HOW TO BUILD A BOMB-PROOF INVESTMENT PORTFOLIO:

THE 16 TRUTHS ABOUT INVESTING FOR POWERFUL PERFORMANCE AND LONG-TERM SUCCESS

Part 2 of Investing Success

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

Many people hold false ideas or myths about investing. Some even believe in a “magic formula” that can avoid risk and provide a high return, or that a conspiracy drives the market and fudges prices, or that investing is a way to get rich. At the same time, there are a lot of *true* things about investing that many people don’t know or don’t believe. Here are the truths:

1. In the 230 years that equity markets have existed in 16 countries, there has never been a 20-year period of time when they have shown a negative rate of return.

2. There have been only two periods when stocks underperformed bonds on the average for 30 years. Those periods were the time ending in 1865 (and including the American Civil War), and today.

3. On the other hand, the markets *have* shown negative returns quite frequently for shorter periods of time. For that reason, you should be investing in the market with a long time frame in mind.

4. When you invest, know your risk tolerance *precisely*. This means expressing it as a number, not just a phrase like “I am conservative” or “I am aggressive.” By what percentage can you accept your portfolio declining during a year? Although you can reasonably expect the value of your portfolio to increase over time, fluctuations downward will happen and there will be periods when it will lose value. How much of this fluctuation are you willing to accept?

5. When you invest, you should have a clear idea for what you are investing. Is it to pay for college in ten years? Are you on the brink of retirement and concerned with having enough income for the next 30 years or more? Whatever it is, the purpose for which you invest will determine a lot of our decisions.

6. Inflation matters, even when it is low -- as at present. It’s never zero, and that means your income from investment needs to grow by at least enough to cover the loss in the value of money over the period you’re investing to cover.

7. Investing is not a do-it-yourself, instinctive, by-the-gut endeavor. Our instincts evolved to avoid danger in a primitive environment, and many sound investment decisions go against that mindset. A good investment manager can help with this, as that manager is one step removed from the emotional impact of shifts in the value of your investments. But many managers can fall

into the same trap. Even more than portfolio products and construction, therefore, you need an evidence-based, rules-based system that is sophisticated in its simplicity.

8. You will *not* get rich in the stock market. You already may be rich. If not, you should not place your savings at risk of the price fluctuations. Investing in the stock market is a good way to protect your assets from inflation and ensure long-term appreciation, but the prospect of turning modest means into great riches is a myth. It almost never happens.

9. It is impossible to predict exactly which company, manager, industry, geography, or asset class will outperform the market average. This is why it's important to diversify.

10. Shares in small companies outperform shares in large ones, over time. At the same time, they fluctuate more in value and so may present greater risk (which goes along with their higher average return). How much small company ownership depends on your risk tolerance, your time horizon, and the purpose for which you are investing.

11. Disciplined, *strategic indexing* will provide you with a solid portfolio—the core. This should be at least 50% of your portfolio. And it leads to the virtue of buying low, while selling high.

12. Fees, taxes, and expenses count, and they count a lot. Saving a mere one or two percent in these costs can have a huge impact on the value of your portfolio over 20 to 30 years (the average retirement expectancy). For this reason, we want low turnover in our portfolios. The less frequently you buy and sell company shares, the lower your transaction costs. If you are tempted to "micromanage" your portfolio so as to only hold shares in any particular company when they are increasing in value, keep this in mind. Every purchase or sale carries a cost, and those costs can easily outweigh any gains from time-hopping, particularly since that's unlikely to work well anyway.

13. Opportunity costs also matter a lot. Expenses, taxes, and other lost funds count for more than their face value, because they also cost you what they **could have earned** you if they had not been lost in the first place.

14. Government intervention affects the economy more than it does your long-term investment. The same is true of major economic events such as a recession, even on the scale of the Great Recession. Such things may affect your portfolio's short-term values, and the panic that sometimes sets in among investors can affect it even more (see Number 15 for how that can have a major negative impact), but remember that you should be investing over a long time scale. Watch the world, not the West, and concentrate on the companies, not the countries.

15. Sequence of returns is not important while your assets are accumulating value, but it becomes critical when you reach the distribution phase of your investments. When you are receiving distributions from your investments, a short-term dip in value can have a major negative affect because you may still have to take the distributions in order to maintain your lifestyle. This puts further downward pressure on your account balances. Other strategies, in

addition to investments, may be called for to offset this. While you are not actively taking distributions from the investment accounts, however, what the early or late returns are doesn't matter much. You are concerned mainly with the long-term trend and net investment return.

16. The best time to start investing is 20 years ago. The second-best time is now. Always keep your investments aligned with your long-term strategy, your risk tolerance, your time horizon, and your goals – not someone else's or some arbitrary figure that may have been supplied by an "expert" who doesn't know your situation.

There are other details to the *science of investing*, of course, but these 16 truths lie at the heart of an evidence-based, rules-based, disciplined system that can guide your investments. (See Part 3 of Investing Success in an upcoming issue that details the *seven factor system*). Those rules and that system are not intended to avoid risks or short-term losses (which inevitably will happen and are unavoidable), nor to let you turn modest amounts of capital into great wealth (which is virtually impossible and certainly can't be *made* to happen), but will help you to invest for the reasons investment is a good idea. It will help you to safeguard your assets against inflation, provide you with an income for whatever purpose you need it for, and let you achieve a measure of financial security in retirement.