Tabar Gaul LLC

Our Philosophy of Investing

Many books have been written on the art, science, and philosophy of investing. Two books in particular that provide a wealth of important investing principles include *Common Sense on Mutual Funds* [Bogle 2010] by John Bogle and a *Random Walk Down Wall Street* [Malkiel 2012] by Burton G. Malkiel. A short article on investment tactics and risks cannot possibly cover all aspects on investing. Nevertheless, the following information is provided as an overview of the principles employed by Tabar Gaul LLC.

1. The first principle includes *establishing and maintaining a target allocation* of equities (i.e., stocks) and bonds (i.e., fixed income securities). A typical allocation that is suitable for many investors is 60% equities and 40% bonds (i.e., a 60/40 ratio). The actual recommendation for a client depends on many factors such as risk tolerance, time horizon, age, amount of income outside the portfolio, and goals of the client.

The actual value of the target allocation ratio, be it 60/40, 50/50, 40/60, etc., is not near as important as *maintaining the ratio* through the ups and downs of the market. The discipline of maintaining the target allocation ratio will force the investor to "buy low and sell high", which is the mantra of investing.

Market volatility is the inevitable ups and down of the stock and bonds market. Market volatility is caused by a number of underlying risk factors including market risk, interest rate risk, political risk, regulatory risk and others. All of these risk factors influence investors' sentiment ultimately causing a majority of them to flee from one asset class such as equities to another class such as bonds. This "herd" mentality can often result in panic-driven "sell low, buy high" moves in their portfolios. But by maintaining a target allocation, an investor will actually do the opposite by looking at a large drop in equity prices as a buying opportunity to "buy low" while selling off fixed income investments that are now riding high.

Warren Buffet, a very successful investor who is called the "Oracle of Omaha", summed up his contrarian philosophy of investing as "And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful." [Buffett 2004, page 4]. This contrarian philosophy is at the heart of the principle of target allocation. In other words, buy when others are selling and sell when others are buying.

2. The second principle of investing includes the need for an investor to *assume some risk in order to achieve a portfolio return that is higher than the rate of inflation*. The long term average value of inflation is about 3% per year. This means that in 24 years, an investor that was

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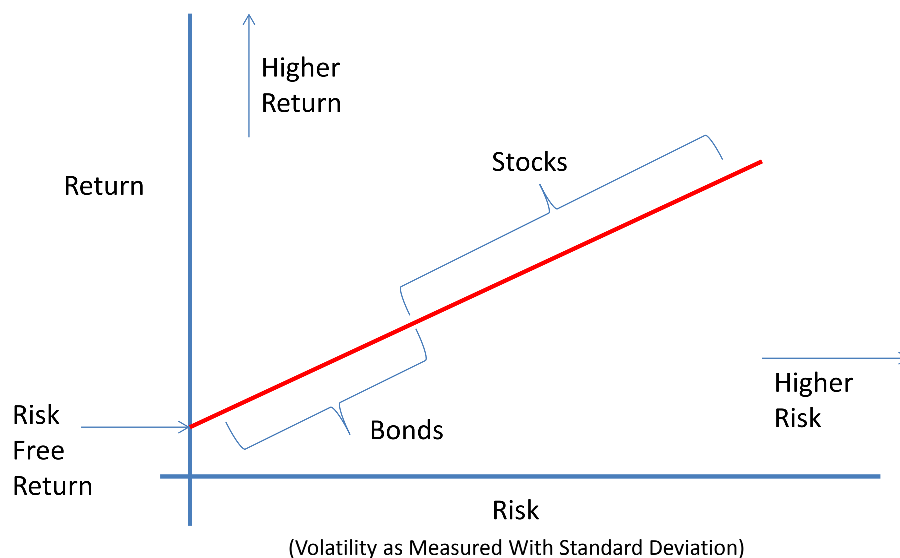
living comfortably on say $100,000 a year will now need $200,000 a year to maintain the same standard of living. A portfolio that is based 100% on "risk free" money markets securities or 3-month T-bills will lose value over time due to "purchasing power risk" which is a fancy term for inflation risk.

A famous quote by J. Kenfield Morley in *Some Things I Believe* [Malkiel 2012, page 303] said "In investing money, the amount of interest you want should depend on whether you want to eat well or sleep well". This is basically saying that one can sleep well by investing in money market funds since they won't be losing sleep during times of market volatility. But over the long term, they won't be eating well since inflation will gnaw away at their standard of living.

