks, albeit ones that are still robust widely accepted standards within the financial community. There is much logic and some distinct advantages to the approach adopted by Dimensional, but that is outside of the scope of this booklet. Suffice it to say that either index funds or Dimensional Fund Advisor funds can be acceptable solutions for the passively minded investor.

Critical Lesson:
Choose low-cost, passively managed mutual funds
by selecting index funds or working with a fee-only advisor to provide
access to Dimensional Fund Advisors mutual funds.

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Part II: Use the Right Tools for the Job

Chapter Four
Asset Allocation: Stocks Versus Bonds

So far, we've discussed why and how to choose low-cost, passively managed index or index-like mutual funds to help you avoid unnecessary costs and complications.

Beside choosing the right passively managed mutual funds, it's equally important to develop good personal investment habits of your own, incorporating the same principles described throughout this booklet into your decision-making.

I believe that successful investing requires you to balance your personal investment goals with your tolerance for market risk. How much wealth do you need or want, and how much risk are you willing or able to take to get there? These are two sides of the same coin. That is, you can't expect to build wealth without sticking to your plan during the inevitable periods of increased risk (lousy markets). On the flip side, you can't expect to lower your risk exposure (decrease the extent and/or depth of those periods of lousy returns) without decreasing expected long-term returns.

As described in earlier chapters, many investors, and even their professional financial intermediaries, mistakenly believe that successful investing is linked to the crystal ball. They want to believe that if someone is good at forecasting future events, success will follow. In reality, evidence shows that your portfolio design — **your asset allocation** — plays the largest role in determining the outcome of your investment experience.

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The key to asset allocation is balancing your investment goals with your tolerance for risk. If the balance is right, your long-term success will increase dramatically.

The most important asset allocation is your ratio between **stocks and bonds.** The more you allocate to stocks the higher your expected return, and associated risk, you inject into your portfolio. The more you allocate to bonds, the less risk you assume (with some caveats that we'll cover in Chapter 5).

At the highest level, you should decide on an overall allocation between stocks and bonds in your portfolio — *and remain true to it.* For example, you may decide on a 60/40 allocation, in which 60 percent of your investments are in a passively managed stock fund or funds, and 40 percent are in a passively managed bond fund or funds. If you want and are able to tolerate more risk during those inevitable market downturns, you could choose a more aggressive stock/bond allocation, such as 80/20.

The correct allocation for you is one that is most likely to help you achieve the returns you need and tolerate the risk that you must. But also remember, you must not only select an asset allocation, but you really must remain true to it over time. If you end up panic-selling, instead of staying the course, when market risk appears and overall returns plummet, then you will have done yourself more harm than if you had accepted the lower, less satisfying returns of a safer portfolio for the long-term. When assessing your stock/bond allocation at the outset, be honest with yourself on the kind of risk you can withstand, so that you can remain a disciplined investor through thick and thin.

Critical Lesson:
Choose a stock/bond asset allocation in your portfolio that reflects your unique risk/reward balance; stick with your allocation through all market conditions.

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Chapter Five
Asset Allocation: A Closer Look

How you allocate your portfolio between stocks and bonds represents the risk/reward balance within your overall portfolio. The next step is to further diversify your portfolio's holdings among stocks and bonds.

Stock Diversification

You can control the risk within your portfolio by spreading your riskier stock investments among a larger number of global companies which represent various different market components, or levels of risk. Don't put all your eggs in one basket.

There's good news here. As investors have been discovering the benefits of passive investing, suitable index funds for capturing these various specific market components have become more widely available, making it increasingly easy and affordable to properly diversify across a mix of low-cost, passively managed index funds.

A well-diversified portfolio invests in:

- Stocks of **large** (less risky) and **small** (more risky) companies.
- Stocks of "blue chip" **growth** (less risky) and distressed **value** (more risky) companies.
- Stocks of both **U.S.** companies and **international** companies, including companies in emerging market nations.

Since small and value companies carry more risk than large and growth companies, you can build more or less risk into your overall portfolio by increasing or decreasing these components. For example, if you've allocated a lot of your overall portfolio to stocks versus bonds, you may choose to minimize your exposure to the riskier value/growth stocks … or vice-versa if your bond allocation is high.

Bond Ratings and Terms

What about bonds? Do you need to diversify among different kinds of bonds too? Fortunately, by choosing a low-cost, index-based bond fund, any need for diversification should be taken care of for you within the fund. But there are still some basic asset allocation decisions to consider for your bond holdings.

A **stock** represents actual unit ownership in the company whose stock you hold. For example, if you buy a share of Microsoft, you own a tiny bit of the company. A bond, on the other hand, represents a loan to a company, government or municipality. The borrower pays you regular interest over the life of the bond, in exchange for your loan, and when the loan comes due, they're supposed to return your original money (your "principal") back to you.

