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Five Keys of Maximizing Your Wealth

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This article describes five of the top actions individual investors should take to maximize the performance of their financial portfolios.

Abstract: Every week, the latest fads and hype for hot new investment schemes cover popular magazines and newspapers, while television news highlights the latest Wall Street darlings and dogs. Individual investors who try to assimilate all of this information may find themselves overwhelmed and confused about which advice to follow. Meanwhile, unfortunately, little press coverage goes to the scientific research behind finance, investing, and getting the best return for a given level of risk. By evaluating the factual data and analyzing the latest research from top financial universities, we can distill five key themes that will benefit investors and remain true over time. Those who follow these concepts are more likely to maximize their wealth by improving their risk/reward position, increasing their portfolio performance, and reducing costs and taxes.

These five keys are:
#1: Diversify broadly for the best risk/reward
#2: Buy index funds and other passively-managed stock and bond funds
#3: Obtain investment advice from someone whose interests are aligned with yours
#4: Choose investment products from low-cost leaders
#5: Minimize taxes to maximize your net worth

Key #1: Diversify broadly for best risk/reward

Build an investment portfolio that focuses on obtaining the best risk/reward position. Many investors focus only on getting a good return and give little serious thought to minimizing their level of risk. An investment portfolio should be specifically designed with the goal of providing the maximum possible expected return *for the level of anticipated risk*. Likewise, the goal is to provide the lowest possible anticipated risk *for the expected return*.

The reason investors hold risky investments such as stocks, stock mutual funds, and real estate in their investment portfolio is that risky investments have a greater expected return than safe investments. The reason bonds, bond mutual funds, cash, and other safer investments are held in the portfolio is to provide income and to reduce the level of risk.

Extremely broad diversification is the key to getting the best expected return along with the lowest possible risk. When investments are mixed together, the blend has lower risk than the individual ingredients. The better the blend, the better the risk/return position.

One step toward broad diversification is to choose mutual funds. A single mutual fund holds many individual securities. This makes the mutual fund less risky than its separate ingredients. Bond, domestic-stock, international-stock, growth-stock, value-stock, and Real Estate (REIT)-stock mutual funds along with cash should be blended to provide the best risk/reward position for you and your particular situation.

Broad diversification including international holdings is important for maximum risk reduction over both short and long time periods. For example, the United States was the economic leader during much of the 20th

century. In other time periods, Holland, France, Spain, England, and other countries were the leader. By diversifying internationally, we won't miss out on tomorrow's leaders, especially as the world economy develops and jobs are outsourced globally. There have been time periods when small-company stocks have outperformed large-company, when value-company stocks have outperformed growth-company shares, and when REIT stocks have outperformed all others. By diversifying broadly, an investor can reduce the risk of having too many eggs in any single poorly performing basket while increasing the odds of having held the latest "hot" asset class.

It is difficult to build an efficient risk/return portfolio with individual stocks because the majority of stocks perform worse than average. There are always a few "superstar" stocks that swing the average. Your portfolio is very likely to under-perform benchmark indices if you don't happen to hold some of these "superstars." It is also difficult to adequately diversify into all of the investment asset classes discussed above with individual stocks.

The first step in risk reduction is to develop an asset allocation plan that includes all of the major investment asset classes discussed here along with their appropriate percentages for your particular situation. Following that, the individual investments within each asset class can be selected.

How we can help: Bickford IMS can help you build a diversified investment portfolio that best fits your needs and your personal risk/return comfort level.

Key #2: Buy index funds and other passively-managed stock and bond funds.

If tomorrow's superstar mutual fund could be predicted today, a lot of money could be made. Due to the tremendous potential, very intelligent people have performed serious research on the best ways to exploit this potential opportunity. Their findings show that market-beating active managers cannot be predicted.

For example, many investors are familiar with Morningstar's mutual fund ratings. Funds are rated from one to five stars based on how well they've performed in comparison with similar funds. The *Hulbert Financial Digest* tracked the performance of the top rated five-star funds for the period 1993-2000 and found that their total return averaged 106 percent. This compared rather poorly to the total US stock market (Wilshire 5000) at 222 percent. This example is but a single stone in a mountain of evidence that market-beating active managers *cannot be selected in advance* and that it is risky to try to do so.

Past performance for active managers does not predict future performance and actively managed funds also come with an additional layer of risk. The investor must consider not only how a particular asset class will perform, but how their active manager will perform relative to that asset class.

Picking actively managed funds is like gambling in Las Vegas. You may choose to do it for fun -- and you may win at times -- but the odds are stacked against you. Index funds and other passively-managed funds have lower expenses and better expected return, along with lower risk, than actively managed funds.

How we can help: Bickford IMS can help you select low cost passively-managed funds that complement your target asset allocation and perform predictably relative to their asset class.

Key #3: Obtain investment advice from someone whose interests are aligned with yours.

Conflicts of interest arise when you work with someone who is compensated more for recommending a specific product. For example, a Chevrolet salesperson will tend to recommend a Chevrolet vehicle, regardless of what is best for the customer. Further, there may be a product that the sales manager is trying to move and this product may carry an extra incentive for the salesperson.