The curve shown below is plotted with portfolio volatility along the x-axis and portfolio return along the y-axis. The plot shows that to achieve higher rates of return, one must accept greater volatility in the returns. Greater volatility means a higher risk that the returns may be negative, in other words, a higher risk of losses in portfolio value. The returns in even a well-diversified portfolio will generally be negative when the entire market slumps due to "market risk". In a similar manner, the returns in a well-diversified portfolio will generally be positive when the market rises.

Risk Versus Return



The key to managing market risk is to use diversification across many different classes of assets in order to maximize the return for a given amount of risk. This is the premise of the concept called Modern Portfolio Theory [Markowitz 1952]. To best employ this theory, one should select classes of assets that are negatively correlated. In other words, when one class of

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assets has positive returns, the other class has negative returns. This serves to smooth out the wild swings, in other words reduce risk, while still providing a decent rate of return for the portfolio as a whole. Stocks and bonds do not have perfect negative correlation but they are uncorrelated enough to have a smoothing effect when the stock market experiences big drops. In *Common Sense on Mutual Funds* [Bogle 2010, page 82], John Bogle said "The greatest benefit of a balanced investment program is that it makes risk more palatable." Indeed, for many investors, a balanced fund consisting of 60% equities and 40% bonds can provide decent long term returns with milder drops in value when the stock market swoons. The investor only sees the overall portfolio value and does not observe the ebb and flow of the stock portion or the bond portion so they are less likely to get fixated on their "losers". The balanced fund takes care of rebalancing to achieve a nominal target allocation of stocks and bonds. Thus, the investor does not need nerves of steel to buy stocks when there is a steep market sell-off or similarly to take some gains off the table when the stocks are doing well and reinvest the proceeds in bonds which may be losing value.

3. The third and final principle is *Efficient Market Hypothesis* [Fama 1970] which basically boils down to the inability of even the professionals to consistently beat the market through the judicious selection of equities. Instead, in the long run it is better to be invested in low cost index funds, passive mutual funds, and Exchange Traded Funds (ETF's) that seek to provide returns as close as possible to an index such as the S&P 500.

Tabar Gaul LLC combines these <u>three</u> principles along with risk tolerance, planning horizon, and the needs of the client to arrive at an optimal portfolio of equities and bonds. The majority of the equity portion of the portfolio is constructed from value based equity funds that have low fees, pay consistent dividends, and provide long term growth. Investment grade bond funds are used to balance the risk in the portfolio while providing steady income in the form of interest payments. Additional allocations within the portfolio may include some exposure to specific sectors such as health care which has been doing very well and is expected to continue to do well in light of the "greying" of the baby boomers. High yield (i.e., less than investment grade) bond funds and floating rate note funds are also possibilities since they will likely hold up well as interest rates begin to rise over the next few years, given the anticipated tapering of the Federal stimulus (known as quantitative easing).

Individual securities are generally not used within the portfolios in order to ensure a high level of diversification. The risk of default in bonds or the risk of large drops in individual stocks is greatly diminished when a portfolio is diversified by using funds. Nevertheless, some exposure to individual tax-exempt municipal bonds with high credit ratings may be warranted, especially if the investor is in a high marginal tax bracket. In this case, a sufficient number of individual bonds (10 or more) are used to diversify the small amount of default risk associated with holding individual municipal bonds. It must be emphasized that interest rate risk can substantially lower the value of long duration bonds such as municipal bonds. Therefore,

individual municipal bonds should be planned to be held to maturity which is often 25 years or more. At maturity, the issuers of the bond will return to you the original par value of the bond.

Tabar Gaul LLC does not normally recommend investing in foreign securities. Although foreign stocks and bonds can provide positive returns in years when domestic returns are negative, they are generally outperformed by domestic securities over longer time horizons (5 years or so). There are significant risks associated with foreign investments such as political risk and currency exchange risk. Many large cap domestic stocks are actually multinational and therefore provide foreign exposure to portfolios without the need to invest directly in foreign securities.

Lastly, a recent study [Salter et al 2013] by John Salter of Texas Tech University found that it is critical for retirees to allocate about 4% of their portfolio to cash. The study determined that accounts without a cash reserve had considerable trading costs because the investment portfolios needed to be tapped every month for expenses. Portfolios without cash reserves are more likely to lose money by selling assets at inopportune times such as during market pull backs. Taxable accounts without cash reserves may rack up higher taxes because some of the monthly trades may throw off short term capital gains that are taxed at ordinary income tax rates. Opportunities to "buy on the dip" can be capitalized on by maintaining a cash reserve. All sources of a retiree's income need to be considered to determine the appropriate level of cash reserves.

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