Heritage Perspective

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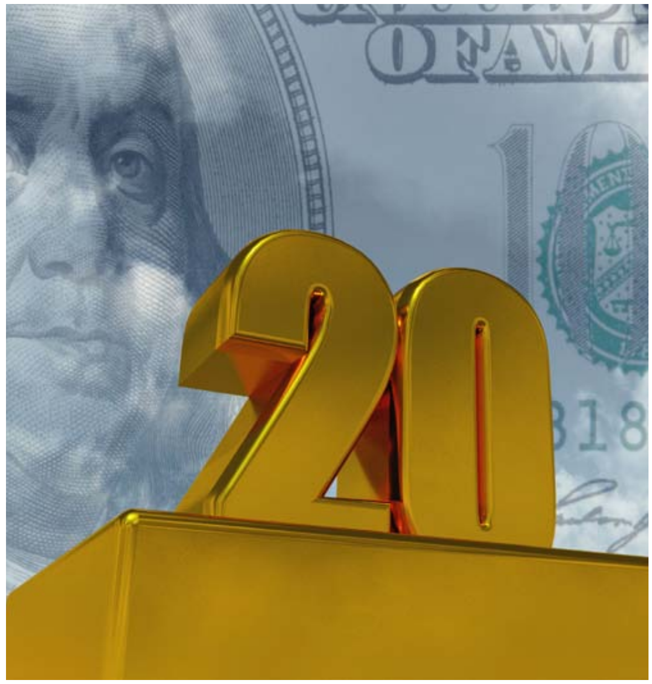
Twenty Years of Capitalism

This year marks the 20th anniversary of the founding of Heritage Investment Group. Upon reaching this milestone, we at Heritage paused to reflect upon where we have been over the past 20 years and where we are headed over the next 20. As we thought about this, we realized that while the world around us has changed dramatically over the past 20 years, the power of capitalism and the core principles of a successful investment process have remained remarkably constant.

Think about where you were in 1993. Were you recently retired, recently promoted, recently married or a recent college graduate? Consider all of the events, both positive and negative, that have transpired since then. Treatments for a wide variety of diseases have improved dramatically and communication technology has progressed from basic mobile phones to the internet to handheld smart phones. There are currently more millionaires than ever before and global poverty has been reduced by half since the early 1990s. At the center of all of this remarkable progress and wealth creation is capitalism. Capital markets financed the companies that have created miracles in communications and even bigger miracles in medical science, and capitalism has been the lead engine of the dramatic increases in global wealth that have lifted *one billion* people out of poverty in the past two decades.

> *"...capitalism works, markets are unpredictable, risk matters, and discipline prevails."*

Granted, we have seen our share of negative news: wars, terrorist attacks and financial crises have been



experienced, and these are not to be taken lightly. The world in which we live will always be marked by both positive and negative events, and the challenge that we all have is to be able to navigate these events in such a way that we emerge stronger and more confident about the future. From an investing standpoint, managing risk, providing unfailing discipline and recognizing that capitalism will prevail has allowed us to ride out the storms of the past 20 years with confidence. During difficult times, human nature drives many investors to change their strategy based on an emotional reaction to events, often with disastrous consequences. Instead of *reacting* to dramatic events, as fear and greed often encourage us to do, a wise investor will *manage through* these events with a time-tested strategy that has a proven ability to survive. A solid investment strategy

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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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never goes out of style; this was true 20 years ago and it is no less true today. Combining a disciplined approach with an understanding of the unpredictable nature of markets has allowed Heritage to build diversified portfolios that have generated wealth over time.

In 1993, Heritage was a start-up family business founded by a core group of partners who shared a vision of bringing honesty, structure and discipline to the wealth management process. We had a novel idea about how wealth should be managed and about how clients should be treated, and our belief in this idea is just as strong today. We are privileged to have had the opportunity to lead our clients through the ups and downs of the market throughout this time and to allow them to participate in the wealth-creating power of the capital markets over the past 20 years. The world has changed, but our belief in the fundamental principles of the capital markets has not; capitalism works, markets are unpredictable, risk matters, and discipline prevails. We are looking forward to the next 20 years.

Activity Bias

"There is nothing so terrible as activity without insight." – Johann Wolfgang von Goethe

In a previous article, we addressed the negative impact that overconfidence can have on portfolio returns. In this article, the third in our series on behavioral finance, we will highlight a related concept known as activity bias. Activity bias is the natural human tendency to favor activity over inactivity, especially in times of stress.

We are all familiar with activity bias in our everyday lives. When the world around us is not acting the way we want it to, we have a tendency to want to do *something* about it. If we see smoke coming from the kitchen, we immediately decide to do something about it, before identifying what that something should be. More often than not, embracing the activity bias has positive results such as preventing a house fire. Activity is associated with success, vitality, and happiness, and a lack of activity can often imply laziness or indifference. However, activity bias can also lead to actions that are detrimental or just plain silly. For example, every time you go to the airport, there is always one fellow traveler who will do whatever is necessary to be the first to board the airplane, as if such activity will get him to Baltimore faster. Although activity bias may be a benign waste of energy at the airport, in an investment context it can be downright harmful.

