LIFE PLANNING PARTNERS
FINANCIAL HEALTH FOR LIFE

Investment Management

Investment management is a critical component in the financial planning process. A basic understanding in the beginning increases satisfaction with future portfolio performance through good and bad markets.

It is our belief that proper investment management is about making unbiased, well-informed financial decisions and minimizing costly mistakes. There should be a reason and a process behind decisions, rather than hunches, emotions or media hype. We take an evidence-based analytical approach, infused with a solid dose of common sense.

This document is designed to clarify how we view investment management and to address some of the questions and concerns that arise. The objective is to explain *what* we do, *how* we do it, and *why* we do it.

Investment Philosophy

Saving and investing is important to protect your current life and prepare for the future. For many people this is the most important part of financial planning services. Our philosophy aligns with client goals in the following ways:

Prudent Management of Risk
It's an unavoidable truth that all investing involves some degree of risk. Many people focus strictly on short-term fluctuations in value (market risk), but keeping up with rising prices (inflation risk) over time is equally important. Our task is to help clients achieve their objectives while taking no more risk than necessary. All funds are placed at a large independent custodian to provide ease of management and safekeeping for our clients.

Sound and Justifiable Approach
All investment decision-making should hold up to the most current academic studies, empirical data and every-day common sense. Our investment strategy is an "evidence-based" approach incorporating decades of rigorous peer-reviewed research from top universities and practitioners. There will always be a well-thought out reason and rationale behind everything we do.

All investments have the potential for profit or loss. Past performance does not guarantee future success.

Focus on Costs and Tax-Efficiency
Taxes and expenses have an unquestionable impact on investment results. They also happen to be two areas where we have considerable control. As a result, we focus on both intently and strive to minimize their effect. We use a combination of low cost exchange traded funds, mutual funds, and bonds to implement investment strategies.

Asset Allocation and Diversification
Investing would be quite simple with perfect foresight –simply pick the single investment that will do best in the future. Unfortunately, we all know it's not that easy. The future is unknowable, and should be treated as such. There are many possible outcomes, several of which are difficult to imagine today. A portfolio should be structured to withstand whatever the future might bring, and proper asset allocation and diversification are the logical ways to approach an uncertain world.

Long-Term Focus
We are not market timers or short-term traders, and we make no attempt to predict market tops or bottoms (or even direction). Consider how often forecasts miss the mark in sports, weather and politics – financial markets arguably have as many (or more) variables impacting results, and the likelihood of consistently guessing outcomes and predicting changes is exceedingly low. We believe the best strategy is a disciplined approach to take advantage of the benefits that accrue to patient investors over time.

Valuation Matters
Markets can (and do) drift away from a reasonable estimate of long-term "fair value," and the risk / return tradeoff can become distorted. When this happens, maintaining a static allocation to an asset class just isn't logical. Our approach is based on valuation sensitivity – focusing on the long-term investment opportunity available for each asset class, and we will adjust exposures when warranted.

Passive Investing
We strongly believe in a low-cost, diversified "passive" approach to investing. This is much different than the typical Wall Street approach taken by most brokers and product salespeople. For a more in-depth discussion, see *"Active versus Passive Investing."*

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Investment Process

When you become a client
One of the first steps in your investment process is moving what accounts we can to an independent or qualified custodian so your assets are with a large, secure, third-party financial institution. Our firm has an institutional relationship with Fidelity Investments to provide this service. Through this relationship we are able to provide our clients with low cost investment choices and avoid some account fees that may be charged to individuals. We are not employed by Fidelity and we are not compensated in any way by Fidelity. Fidelity is the facilitator for transactions, safekeeping, and reporting of your investment holdings.

We can purchase a vast array of mutual funds, exchange traded funds, bonds, stocks, or other investments; we are not limited to Fidelity products. Some accounts may not be able to move to Fidelity (e.g. workplace 401k plans, children's 529 plans). We still manage these accounts, either directly or indirectly, and include them in your overall portfolio allocation. We do this by choosing the best options available in these plans, and rounding out your entire portfolio with investments held in your other accounts.

Your Investment Policy Statement
Before investing your accounts, we work with you to determine an appropriate asset allocation for your situation. Asset allocation is the combination of investment classes with varying degrees of risk, that make up your portfolio and it has a major impact on long-term investment results.

To determine an allocation, we incorporate your Money Personality Questionnaire, overall financial plan, time horizon, ability to save, and general conversations on your investment history and background. These components give us insight into your ability to take risk, both financially and emotionally. We formalize this in an Investment Policy Statement (IPS), which provides the framework for how investments will be managed.

Types of Investments
The asset classes included in your portfolio will generally be a combination of equities (stocks), fixed income (bonds), and alternatives (real estate, natural resources, commodities). Each of these classes has different, inherent levels of risk.