With that in mind, three important choices when selecting a bond fund are:

- **Bond quality —** What are the odds that a bond may default and you'd lose the amount you loaned? The higher the quality, the less the risk … and, typically, the lower the expected return.

- **Bond term —** How long do you have to wait before your loan is due back to you? The less time you have to wait, the lower the risk … and, typically, the lower the expected return.

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- **Bond holder —** To whom have you loaned your money? The U.S. Government is considered the safest debtor, followed by local municipalities and then corporations.

Pop quiz: Remember why you are investing in bonds to begin with? If you said something along the lines of reducing overall financial risk, then give yourself a gold star. Bonds are not supposed to deliver spectacular returns; they're supposed to earn a little bit, while protecting your principal. But they're mostly to help keep your overall portfolio risk within tolerable levels. (Stocks are where your premium returns and your higher risk are at.)

We recommend allocating your bond funds to the safer side of investing: Stick with short-term government bonds or very highly rated municipal bonds. The more you slip into the riskier side of corporate bond investing — accepting lower ratings, longer terms or questionable debtors — the less likely your bond allocation can effectively do its job of stabilizing your portfolio.

Critical Lesson:
Within your stock/bond asset allocations, diversify your stock index funds and invest in the safest kinds of bonds.

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Chapter 6
Portfolio Rebalancing: Routine Maintenance

To ensure your portfolio continues to perform as planned — generating the long-term returns you designed it to provide — it must have a preventative maintenance schedule. This is called portfolio rebalancing.

Over time the balance of your portfolio changes as the various positions of your portfolio increase or decrease in value. These changes impact the growth of your portfolio and how efficiently it manages risk.

Rebalancing requires you to make periodic buys and sells, but these trades are quite a bit different from the panic-selling which occurs when the market tanks, or stocking up on a hot tip just because everyone else is doing it. This isn't about guessing what's going to happen next in the market; it's about you and sticking by your own long-term financial goals.

For example, imagine a year in which stocks perform spectacularly, beyond everyone's wildest expectations. If you started out with a portfolio that was 50 percent stocks and 50 percent bonds, by the end of that year, your stock/bond allocation will have changed. You may now hold closer to 60 percent stocks and 40 percent bonds, which isn't what you originally planned. Moving forward, your portfolio has become more risky than you intended.

To rebalance your portfolio once a year or so, you must sell off some of the stocks and buy bonds, until your allocation is back to the planned 50/50 mix. This may feel counter-intuitive at first. After all, you're selling stocks, which have been doing so well, and you're purchasing bonds, which have only been plodding along. But think about it this way. You

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also happen to be selling highly priced stocks to purchase lower-priced bonds. Sell high, buy low. What a great idea!

Our new breed of mutual funds used by SensiblePortfolios is designed to be self-balancing. Rebalancing of mutual funds by the fund manager not only greatly reduces the time you have to spend monitoring the design of your portfolios, it can be more cost- and tax-efficient, and it ensures that it is done according to schedule.

Critical Lesson:
Once you've built a sensible portfolio that reflects your unique goals and risk tolerances, periodically rebalance your portfolio to its original allocations, to keep your plans on track.

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Summary

SensiblePortfolios has been telling investors for years that there is no such thing as a crystal ball, or a genius behind the curtain, when it comes to investing.

Based on what you see and hear in the popular press, you may have been taught to believe that good investors must “beat the market” to be successful. I believe this is a misleading, and downright dangerous approach to investing.

Instead, try viewing the market as a friend, not a foe. Rather than trying to beat the market, understand that the global capital markets are expected to generate the returns you need to be successful — if you build and maintain a portfolio designed to capture those returns when they occur and minimize the costs involved in doing so. Understand that today’s index funds make it easier than ever for you to adopt this sensible strategy. Concentrate on factors that you have control over. Keep your expense ratios low, hold a broadly diversified portfolio, focus on the design of your portfolio as a way to manage risk. Understand the passive investment style, like the tortoise, is how you can expect to be a successful long-term investor.

Are SensiblePortfolios Right For You?

We have designed a family of model portfolios suitable for the most aggressive investors, right to the most defensive investors; for tax-managed or tax-deferred strategies; and for large or modestly sized portfolios.

One thing all of our clients do have in common: They are long-term investors who agree that the passive investment strategy described in this booklet makes sense for

their money and their lives. Our fees are fair, based on the account size and the time needed to manage the relationship. After all it is capitalism not a competitive sport… we should all be winners.

About the Author

Darrell Armuth, CPA is the founder of SensiblePortfolios, a provider of low-cost globally diversified investment strategies. He has operated Armuth Asset Management for sixteen years and is a Certified Public Accountant. Darrell is married with three children and lives in Reno, Nevada.