Getting in and out

Investment-related activity bias causes many investors to trade in and out of the market. It has often been observed that amateur investors, driven by emotion, tend to buy after periods of relative strength in the markets and to sell after periods of relative weakness. This type of activity, which is the polar opposite of the age-old "buy low, sell high" adage, has a dramatic negative impact on returns. In their 2012 study of investor behavior[1], the independent research firm Dalbar found that the average investor in U.S. equity mutual funds dramatically underperformed a simple buy-and-hold strategy over the prior twenty years. Over that time period, the average equity investor earned 99% while the U.S. stock market (as measured by the S&P 500 index) earned 350%. Although the high cost of some of the mutual funds was certainly a contributing factor, the difference in returns between the market and the mutual fund investors was mostly attributed to excessive activity. Their impatience cost these individual investors over half of their potential wealth.

Professionals make the same mistake

Professional investors, as a group, tend to suffer the adverse consequences of activity bias as well. Where amateur investors tend to move in and out of the market as a whole, professional investors tend to trade within the market, swapping one stock for another in an attempt to gain an edge. Unfortunately for these professionals (but even more so for their clients), trading activity is costly and usually detrimental to returns. A recent study[2] in the *Financial Analysts Journal* found that mutual funds whose turnover and trading costs were in the lowest quintile had returns that were 1.78% per year higher than the returns of the firms with the highest trading costs. Clearly, the tendency to activity is not helping the professionals either.

Activity without insight

Amateur and professional investors alike have an innate tendency towards action, despite the fact that it is usually detrimental to returns. Professional investors often have the additional temptation to use trading activity to create a sense of "sizzle" for their clients or simply to justify their existence. Instead of using activity as a way to justify his fee, a good professional advisor should have the integrity to communicate to his clients that a lack of activity does not imply a lack of thoughtful and insightful analysis. More often than not, activity leads to lower returns and the best recommendation is to stay put if a sound strategy is already in place. Making a commitment to remain disciplined is a far better strategy than succumbing to the all-too-human temptation to act just for the sake of acting, and a good advisor will recognize this and design his portfolio strategy accordingly.

> *"When the world around us is not acting the way we want it to, we have a tendency to want to do something about it."*

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

[1] Dalbar, Inc., "2012 Quantitative Analysis of Investor Behavior," (www.dalbar.com).
[2] Edelen, Evans and Gregory, "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance," Financial Analysts Journal, Vol. 69, No. 1

Riding the Emerging Markets Tiger

Many investors jumped into emerging market stocks a few years ago after they had delivered sizeable returns. More recently, the associated risk has reasserted itself and the infatuation has faded. What's the right approach?

A major theme in media commentary since the turn of the century has been the prospect of a gradual passing of the baton in global economic leadership from the world's most industrialized nations to the emerging economies. Anticipating this change, investors have sought greater exposure to these changing economic forces by including in their portfolios an allocation to some of the emerging powerhouses such as China, India, and Brazil.

An emerging market is broadly defined as the stock market of an economy that is in the process of rapid growth and industrialization. These markets historically have provided higher average returns than developed markets. But the flipside of these returns is that emerging markets also tend to be riskier and more volatile. That's because their systems of law, ownership, and regulation are still developing, and they are often less politically stable. This is reflected in their higher volatility.

In its latest economic assessment released in September, the Organization of Economic Cooperation and Development (OECD) noted that while advanced economies were growing again, some emerging economies were slowing. "One factor has been a rise in global bond yields – triggered in part by an expected scaling back of the US Federal Reserve's quantitative easing – which has fueled market instability and capital outflows in a number of major emerging economies, such as India and Indonesia," the OECD said.

Naturally, many investors will be feeling anxious about these developments and wondering whether emerging markets still have a place in their portfolios. There are a number of points to make in response to these concerns. First, this information is already in the price. Markets reflect concerns about the impact on capital flows of the Fed tapering. Changing an agreed portfolio allocation based on past events is tantamount to closing the stable door after the horse has bolted.

Second, just as rich economies and markets like the US, Japan, Britain, and Australia tend to perform differently from one another, emerging economies and markets tend to perform differently from rich ones. This just means that irrespective of short-term performance, emerging markets offer the benefit of added diversification. And we know that historically, diversification across securities, sectors, industries and countries has been a good source of risk management for a portfolio.

Third, emerging markets perform differently from one another, and it is extremely difficult to predict with any consistency which countries will perform best and worst from year to year. That's why concentrated bets are not advised. Rather than taking a bet on individual countries or even groups of countries, the key to investing in emerging markets is to take a cautious approach – investing in a number of countries, keeping an eye on costs, and regularly reviewing risk controls.

Fourth, in judging your exposure to emerging markets, it is important to distinguish between a country's economic footprint and the size of its stock market. China makes up only about 2% of the global stock market – and that is the biggest single emerging market. Combined, emerging markets make up only 11% of the total world stock market.

This is not to downplay the importance of emerging markets. The global economy is changing, and the internationalization of emerging markets in recent decades has allowed investors to invest their capital more broadly. Emerging markets are part of that. The increasing opportunities for investment also increase diversification, so while one group of markets, countries, or sectors experiences tough times, another group may be posting strong returns.

While emerging market performance in recent times has been less than stellar, it is important to remember that they are still providing a diversification benefit and that over the long term they have delivered strong returns. Getting out of emerging markets or reducing one's exposure to them after stock prices have dropped means forgoing the potential for higher future returns.

Volatility is part and parcel of the emerging markets experience. A bumpy ride on this tiger is not unexpected. But for those investors who are adequately diversified with an asset allocation set for their needs and risk appetites, it is worth holding on.