> ***Equities*** are more commonly known as "stocks" and represent ownership in publically traded companies. On the scale of risk, equities are on the higher end. We like to use low cost "funds" to fill this category. Funds hold multiple company stocks within them, as opposed to us purchasing individual stocks directly for you. There are internal costs associated with funds, and we look at these carefully. An advantage of funds is that they provide low-cost diversification, which limits exposure to any one company, industry or sector of the economy.

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Fixed Income includes all forms of interest-paying investments. The most common fixed income asset is a bond. A bond is a “debt security,” a loan to a company or government entity. The borrower agrees to repay the investor over a defined period of time, with the investor receiving interest as compensation for loaning the money. On the scale of risk, bonds are generally on the lower end (provided the borrower is credit worthy). We use individual bonds for cash flow purposes as well as bond funds for liquidity. Cash and bank certificates of deposit also fall in the fixed income category, as they generally pay interest at regular intervals.

Alternatives include real estate, natural resources and commodities. These are investments that have risk and return characteristics comparable to equities, but may be affected by different economic factors. We also use funds to invest in this class since they offer the most liquid and cost-efficient way to get exposure.

Asset Location

We consider tax consequences when determining the types of investments and the accounts in which they are held (asset location), as well as any time sales are made.

Taxable accounts are generally invested in equities and municipal bonds (federally tax-exempt). For individuals in lower tax brackets (with less tax sensitivity) taxable bonds may be used.

Roth IRAs are often considered to be an account that will be used well into the future for cash flow needs. Generally having the longest time horizon of all your accounts, this will often be invested more aggressively relative to other accounts. In other words, this type of account may hold more stocks and alternative assets, and you will see more fluctuation relative to your other accounts.

Traditional IRAs and other tax deferred accounts tend to be more flexible in terms of the investments held within them. Since there are no tax considerations for investment gains, we generally use this as the place to round out your investment portfolio.

It’s important to keep in mind that all of your accounts are individual parts of the whole portfolio. You may hold aggressive investments in one type of account and safer investments in another, resulting in much different rates of return in each type of account.

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Implementation and Ongoing Investment Management
After your current investments transfer to Fidelity, we will gradually shift your portfolio to match the target asset allocation of your Investment Policy Statement (IPS) and will continue to monitor compliance with your IPS.

It is important to make any adjustments and investing decisions in a tax-efficient manner and with an eye toward transactions costs. For certain accounts it may take longer to transition to avoid generating unnecessary fees or tax consequences.

At least once per quarter your portfolio will be evaluated for rebalancing, intended to bring your overall portfolio mix into compliance with your Investment Policy Statement (IPS) target asset allocation. Transaction costs and tax implications are taken into consideration prior to making any investment changes. When significant balances are held outside of our authority, we may need your assistance in rebalancing those accounts. If you are not able to help us make adjustments, your overall portfolio mix may drift outside of your Investment Policy Statement (IPS) target asset allocation. Periodic rebalancing helps to maintain an appropriate level of risk and allocation between the asset classes.

The level of cash in your portfolio will vary as bonds mature, dividends and interest are paid, and other investments are sold. Cash is valuable for funding withdrawals and rebalancing a portfolio without being forced to sell other assets. In addition, the stability of cash tends to smooth out portfolio volatility, making it a better diversifier for stock market risk than any other defensive holding. We view cash as a unique and important asset class, and a modest allocation of a few percentage points is reasonable and beneficial.

Keeping you informed
You will receive monthly statements from Fidelity for each of your accounts. You will also have electronic access to performance and return information provided by Fidelity.

We provide access to an online financial portal that gives an overview of all your investment accounts. It provides an overall, consolidated picture of your accounts, values, asset allocation, transactions, etc. plus a snapshot of your total net worth.

We recommend meeting with you on an annual basis or upon your request to discuss your investments, including evaluation of your underlying portfolio assets, asset allocation, current market conditions, and investment results to ensure investment strategy and expectations remain aligned with your stated goals and objectives.

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Active versus Passive Investing

There are two distinct approaches that can be taken to invest in asset classes: active or passive. *(These definitions can apply to any investment, but for simplicity we will use stocks here.)*

What's the difference?
Passive investing is the effort to capture market returns as efficiently as possible by using a low-cost, broadly diversified portfolio of stocks.

Active management is an attempt to generate returns that are higher than the broad market through stock selection, frequent trading, and market timing. In simple terms, it's trying to "pick the winners" to "beat the market."

The active approach is a path taken by millions of people. The common method is to pay someone to pick the future winning stocks (a manager), often through a mutual fund or separate account manager.

