RETHINKING YOUR NEW YEAR'S TRADITIONS

THOUGHT LEADERSHIP PERSPECTIVES

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START A NEW TRADITION THIS YEAR BEGINNING WITH YOUR PORTFOLIO

Here in the U.S., we celebrate the New Year with the Times Square Ball Drop. In Japan, 'Bonenki' (forget-the-year parties) are held to bid farewell to the problems and concerns of the past. In the Netherlands, the Dutch burn their Christmas trees in large bonfires—to purge the old and welcome the new.

It seems that investors also have an annual New Year's tradition—that of cleansing and purging their portfolios. They eagerly await publication of various mutual fund ranking reports. Armed with this data, they rush to analyze their portfolios and prepare a list of 'must have' funds selected based on last year's performance. As a result, their current investment holdings are divided into two camps: "Winners" and "Dogs". Following the traditions of the Japanese and the Dutch, the "Dogs" are sold from the portfolio and replaced by "Winners" from the fund ranking lists they created.

The return of volatility to the market may further cause investors to feel uncertain and fearful, compelling them even more strongly to make portfolio changes. After all, it's human nature to "hurry up and do something" when confronted with fear. For example, the 19.8% down-draft from last year's market high may have caused your adrenaline to rise, but in reality, such declines are fairly typical over the course of a market cycle.

Do not overreact; staying the course may be your best strategy. But this statement assumes you have a formalized investment plan in place. To help you chart the way for 2019, we'd like to offer you 5 sound investment fundamentals:

1) REASSESS YOUR RISK TOLERANCE.

If recent volatility has you rattled, you need to rethink your risk level and consider reducing your stock holdings to a tolerable level. Recent volatility is around "normal" levels. It only feels worse coming on the heels of extraordinarily low levels of volatility in recent years.

2) REASSESS YOUR OBJECTIVES TIME HORIZON.

What are you asking your portfolio to do over your remaining lifetime? What is your standard of living and is it reasonably sustainable with your portfolio?

3) REASSESS YOUR OVERALL ASSET ALLOCATION STRATEGY IN CONSIDERATION OF STEPS 1 AND 2.

Asset allocation, or more simply how you divide your assets among stocks, bonds and cash, will be the primary determinant of your investment return over the long run.

4) TAKE TIME TO EVALUATE THE UNDERLYING HOLDINGS IN YOUR PORTFOLIO.

Try to avoid the urge to sell something merely because it is down. Instead, compare your holdings to a range of metrics, like expense ratio or long-term performance, vs. an index or peer comparison. Beware of labels; is the fund really investing in what you think it is?

5) COORDINATE YOUR TAX-FAVORED ACCOUNTS, SUCH AS IRAS AND 401(K)S INTO YOUR OVERALL ALLOCATION.

It is important to populate those accounts with tax-inefficient holdings. This concept of 'tax asset allocation' will help maximize the benefits of tax-deferral and help prevent converting capital gains into ordinary income.

Unfortunately, the most likely result of a fear-based response to portfolio management can be a series of "sell low" and "buy high" transactions. Investors may also unknowingly concentrate the risk within their portfolio, as an unintended consequence. By basing purchase decisions on recent performance, holdings become concentrated into whatever segment of the market is in favor at that time. Such actions create a bubble that WILL BURST when that segment falls out of favor. These actions—those based on overreacting to market volatility—can exacerbate the volatility of a portfolio compared to a well-diversified approach. In turn, this heightened volatility can lead investors to double-down on the problem by repeating the "Winners and Dogs" process throughout the year.

The result: underperformance, higher transaction fees, and ill-timed recognition of capital gains and losses for tax purposes.

Investors often wonder about how long to retain a fund that is underperforming. In general, we caution to wait a full market cycle before taking any action. The investor also needs to compare the fund to a relevant market benchmark and peer group, and then analyze how a fund's strategy fits into that landscape.

Business executives often say, "I would never let one of my business segments fall below expectations for more than two quarters, let alone a full market cycle!" Such an approach may not translate well to asset management. If you look at any ten-year period (a longer, more realistic perspective), it is very common for top-quartile performers to spend at least two years in the bottom quartile. Using the business approach, the investor would have already sold the ten-year top-quartile performer. An impatient investor or one unwilling to perform the requisite ongoing due diligence would be better served investing in index funds. Such an approach would reduce costs, improve tax efficiency and alleviate anxiety over short-term underperformance.

IF YOU ARE CONCERNED ABOUT YOUR CURRENT INVESTMENT APPROACH AND LACK THE TIME, WILLINGNESS, OR ABILITY TO ADDRESS IT ON YOUR OWN, WE ARE HAPPY TO HELP.

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