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Balancing Your Fixed Income Decisions

The volatility in bond markets this year has focused the attention of many investors on the fixed income portion of their portfolios. Fixed income can play an important role in a portfolio, but its role may vary according to an investor's financial needs and concerns. For example, many investors look to fixed income for safety, income, and more stability in their portfolios.

They must weigh these priorities against their concerns over future interest rates, inflation, government debt, and other factors that might affect fixed income returns.

Striking this balance can be a challenge in any market environment, but this is especially so now, as the low interest rates of recent years have sent many investors on a quest for higher-yielding bonds or alternative investments. Depending on your approach, this pursuit of yield may invite more risk, some of which may be hard to see or understand. Recent volatility in fixed income markets has revealed to many investors that their fixed income carries greater risk than they had previously thought.

So, what's an investor to do? How can you make prudent fixed income decisions while also addressing low interest rates? Consider these principles:

Remember how markets work

The same core investment principles apply in any market environment. One key principle is that in a well-functioning capital market, securities prices reflect all available information. Today's bond values reflect everything the market knows about current economic conditions, growth expectations, inflation, Fed monetary policy, and the like. So, according to this principle, the possibility of rising interest rates is already factored into fixed income prices.

This is one reason investors should view future interest rate movements as unpredictable. Even the market experts who have access to vast amounts of research cannot accurately predict the future direction of interest rates. Rather than trying to predict macroeconomic forces that are difficult to foresee, investors can look to the market to set prices and focus on the variables within their control.

Know what you own

Strive for transparency in a portfolio. This means understanding an investment manager's basic strategy and knowing how the instruments held in the portfolio might respond in different economic, market, and interest rate scenarios.

Unfortunately, investors who chase performance often make their investment decisions based on the past performance and perceived popularity of the strategy. For example, some of the mutual fund categories experiencing the heaviest inflows of cash in the industry are in asset groups that have recently experienced higher than average yields. Higher yields

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Heritage Investment Group
www.heritageinvestment.com

2480 N.E. 23rd Street
Pompano Beach, FL 33062
Phone: 954.785.5400
Fax: 954.933.0966

115 South Fielding Avenue
Tampa, FL 33606
Phone: 813.258.1759
Fax: 813.254.3756

1540 International Pkwy., Ste. 2000
Lake Mary, FL 32746
Phone: 407.536.5370
Fax: 407.536.5301

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are typically accompanied by higher risks. But do investors know what risks their managers are taking to deliver those attractive yields?

Understand the tradeoffs

When reaching for higher yield, investors should carefully consider the potential effects of their decisions on expected portfolio performance and risk. In the fixed income arena, investors have two primary methods to increase expected yield and returns on bonds. They can:

- Take more term risk by extending the overall maturity of their bond portfolios
- Take more credit risk by holding bonds of lower credit quality

These may seem like reasonable actions, however, remember that pursuing higher income means accepting more risk, as measured by interest rate movements, price volatility, or greater odds of losing value if the issuer defaults.

Consider a global fixed income strategy

Investors have other tools to enhance risk and expected returns in fixed income. You can expand your opportunity set by moving beyond your domestic fixed income market to access yield curves in foreign country markets. By owning bonds issued by governments and companies from around the world, you can enhance diversification in your fixed income portfolio. After hedging against currency risk, bond markets around the world have only modest correlation with each-other. As a result, a globally hedged bond portfolio should exhibit lower volatility than a single-country portfolio, while at the same time offering the opportunity to take advantage of more attractive yields abroad.

> *"...in a well-functioning capital market, securities prices reflect all available information."*

Summary

No one really knows when and by how much future interest rates will change. Investors looking for higher bond yields should understand the higher risks tied to their decisions. Most investors are best-served by building a fixed income strategy to complement their broader portfolio objectives, understanding the sources of risk and expected return, and looking beyond their own country to capture yields in other countries' markets.

Investing with Overconfidence

"How fortune brings to earth the oversure!"
– Petrarch

In our most recent newsletter, we introduced the topic of behavioral finance. Behavioral finance uses psychology to describe the financial decisions that individuals make and to explain why these decisions are often irrational. Over the next several quarters, we will address some of the main concepts in behavioral finance in order to make you more aware of the financially dangerous psychological biases that all humans have. In this article, we begin by addressing one of the most common psychological biases: overconfidence.

Humans have a natural tendency to be overconfident. We tend to overestimate our knowledge of a particular subject, overestimate our skills, overestimate our ability to control outcomes and underestimate the risks involved in uncertain situations. In one classic study (Svenson, 1981), a group of American drivers was asked to rate their own driving skills as being either better or worse than the average person. If the study participants were accurately describing their own driving skills, we would expect that approximately 50 percent of the respondents would claim to have better than average skills and 50 percent would claim to be worse than average. However, an astonishing 93 percent of the participants claimed to be better than average drivers, which demonstrates a significant tendency towards overconfidence. Similar results have been found when asking people to rate their own intelligence, popularity, or the time that it takes them to use an ATM.