What are the failings of active management?
Long odds – Over four decades of research has consistently shown that most actively managed portfolios **do not** produce better long-term results than a passive approach. The website for the U.S. Securities and Exchange Commission (SEC) provides a good summary in this regard:

> *"In any given year, most actively managed funds do not beat the market. In fact, studies show that very few actively managed funds provide stronger-than-benchmark returns over long periods of time, including those with impressive short term performance records."* *(*http://www.finra.org/investors/mutual-funds*)*

Winners don't repeat – Although most active managers underperform, some do better than the market. Shouldn't we utilize proven winners? Unfortunately, substantial research shows that **few winners repeat their success**. In other words, the past tells us very little about who will win in the future. For example, Standard & Poor's Persistence Scorecard measures the ability of a fund manager or strategy to deliver above-average returns consistently over multiple periods. From the December, 2019 scorecard:

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> *"Less than 3% of equity funds in all categories maintained their top-quartile status at the end of the five-year measurement period."*
> *(http://us.spindices.com/documents/spiva/persistence-scorecard-december-2019.pdf)*

Skill or luck? – Unfortunately, research suggests that luck may have a much larger impact on stock picking than we imagine. A study reviewing U.S. stock funds over a 30-year period *("Luck Versus Skill in the Cross Section of Mutual Fund Returns"; Fama & French)* estimated that a mere **3% of active funds appeared to demonstrate any skill**. Another study examining nearly 2,100 funds over 30+ years (*"False Discoveries in Mutual Fund Performance"; Barras, Scaillet,& Wermers*) came up with a slightly lower **estimate of skill (after expenses) – 0.6%**. Even the authors of the study expressed surprise, with professor Russ Wermers describing the prospect of picking a winning fund ***"almost hopeless."***

These are just some of the problems that plague an active investment approach. Others issues include concentrations of risk (fewer securities), tax-inefficiency, changing investment styles, fund management changes, lack of portfolio transparency, and the financial drain of increased fees. Taken together, these disadvantages are nearly insurmountable for an active approach.

Why does active management fail?

Market efficiency – Inherent in an active investment approach is the notion that markets are *inefficient* – meaning stocks are priced incorrectly and mistakes can be exploited for a profit. There is a logical problem here: If markets are inefficient and pricing errors are prevalent, it's not clear that prices would be corrected in a reasonable timeframe to generate above-average profits. In other words if markets can't set prices correctly, it won't do any good to find "mispriced" stocks.

The idea that markets are actually quite good at setting prices goes back to the 1800's, and it has been the focus of academic research for over a century. The research shows that markets do a decent job, and even most active managers will acknowledge that markets are reasonably efficient. Markets may not set prices perfectly, but they do it well enough to make it *exceedingly* difficult to systematically "beat the market."

In the words of a (former) Chief Investment Strategist at one of the largest active investment firms:

> *"Let me start with a common sense observation about market efficiency: It is clearly hard for active managers to outperform the market, which has been true for as long as anyone has tracked the results of active managers."*
> *– Michael J. Mauboussin, Legg Mason Capital Management*

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Cost – Active management is expensive. The research staff, data services and trading costs for active stock picking add significantly to investment expenses. According to the 2020 Investment Company Fact Book, the asset-weighted average expense ratio for active stock funds is ***more than 7 times higher*** than for passive index funds. These expense numbers do not include the impact of frequent trading, which has more of a hidden impact. According to the Dimensional Funds 2020 Mutual Fund Landscape, "Equity trading costs, such as brokerage fees, bid-ask spreads, and price impact, can be just as large as a fund's expense ratio." Altogether these costs create a significant hurdle for active managers each and every year, and it directly reduces investors' net returns.

Passive Wins

Hope springs eternal, and many of us like to think we are above average (or can at least find someone that is above average) in most pursuits. This is also true when it comes to picking investments. However, the evidence just doesn't support this concept. Academic researchers, including multiple Nobel Laureates in Economics, have overwhelmingly supported a passive approach as the most logical way to pursue investment returns.

Implementation

A common way to implement a passive investment approach is through the use of index funds, which mirror a broad market benchmark (a common example being the S&P 500 index). These funds are very useful in capturing the returns of broad economic forces in a given market, and we utilize them in many portfolios. Firms such as Vanguard and Fidelity offer extremely cost effective index products.

A more unique manner of passive investing that we often incorporate in portfolios is provided by Dimensional Fund Advisors (DFA). This institutional investment firm incorporates strategies backed by academic research which are designed to enhance results. For example, factors such as company size and value/growth measures have been shown to produce different long-term stock results, and DFA adjusts stock portfolios for these characteristics. DFA also focuses closely on how securities are bought and sold and avoids the use of commercial indexes, all in an effort to reduce costs. The goal is to deliver the performance of broad capital markets along with improvements through portfolio design and trading efficiencies.

Summary

Randomness, unpredictable behavior and unexpected events all make it difficult to predict the future consistently. This is essentially what active stock pickers try to do, and their track record is abysmal.

Studies have regularly shown that investment returns are provided by markets, not by people trying to outsmart markets. Such efforts have generally had a negative impact for investors and favored only the active manager. The most reliable way to invest is to capture as much market return as possible by using a diversified, low-cost, passive approach.