

HOW TO BUILD A BOMB-PROOF INVESTMENT PORTFOLIO:

THE SEVEN FACTOR™ SYSTEM

Part 3 of Investing Success

(excerpted from the forthcoming book, *The Science of Successful Investing Made Simple*)

Too many in the financial media suggest that investing is an “art.” They encourage investors to seek help from “special” individuals who have unique talents in the “art” of “beating the markets.”

In reality no individual and no method can reliably “beat the markets” over the duration of a long-term investment lifetime. But that isn’t necessary. You won’t get rich investing in stocks anyway, contrary to myth. You will enjoy solid growth, over the long run, *without* “beating the markets.”

It is better to treat investing as a science rather than an art. It doesn’t require any special talent or mystical insight. All that’s necessary is an *evidence-based* system with sound rules and good discipline to follow it.

With that in mind, here is an outline of the Seven Factor™ System: simple rules that drive powerful performance.

1. Control costs and risks. Each transaction (buying or selling) carries associated costs and fees. These can add up over time, and the more often you trade, the more fees you will incur. It’s important to know these costs and to include them in your calculations. Also, it’s important to know the risk of loss for any investment. Risk and return are two sides of the same coin. The higher the returns expected for an investment (on average), the higher the risk. Investments with very high return also run a high risk of losing money instead in any specific case, while relatively safe and secure investments are also low return. As discussed in Part 2, avoiding the losses is more powerful than picking the winners, and consistent excellence outperforms occasional brilliance.

That doesn’t mean there’s anything “wrong” with either a low-risk, low-return investment or a high-risk, high-return one, but it does mean you need to be aware of the risk factor with any investment you consider.

2. Own shares of the world’s greatest companies. Watch the world, not the West, and concentrate on the companies, not the countries. However glum the economic outlook may seem for the U.S. and some other advanced countries, the world is in growth mode, with millions of people exiting poverty every year and the global middle class growing quickly. The world’s greatest corporations are seeing record profits, and owning a share of that business is simply good sense.

3. Diversify broadly. How can you tell which companies will do well and which will do poorly, so as to know where to invest? You can't. It's that simple. No one can. You can make an educated guess, but unpredictable factors can undermine even the best companies and managers. Yogi Berra, the professional baseball star known for his malapropisms, said "predictions are difficult to make – especially about the future." The solution is to diversify your investments in a wide variety of companies, industries, countries, and management styles.

4. Leverage inexpensive stocks. "Inexpensive" here doesn't mean low-priced, but rather a low *price-to-book-value* ratio. There are many reasons why this can happen, and these are not the only stocks you should invest in, but they are an important part of any buy-low/sell-high strategy, as the price is low but the company has assets indicating it could generate more value.

5. Utilize smaller companies. Smaller companies have more growth potential and hence higher returns on investment. They also have higher risk to go along with that. This may not be obvious. It has to do with the way that growth works. Say you have a company that's worth two billion dollars compared to one that's worth 200 billion, and suppose that each grows by \$500 million in a given year. For the smaller company, that represents 25% growth, but for the larger one only 0.25% growth. It's the percentage that affects the stock value rather than the aggregate growth, and smaller companies tend to grow faster in percentage terms because they start with a smaller base. At the same time, with a smaller base, the smaller company can also see heavier losses, not because it is likely to lose more total dollars than a big company, but because any such loss represents a greater percentage of its total assets.

Your portfolio should not consist only of smaller companies (diversify, once again), but these investments are the ones that can potentially grow the fastest and see the highest returns.

It's important to bear in mind that a risk of loss exists on every individual investment. The idea is not to avoid that risk (that's impossible), but rather to see a solid net return – gains minus losses – over time.

6. Allocate strategically. Know the reason why you are investing in the first place, and allocate your investment resources so as to achieve that goal. There are a number of models for doing this. One of the most effective is a "core and satellite" approach, in which you make a distinction between investments which provide a solid, steady return with lower risk (the "core") and those that can generate higher returns but carry greater risk (the "satellite" investments). Maintain a certain percentage of your portfolio in the core investments, and you may designate a portion of your investment funds as going to satellite investments. This goes beyond investing in stocks; bonds, commodities. And insurance products may form a part of a portfolio as well. The strategic allocation of resources into each asset class reduces risk, since factors that may impact one class negatively may have no effect or even a beneficial effect on others. This is called low correlations.

7. Take a disciplined approach to managing your investments. The investment research company DALBAR discovered that the average investor's portfolio underperforms the market average by three to seven percent per year. The biggest culprit, the firm found, is investor (and unfortunately, too many advisor's) behavior, specifically emotion-driven behavior such as track-record chasing, and the greed-fear cycle. Investment decisions driven by emotion and impulse can cause an investor to buy high and sell low, to make too many transactions and incur unnecessary fees and costs, to panic when an investment loses value and sell out when you shouldn't, or to jump on the bandwagon of a rising asset without considering whether the rise can continue or for how long, or that by the time an investor has noticed the growth the price is already high (and the price-to-value ratio may be higher still).

The use of objective rules; a recognition that all investments carry risk (albeit this is unavoidable); awareness of the costs and fees associated with transactions and how these add up and cut into the returns on the investments; and above all, maintaining discipline and avoiding impulsive actions based on emotion rather than reason -- is the key to making it all work for you. This may be the most important of the seven factors, as violating it is the main reason why so many investors see a poor return (in many years, actually lower than the rate of inflation).

There is a good deal more to the science of investment than these broad rules, of course, but keeping these seven factors in consideration at all times will allow you to invest and see, over time, a good return.