Most financial professionals are compensated similarly to a Chevrolet salesperson. They receive a commission based on product sales and some of their financial products pay higher commissions than others. They are likely to recommend commission generating products and actions -- rather than what's in the investor's best interest (which is usually a zero-commission product).

The primary goal of most investment publications is to generate advertising and subscription revenue. However, articles on index funds and passive investment don't make catchy magazine covers and are inconsistent with the interests of most of their advertisers. So, index funds and passive investing receive little press coverage.

A consultant's recommendation is more likely to be impartial if it is independent of their compensation. The investment advisor's only compensation should come from clearly visible client-paid fees. By receiving no remuneration from any other sources, the advisor is then free to recommend what is truly best for the investor without negatively impacting the advisor's revenue.

How we can help: Bickford IMS has a fee-only business model that eliminates these conflicts of interest.

Key #4: Choose investment products from low-cost leaders

Vanguard and Dimensional Fund Advisors (DFA) are the two mutual fund companies whose practices are most consistent with Modern Finance -- the field engaged in the scientific research of finance and investing. While there are other providers of passively-managed investments, these two have the lowest overall cost and the broadest array of offerings.

Vanguard is the undisputed asset leader in index funds and their costs are the lowest in the industry. Their index funds are capitalization-weighted (like the S&P 500) which means large index weightings go to large companies (such as GE) and small weightings go to smaller companies (such as American Greetings).

DFA is a more advanced institutional money management firm which offers a broader array of passively-managed "enhanced index funds."   DFA's product offerings are focused on exploiting currently accepted theories and evidence of Modern Finance. These include the Fama/French three-factor model, which shows that small-company and value-company stocks have provided better returns than large-company and growth-company stocks around the world and over time. DFA also achieves better returns through engineering and trading. These include reducing the high cost of index tracking precision and exploiting the limited liquidity of small-company stocks. DFA has been described as being similar to Vanguard but with a couple of Nobel Prize winners hanging around the water cooler. DFA's directors and officers are the "who's who" of Modern Finance.

Vanguard funds are available directly to individual investors. DFA's products are more advanced and complex and are available to institutional investors as well as individual investors who are working with qualified DFA-approved fee-only investment advisors.

How we can help: Bickford IMS provides consulting on Vanguard accounts and investments. Bickford also offers fully managed fee-only accounts ($1-million typical portfolio minimum) with Vanguard and/or Dimensional Fund Advisors at less than half the cost of the average fee-only investment advisor.

Key #5: Minimize Taxes to maximize your net worth

In order to maximize their net worth, investors need to plan and organize their investments to minimize the amount of taxes paid. All components of an investment portfolio including taxable accounts, Individual Retirement Accounts (IRA's), 401K, and other accounts should be viewed in aggregate and investments for the individual accounts selected based on tax and spending considerations.

Currently, the maximum federal income tax rate on long-term capital gains and qualified dividends is set at 15%. Interest income and non-qualified dividends (often from REITs) are currently taxed at ordinary income tax rates of up to 35%. Tax considerations are a primary factor in deciding which account will hold these and other particular investments when funding the investment asset allocation.

Index funds and other passively-managed funds tend to be significantly more tax efficient than actively managed funds because they generally distribute fewer short-term capital gains. Tax-managed passive funds can be managed in a manner that harvests short-term capital losses, avoids short-term capital gains, and minimizes taxable dividend distributions making them more tax-efficient still.

How we can help: Bickford IMS can help build your asset allocation and decide on the optimal placement of the individual investments.

Summary:

Key #1: Diversify broadly for the best risk/reward. When risky investments are mixed together, the blend has lower risk than the individual ingredients. The better the blend, the better the risk/return position.

Key #2: Buy index funds and other passively-managed stock and bond funds. Picking actively managed funds is like gambling in Las Vegas. The odds are stacked against you. Index funds and other passively-managed funds have lower expenses, better expected return, and lower risk than actively managed funds.

Key #3: Obtain investment advice from someone whose interests are aligned with yours. A consultant shouldn't profit more or less for various financial recommendations. A fee-only (no commission) business model eliminates these conflicts of interest.

Key #4: Choose investment products from low-cost leaders. Vanguard and Dimensional Fund Advisors (DFA) have the lowest overall cost and the broadest array of passively-managed fund offerings for use in the construction of an efficient portfolio.

Key #5: Minimize taxes to maximize your net worth. Tax rates on various investment options should be considered. Investments should be placed in appropriate accounts for wealth maximization.

Suggested resources for additional information on these topics:

The Four Pillars of Investing by William Bernstein
The Successful Investor Today by Larry Swedroe
The Intelligent Asset Allocator by William Bernstein
Asset Allocation by Roger Gibson
Bickford Investment Management Services Website: www.bickfordinvest.com
Dimensional Fund Advisors Website: www.dfaus.com
Vanguard Website: www.vanguard.com

Bickford Investment Management Services provides clients with intelligent investment portfolio construction and management on a fee-only (no commission) basis at less than half the fees charged by the average fee-only investment advisor.