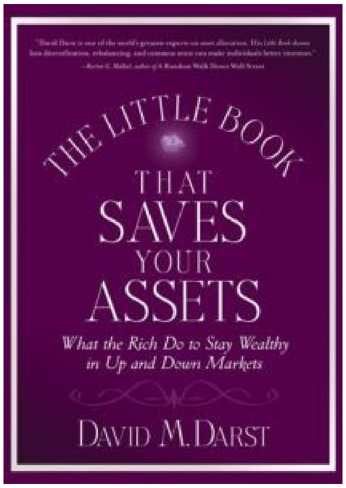

Book The Little Book that Saves Your Assets

What the Rich Do to Stay Wealthy in Up and Down Markets

David M. Darst
Wiley, 2008
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Recommendation

A successful football team needs a strong offense to gain ground and score points, a sturdy defense to hold firm under attack and a decisive coach to make intelligent substitutions when necessary. These are exactly the characteristics you need to manage your investment portfolio, says David M. Darst, chief investment officer at Morgan Stanley. Darst is an acknowledged expert on asset allocation, a "fundamental principle of investing," which stipulates that you shouldn't put all your financial eggs in one basket. Instead, you should spread your wealth among various diversified, "uncorrelated" investments. Although Darst's numerous analogies are oversimplified, and his information on how to rebalance your portfolio is fairly general, his skill at breaking financial concepts down into simple terms makes his libretto very useful to rookie investors. *BooksInShort* recommends his basic, savvy book to anyone who may be confused by the financial jungle, or anyone who wants to invest simply and smartly.

Take-Aways

- Effective wealth building depends on intelligent asset allocation.
- This requires investing in a portfolio of assets that behave differently depending on the financial environment. Termed "noncorrelation," this is the essence of diversification.
- Your portfolio should contain a careful mix of financial assets: bonds, stocks, real estate, cash, commodities, gold, and so on.
- Before investing, work out how risk averse you are and what you need your portfolio to do for you. Clear goals will make the job of allocating your assets a lot easier.
- Routinely rebalance your portfolio according to the "buy low, sell high" principle.
- Adopt both a strategic (big picture) and tactical (trend responsive) approach to asset allocation in light of your financial objectives.
- Carefully choose an asset manager. Feel free to quiz potential managers on their expertise before agreeing to do business.
- Don't ignore the risks or become an overly active, aggressive investor.
- At the same time, don't sit back and do nothing or meekly follow the crowd.
- You will make mistakes, but to become an intelligent investor you must learn from them.

Summary

Asset Allocation

Investing requires common sense. If you place all your money in only one or two types of investments, or in assets that are all in the same class (only stocks or only real estate, for example), you risk losing everything if that sector goes sour. The best way to organize and manage your financial portfolio is through a balanced asset allocation. This approach means investing in a mix of financial assets – bonds, stocks, real estate, cash, commodities, gold, and so on – to achieve your investment goals. Each class of assets responds differently to shifts in the economy and financial markets. Therefore, diversifying your assets enables you to minimize the risk of loss while maximizing your potential gain. Failure to do so can be a major mistake for any investor. Asset allocation is important for three primary reasons:

1. **Diversification** – Regardless of the economic and financial environment, some kinds of investments will continue to earn. Thus, you can build wealth over time. Invest in "uncorrelated" assets, that is, asset classes that react differently to market forces or changes in the economy. For instance, bonds are a wise investment during periods of deflation, real estate is preferable when inflation is high, and equities perform well during periods of low inflation and economic recovery.
2. **Protection** – Asset allocation reduces your exposure to financial risk and leaves you less vulnerable to changes in the economy. To reinforce your portfolio, regularly rebalance the proportion of money invested in each asset. You can base this decision either on time (rebalance every three months or once a year, for instance) or on price (rebalance whenever asset prices deviate, say, 10% from the original allocations).
3. **Reality-check** – Asset allocation requires you to rebalance the "long-term weightings" of your financial assets. To do this properly, routinely stay abreast of what takes place within the financial marketplace. How do your assets perform during economic ups or downs? Will an investment's value change? How predictable are your returns?

> "Asset allocation has helped build wealth, protect wealth and extend wealth."

