HERITAGE PERSPECTIVE

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Running to Stand Still

Trying to correctly time your entry point into the market is never easy. Just ask the experts. In December 2011, the veteran US newsletter writer Richard Russell, author of the Dow Theory Letters, told his clients in unequivocal terms to "get out of stocks." "I believe we're going to see a brutal stock market that will shock the Fed and the bulls and the public – and all who insist on remaining in this bear market," he said. But 15 months later, Russell changed his tune, telling his clients to buy stocks after a rally that took the broad US stock market to a new record high, more than double the levels prevailing at its bottom in March 2009. "Yes, I know that this market is uncorrected during its long rise from the 2009 low, and I know that there are risks in buying an uncorrected advance that is becoming uncomfortably long in the tooth, but my suggestion is that my subscribers should take a chance (after all, Columbus took a chance)," Russell said in March 2013.

This sort of commentary isn't just happening in the US. In Australia, one of the most recognized market gurus, writer Alan Kohler, issued an ominous warning to his subscribers in a regular note in December 2011: "The conditions are in place for a panic sell-off," he said. "It is not certain that it will happen... but the risk is now such that you must take action. I will be significantly reducing my already reduced exposure to equities, possibly to zero." Explaining his mistake later, Kohler said he had not foreseen the extent to which central banks would continue to pump cheap money into the financial system. That's all very well. But the fact is anyone who followed his advice and exited the stock market missed a rally in Australian equities of more than 20%.

Providing reliable investment advice based on macroeconomic, technical, and political news is a tough gig. For the everyday investor, the lesson is that the closer you are to media and market noise, the harder it is for you to pay attention to the bigger picture. Markets are moving constantly as news and information is built into prices. Sentiment is buffeted one way, then the other.

The job of media and market analysts frequently boils down to creating plausible narratives around disconnected events so that it all appears seamless. The next day, they start all over again. As a broker or a journalist, whose horizons are in minutes, this approach to markets makes sense. But for investors with long-term horizons, basing investment decisions on the news of the day is unlikely to deliver sound results.

A better approach is to work with a trusted advisor on building a diversified portfolio of assets tailored for your needs and appetite for risk. The portfolio should be rebalanced regularly to match your risk tolerance, not according to what is happening in the markets.

Tactical asset allocation can sound tempting, but there is always a risk that the news will overtake you. Then you are left having to change everything all over again. As a wise man once said, running inside a moving bus won't get you to your destination any quicker.

Heritage Investment Group would like to thank all of our clients for their continued support. If you have any friends or family members who could benefit from our disciplined investment process, we would welcome the opportunity to speak with them. Please contact us at (954)785-5400.

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The Psychology of Investing

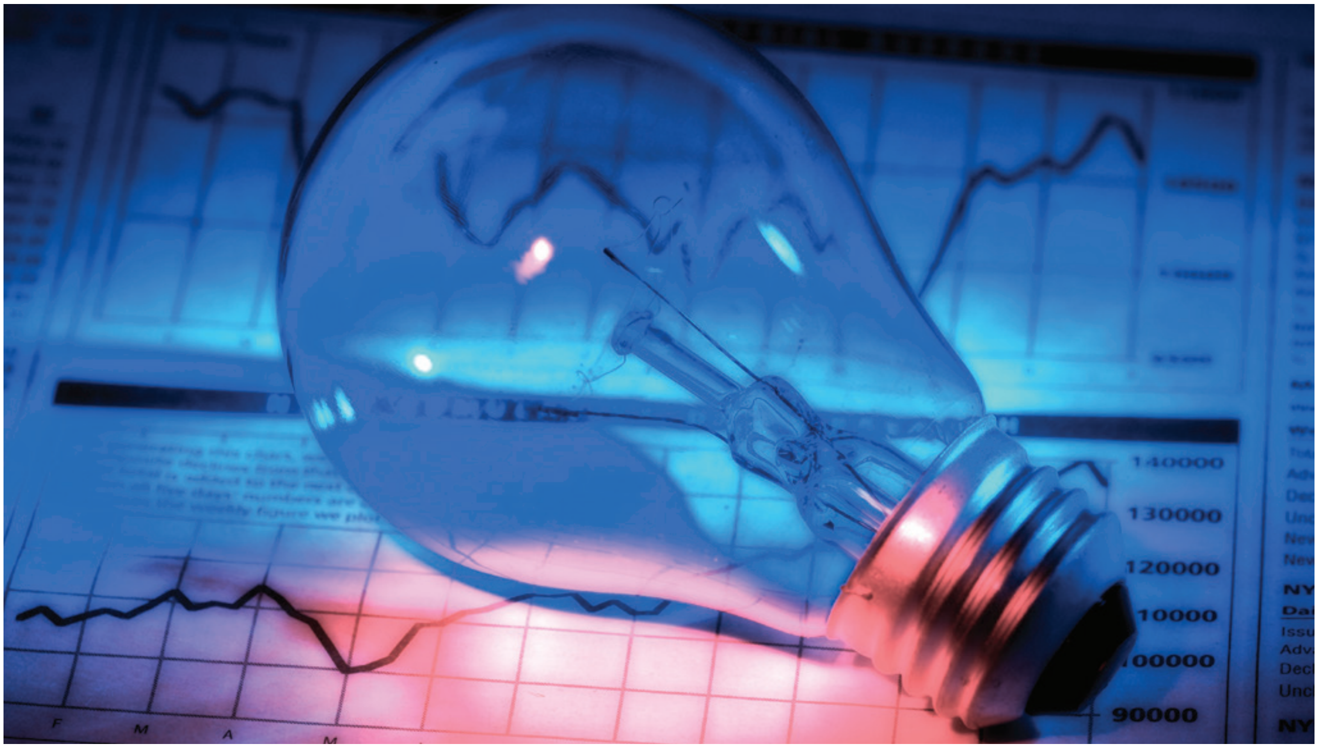
"The difficulty for most investors arises from a lack of psychological discipline."