The human tendency to be confident is beneficial in many areas, including athletics, business and science. Mankind needs to have its dreamers; without them our rate of progress would be far less rapid and our outlook on life would be more pessimistic. However, overconfidence is not a beneficial trait in the world of investing. It can lead us to falsely believe that we can predict the future movements of individual stocks or the market as a whole, that we can control the return on these investments, or that our activities involve little or no risk.

Overconfident amateurs

Many amateur investors engage in overconfident behavior without even realizing it. For example, whenever you buy the stock of any individual

company, you are suggesting that your knowledge of the company's prospects is superior to the overall knowledge of the market as a whole. Your implicit claim is that you have an ability to predict the future movement of the price of that particular stock and that the stock will outperform other stocks of comparable risk. But how can you justify such a claim? Do you know more about the company than dozens of Wall Street analysts whose job it is to assess the company's future prospects? Can you predict how the irrational sentiments and behavioral biases of other investors will impact the future price of the stock? The truth is that stock picking is a speculative enterprise, and any individual who claims to be able to accurately predict future price movements is simply exhibiting the very natural human tendency to be overconfident in his own abilities.

Overconfident professionals

Not only do we exhibit overconfidence in our own abilities, we also tend to be overconfident in the abilities of certain "experts," including economists and financial strategists. While it is obvious that most amateur stock pickers are likely to underperform, many people still maintain a belief that the professionals have an edge and that their predictive ability holds the key to investment success.

Unfortunately, the results for the pros are no better. It is an established fact that, on average, professional investors who attempt to pick stocks or time the market tend to underperform. Their overconfidence leads them to a false belief about their skills, which in turn leads to over-trading and high expenses. Yet, despite the dismal performance of professional stock pickers, individual investors continue to solicit their services. The public's overconfidence in the abilities of these professional managers reinforces the overconfidence of the managers themselves, and the vicious circle of overconfidence is perpetuated.

"Many amateur investors engage in overconfident behavior without even realizing it."

Overconfident advice

As we learn about psychological biases such as overconfidence, we must keep in mind that these biases are an integral part of human nature and they cannot be removed from our psyche. The best we can hope to do is to increase our awareness of the presence of these biases so we can account for them when making financial decisions.

When working with a financial advisor, you should make sure that the advisor recognizes that overconfidence is present in all of us, that the future is not predictable, that we have limited control over market outcomes and that hidden risks are everywhere. An advisor who is aware of these biases can implement a disciplined investment strategy for you, but a lack of such awareness can be very hazardous to your financial health. As noted economist Ken French has said, "Overconfidence is almost certainly the most important bias in behavioral finance. But most people still think I'm not talking about them."

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

Rebalancing Is Difficult, but Worth It

> *"You should consider rebalancing your portfolio quarterly, semi-annually or annually."*

A great deal of research has supported the benefits of regularly rebalancing a portfolio. It suggests that you should start with a target asset allocation and then regularly sell or buy individual holdings in order to keep that allocation steady. For instance, suppose you start with a 50 percent allocation to stocks and a 50 percent allocation to bonds. A year later the stock market has fallen, and you now have 40 percent in stocks and 60 percent in bonds. To rebalance, you should sell enough bonds and buy enough stocks to restore the original 50/50 balance. This simple process forces you to systematically implement one of the most basic and important tenets of investing: buy low, sell high.

Emotional resistance

"Anecdotal evidence suggests that most investors do not rebalance their portfolios," according to Research Affiliates, an investment management firm based in Newport Beach, California. "Perfectly rational individuals exhibit changing risk aversion that makes it hard for them to rebalance into high-return assets that have had steep price declines," wrote Jason Hsu, chief investment officer of the firm. He said it is not just individuals who fail to rebalance, "but also sophisticated institutional investors advised by investment consultants and academics who are also prone to the same behavior."

This behavior overlooks research that shows the individual investment asset classes exhibit long-term mean reversion in prices. In other words, periods of outperformance are eventually followed by periods of under-performance, and vice-versa.

Creating opportunities

"So when an asset class falls in price… it's more likely to experience high subsequent returns," Hsu wrote. For instance, after extended falls in the Standard & Poor's 500 Index, subsequent five-year returns have been significantly above average.

You should consider rebalancing your portfolio quarterly, semi-annually or annually. That way you will not be swayed by short-term market movements. More frequent rebalancing may be counter-productive because assets tend to have momentum when moving in one direction and you may end up selling a rising asset too soon to reap the full benefit of its move upwards.

There are many rebalancing methodologies to choose from. What is important is that you establish a reasonable rebalancing plan and that you have the discipline to implement it on a regular basis. For most people, this is the difficult part; procrastination and emotions like greed and fear will interfere with the efficient adherence to the plan. If you find that you are unable to implement a rebalancing plan on your own, you should consider hiring an advisor who includes rebalancing as an integral part of his or her investment process.

In accordance with rule 204-3(c) of the Investment Advisors Act of 1940, Heritage Investment Group, Inc., hereby offers to deliver, without charge, a copy of its brochure (ADV Part 2) upon request. In addition, upon request, Heritage will deliver, without charge, a copy of its corporate Code of Ethics.

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