Prior to starting your investing program, you need to get a few things straight: First, figure out what kind of investor you are. What are your strengths and weaknesses? Analyze your "mental makeup and psychology." Are you a bull or a bear? Evaluate your capital. What are you likely to earn over the course of your life? This helps you gauge how much risk to take and what assets to focus on at different stages of your life. "Lifecycle investing" requires making good use of "diversification, rebalancing, risk management and reinvesting." Your fiscal goals and risk tolerance will change as you age, so plan and allocate your assets based on portfolio size, need for "loss control," immediate financial needs and "future liabilities...income and expenses."

> "There is no magic formula for success in asset allocation."

Next, appraise whether you can realistically take care of your assets yourself or whether you need to enlist an expert. Then, find a trusted friend or relative, an "Uncle Frank" or an "Aunt Sally," who can advise and mentor you. Such a person can become, without a doubt, your "most valuable resource." He or she should be savvy and wise, and should have a strong investment philosophy.

Your Portfolio is Like Your House

A house is a good analogy for your investment portfolio. Some assets must be "functional" (like an attic), and some must be "relaxing" (bedrooms) or "enjoyable" (TV room). Stocks represent the latter category. You purchase them when economic times are good. Bonds and other fixed-income investments are like bedrooms, chambers where you want to feel sheltered and safe. Some areas are set aside for a specific individual (Dad's den). These represent "alternative" investments, such as precious metals or real estate. Functional spaces, such as the basement with its water heater and electrical panel, equate to cash investments or their equivalent.

> "Too many people make the mistake of buying investments without any regard for what they want the investment to do for them (except make money in a very general sense)."

How you decorate your house depends on your personality and psychology. Will you choose carpets, floorboards or tiles? The specific investments that you make will be equally idiosyncratic. Do you feel equipped to decorate your home by yourself? Or, would you prefer to hire a decorator? Similarly, do you feel competent to manage your own assets? Or, would you prefer to select an expert asset manager? If so, choose your manager with the utmost care.

Your Asset Manager

A horse with a 350-pound jockey is not going to win any races. Similarly, an asset allocation plan without an able asset manager will not protect you or build wealth. Indeed, for certain asset classes, including private equity and real estate, your choice of manager can mean a 5%-20% difference in returns annually. Read and research sources, such as *Barron's*, *Forbes*, *The Wall Street Journal*, Morningstar and FactSet, among others. When it comes to highly specialized assets such as hedge funds, you may need to rely on an expert to help you pick the right manager. Here are 10 important questions you should ask any prospective asset manager:

1. **"Ethics"** – Do you have a document that outlines your principles and code of ethics?
2. **"Philosophy and approach"** – What are your investment beliefs? How do you handle your business?
3. **"Investment edge"** – How do you personally establish this sharpness?
4. **"Disciplines and tools"** – What special measures do you employ to determine whether to buy, sell or retain an investment?
5. **"Human capital"** – How do you train and motivate your employees? How do you evaluate their performance?
6. **"Performance history"** – Can you explain the "market conditions of your returns, standard deviations of returns and correlation of returns with other asset classes"?
7. **"Lessons learned"** – What have your investment mistakes taught you?
8. **"Costs"** – Can you explain "the costs, turnover and tax efficiency" of the management services that you render in terms of investment assets?
9. **"Capture ratios"** – When asset prices rise, "what percentage of the upside" have you been able to attain? When asset prices fall, what is your percentage of the decline?
10. **"Capabilities"** – What have I failed to ask you concerning your investment management approach that I should know about?

"Objective-Based Asset Allocation"

Define your financial goals and figure out what mix of assets is optimal for achieving them. For example, if you want to save for your child's college education 18 years from now, you should choose aggressive high-yield stocks over steady income bonds. Stocks can oscillate violently in the short term but tend to provide the highest returns over time. Knowing what you want your investments to do for you is the essence of objective-based asset allocation, the guiding light for your investment decisions. Generally, investors aspire to achieve one or more of the following goals:

- **Protect against inflation** – Stocks can shield you from low and medium levels of inflation. But beware: During periods of high inflation, companies struggle to keep costs down and to borrow less, making it difficult for them to grow faster than inflation.
- **Profit from growth** – International stocks can expose your portfolio to faster-growing economies. "Equity asset classes" are a good choice during long periods of growth.
- **Provide security "from bad times"** – Fixed-income assets, such as "high-grade bonds, cash investments and...inflation-indexed securities," can shelter your savings.
- **Generate income** – The whole point of an investment is the cash it will eventually provide. The best "payment" assets are "dividend-paying stocks, preferred stocks and real estate investment trusts." Inflation-indexed securities also perform well.
- **Create stability** – Depending on how risk averse you are, your portfolio will need some steadiness to protect it from sudden market changes. Stable assets include "cash accounts, precious metals and professionally managed futures funds." You may also want to consider special-purpose hedge funds and exchange-traded funds.
- **Counter currency depreciation** – One good method is to denominate some investments in foreign assets, for example, "emerging-market stocks and bonds."

> "Blindly investing with the crowd is like letting a random group of people manage your portfolio and dictate your asset allocation."

An objective-based asset allocation approach enables you to develop a portfolio mix that fits your goals. This approach reduces costs since you undertake less buying and selling. You can handle asset allocation strategically or tactically. "Strategic Asset Allocation" involves setting long-range percent-of-portfolio allocations for your assets, then maintaining these percentages for an extended period. "Tactical Asset Allocation" entails routinely adjusting your asset mix to take advantage of market trends. Think of tactical asset allocation as a responsive mechanism that enhances your strategic approach. By keeping a careful eye on your portfolio's performance, you can sell off assets that have been doing well and, thus, have grown to represent a "larger-than-targeted percentage" of your portfolio. Use the proceeds to buy assets that have recently lost value. Rebalance your portfolio according to the classic investing maxim: "Buy low, sell high."

Seven Primary Portfolio Pratfalls

You must make good asset allocation decisions. A series of bad choices could lead you to financial ruin, but investors commonly make the same mistakes. Be sure that you don't:

- **Ignore the risks** – This is the quickest way to turn your assets into liabilities, and it is particularly easy to do during bull markets or when "investment conditions" are most favorable. Differentiate the types of risks you may encounter – excessive stock valuations, currency movements, and so on.
- **Become one of the crowd** – People often feel more at ease when they fail as part of a group than when they succeed alone. Don't be a herd animal.
- **Be overly bullish** – Markets get hot and then they cool. The values of investments do the same. Just because an investment's value is on an upward swing today does not mean it will remain so tomorrow. Always be conscious of the "reversion to mean" principle, the tendency of an asset whose value changes over time to return to its "long-term average" value after a period above or below that figure. In other words, "what goes up must come down." Reversion is connected to another principle that is dear to financial advisors: standard deviation, or the average asset return over a set time period. Note this figure. Also observe the number of times an asset's returns have been better or worse than this average, and by how much. These calculations help you determine an asset's volatility. Plus, they can illustrate "when a specific asset class might be about to revert to its mean."
- **Pursue hasty results** – Immediately getting rid of an investment asset class, or even an asset manager, because of a temporarily low return is not smart. Indeed, when you chase performance, you often end up selling when you should buy. Does the asset possess intrinsic value? If so, its poor performance will probably turn around.
- **Do not act** – Research concerning more than one million investors in 1,500 retirement programs found that 80% did not adjust their portfolios during a two-year period. Consequently, even those who began with smart asset mixes ended up with combinations that did not still meet their goals. Don't let your asset allocation drift. Rebalance your portfolio regularly.
- **Be emotional** – "Fear and greed" can quickly steer you off the right investment and allocation course.
- **Think short-term** – A microlevel approach gives you tunnel vision and prevents you from understanding trends that can make or cost you money. But, employing only a macrolevel approach to asset allocation is not smart. You cannot ignore the details. You need to combine both methods, which is not easy. It means you must carefully monitor individual assets while still focusing on your long-term goals.

> "Studies have shown that 90% of the differences in returns for large U.S. pension funds over the years is from differences in their asset allocation."

No matter how well you plan and allocate your investments, results will not always turn out as you hope. It is important – indeed, essential – to learn why. Did you research properly? Were your sources flawed? Were your assumptions misguided? Great investors and asset allocators always gain knowledge from their errors. Indeed, "It is not really a mistake if you learn from it," so be sure that you do.

About the Author

Chartered financial analyst **David M. Darst** is a managing director at Morgan Stanley, and the chief investment strategist for its Global Wealth Management Group. He chairs the firm's Asset Allocation Committee.