C-SUITE QUARTERLY
THE EXECUTIVE'S LEADERSHIP & LIFESTYLE MAGAZINE

Investment Lessons You Need to Know

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The '90s were one of the best decades in history for the S&P 500. The main US stock index returned almost 390% or roughly 17% annually. Back then, many people thought investing was easy. Today, not so much.

During this past decade, real estate and emerging markets both delivered total returns over 150%, while the S&P 500 fell by -9%, making it one of the worst in history for developed country equities. Investors eventually learn that nobody can predict the future consistently and that asset allocation typically drives performance.

Einstein called compounding the "Eighth Wonder of the World" because a small difference in your annual return makes a huge difference in your total assets long-term. As such, these investment lessons are priceless because they are extremely expensive to learn firsthand.

So, what do you need to know?

1. Learn about the leading investment strategies.
2. Employ strategic core diversification.
3. Focus on the right data.

Leading Investment Strategies

Do you know the only growth-oriented investment strategy that delivered gains in both of the equity market crashes this decade? Many investors are unaware of rules-based trend-following because it was only offered in complex products. In recent years however, the growth in exchange-traded funds (ETFs) has finally brought trend-following to mainstream investors.

Our research concludes that trend-following, like index investing, has an investment edge from its efficient and reactive rules-based investment process. Both of these strategies benefit from avoiding human emotion and from reducing investment fees and expenses. Since investors are unable to consistently predict the future, it's a critical distinction that these strategies are "reactive," rather than "predictive."

David Swensen manages Yale's multi-billion dollar endowment fund and his industry leading performance makes him an ideal resource for all investors. When asked recently to comment on the future of portfolio management, Swensen responded that, "[T]he investment management world is a strange place in that the right solution is not in the middle. The right solution is at one extreme or the other . . . intensely active or completely passive."

Investors should note that index funds, and most ETFs, are forms of passive investing, while trend following is intensely active.

Strategic Core Diversification

Beating the market long-term is unlikely for most investors. In attempts to outperform, many people significantly damage their long-term financial freedom. Therefore, leading institutional investors, such as Warren Buffet and David Swensen, adamantly recommend index-oriented core portfolios with strategic multi-asset class diversification and ultra-low expenses.

In his book, "Unconventional Success," Swensen gives readers an efficient core growth portfolio comprised of six exchange-traded funds (ETFs). Over the past decade, this free portfolio gained well over 70%, more than double the 32% gain from a simple 70/30 growth portfolio (70% S&P 500 and 30% Long-Term Treasuries). Investors that compare Swensen's core ETF portfolio to what they have in place will probably find they're paying costly advisory fees to significantly underperform.

The Right Data

Many investors mistakenly focus on the wrong data. The most important factors to monitor pertain, on a long-term basis, to risk, return, diversification, and process.

Regarding risk, don't underestimate the benefit of strategies with smaller losses. The return "of" your principal is even more important than the return "on" your principal because severe losses are more damaging than missed gains. An investment that loses 50% of its value must subsequently gain 100% to break-even so look for investments with a history of smaller losses.

Next, be sure to evaluate the long-term compound annual return potential for each investment. At the bare minimum, review the three to five year performance figures. The emotional reflex to focus on short-term data is a dangerous distraction because the best long-term investment strategies will underperform at times.

Diversification refers to the degree in which your investments move in-synch. It's extremely beneficial to build a portfolio that has some portion doing well when other portions struggle. Most recently, this criterion leaves investors searching for strategies that delivered gains in 2008, such as trend following.

Lastly, evaluate the process. We find the greatest value in strategies that offer efficient reactive exposure to a broad range of asset classes, with excellent liquidity and transparency, strict overriding risk controls, and no leverage.

The Bottom Line

Reactive rules-based strategies, from indexing to trend following, are important portfolio components for strategic diversification. Be sure to monitor Swensen's Unconventional Core and don't fixate on short-term performance. Instead, focus on long-term data points regarding peak declines, compound annual returns, diversification, and process.

David S. Kreinces is the Founder and Portfolio Manager of ETF Portfolio Management (ETF PM), a financial advisory firm specializing in rules-based investing. He is an expert in trend following and successfully delivered gains for clients in the recent market downturn. ETF PM also offers free strategic core portfolios and the firm pledges to donate 15% of its annual advisory fees to the schools and charities selected by clients. (www.etfpm.com) (www.freecoreportfolios.com)