Conversations about investing usually revolve around financial topics. Corporate earnings, interest rates, commodity prices and the financial impact of geopolitical events are all viewed as having a significant impact on the success or failure of an individual's investment strategy. The truth is, however, that the financial aspects of a successful investment strategy are relatively straightforward. If you diversify, keep costs low and recognize that markets are unpredictable, you will most likely have a very successful long-term investment experience. The difficulty for most investors arises from a lack of psychological discipline. Even if you have a simple and financially sound investment strategy in place, you will not be a successful investor if your own human psychology causes you to make poor decisions.

The fact is, individuals tend to make most decisions, and especially financial decisions, based upon emotions rather than reason. It is therefore important to understand how human psychology influences financial decisions and how those influences can affect investment outcomes. It is well-known that fear, greed and regret play a major part in investor behavior. However, the field of behavioral finance has identified some more complex psychological biases that affect our behavior as well:

Overconfidence: It is an observed fact that most people are overconfident in their abilities. This self-centered optimism serves us well in athletics, entrepreneurial activities, politics and life in general, but it is a hindrance to success in the investment markets. An individual investor who believes that she is more knowledgeable than the collective market is setting herself up for disappointment.

Activity Bias: This is the human tendency to always want to be active, especially in times of stress. This natural drive allows us to achieve our goals and to avoid danger, but it is usually counter-productive in an investment context. Because markets are unpredictable by nature, investors are best-served by an investment approach that involves a disciplined inactivity, especially in volatile times.



Trend-following/Representativeness: Humans have a well-developed ability to see patterns in nature. This ability causes us to create stereotypes and to believe that the past, and especially the recent past, is indicative of what the future will bring. However, financial markets do not operate the way nature does. In the short-term, markets move in a random fashion and the recent past offers little (if any) insight into the future movement of the markets.

Herding: We are all mammals, and mammals often exhibit group behavior. Like the activity bias, the herding instinct has been a helpful survival trait in human evolution, but it offers no assistance to investors. Buying just because everyone seems to be getting rich, or selling when everyone is in a panic can lead to a disastrous investment outcome.

> *"It is well-known that fear, greed and regret play a major part in investor behavior."*

Familiarity Bias: This is the tendency to gravitate towards the things that you are most familiar with. Familiarity bias can encourage you to under-diversify by only buying stock in companies that employ your family members or that make products you use. It may compel doctors to invest only in healthcare stocks or software engineers to buy only technology companies. It can also cause you to avoid diversifying outside your home country, thus foregoing potentially valuable investment opportunities. The "buy what you know" strategy may feel good, but it will give you a concentrated, high-risk portfolio instead of a diversified one.

Loss Aversion: This is perhaps the most peculiar of the psychological biases. Numerous studies have shown that humans will have a far greater emotional reaction to a financial loss than to a financial gain of the same amount. Loss aversion can cause an investor to become too conservative after a difficult period in the markets or to hold-on to a poor investment for fear of realizing a loss.

In the coming quarters we will publish a series of articles which will focus on some of these behavioral biases in more detail. These biases are an integral part of human nature and cannot be removed from the human psyche. Our goal, therefore, is not to eliminate these biases, but to make you more aware of them so that you can account for their presence when making financial decisions.

This article was originally written by Heritage for the March 2013 edition of The Light, *a local magazine serving Broward County, Florida.*

HERITAGE PERSPECTIVE

Do Not Pay Extra to Own a "Closet Index" Mutual Fund

Active investment managers claim that their investment expertise will differentiate their performance from that of the stock market, gaining more when markets are up and losing less when markets decline. For this pledge they are compensated quite well. But recent studies show that some of the biggest actively managed stock funds are so closely correlated to the stock market that they are virtually indistinguishable from an index fund (except for their higher fees).

Index funds seek to replicate the results of the market they are indexed to: an S&P 500 Index fund, for instance, would try to duplicate the performance of the 500 large U.S. stocks that make up the S&P 500 Index. An active manager, on the other hand, is supposed to be able to choose subsets of those stocks and to trade them in a timely manner in order to outperform the index.

> *"...some of the biggest actively managed stock funds have become 'closet' index funds..."*

Morningstar Inc., the Chicago-based company that tracks mutual fund performance, says that some of the biggest actively managed stock funds have become "closet" index funds because they closely track the makeup, risks, and rewards of big U.S. stock indexes. American Funds Growth Fund of America, for instance, has a very high correlation to the Russell 1000 Growth Index, which tracks the 1,000 largest growth stocks, Morningstar says. The Fidelity Contrafund, T. Rowe Price Growth Stock Fund and BlackRock Equity Dividend Fund are not far behind.

In fact, the average large-cap stock fund is 99.7 percent correlated to its index, according to Morningstar. This should matter to owners of those funds, who pay 0.70 percent to 1 percent in fees to have their funds actively managed. Instead, they could be paying 0.15 percent or less in fees to own an index fund that will have the same before-fee expected returns as the active funds, but a larger expected net return due to the lower fees.