An Evidence-Based Approach to Investing

By Jason Oshins, Financial Advisor, MBA

Evidence-based medicine is defined as "the conscientious, explicit, and judicious use of current best evidence in making decisions about the care of individual patients."[1] If possible, wouldn't it be prudent to approach investing similarly? Wouldn't it make sense to apply the concepts developed by Nobel Laureates? Well, you can.

Philosopher Alfred A. Montapert famously said, "Do not confuse motion and progress." Motion also creates the illusion of control. An excellent example of this is in the investment world. Wall Street perpetuates the notion that successful investing requires stock picking and market timing. However, according to Nobel Laureates, these aren't necessary to receive healthy, market-based rates of return. In fact, leading financial services market research firm DALBAR[2], in its annual study on investor behavior, finds that these are the precise elements that cause investors to significantly underperform the index.

A little secret - successful long-term investing is far simpler than most are lead to believe. In fact, it can be achieved through the adherence to the following five steps:

1) Maintain a long-term perspective
2) Own equities
3) Diversify
4) Rebalance regularly
5) Remain disciplined

However, be careful not to confuse simple with easy. If successful investing were easy, wouldn't investors be in stronger financial conditions with greater peace of mind?

Let's elaborate on the principles.

MAINTAIN A LONG-TERM PERSPECTIVE
Perspective is important. The market has volatility. Nobody knows which way it will move in the short term – will it increase 10% this month, decrease 10%? Attempting such prognostication is foolish at best. We do know, however, that over the long term, the market has gone up. In addition, each time it has fallen, it subsequently has appreciated to a new high.

OWN EQUITIES
This step is straightforward – be in the market. This essentially is where investors look for returns. According to Nobel award-winning research, a "risk premium" is associated with owning equities.

DIVERSIFY
Often, both investors and fund managers confuse what is meant by diversification. It doesn't simply entail owning "a lot of stuff". A truly diversified portfolio is scientifically constructed, containing asset classes – groupings of securities with similar characteristics – with offsetting correlations, which means they move in different directions. It's comprised of domestic and international holdings, large and small holdings, and growth and value holdings. Different asset classes perform well – or poorly – at different times. However, identifying the winners in advance is a fool's errand. The idea is to position dissimilarly-moving price movements within the portfolio. True diversification helps insulate the portfolio from the impact of unpredictable markets. Nobel Laureates have defined the optimal "mix" of asset

classes to maximize returns for any given level of risk. Essentially, this means that investors are compensated appropriately for the level of risk they are willing to assume.

REBALANCE REGULARLY

Different asset classes perform well at different times. This causes the portfolio to become unbalanced, thus altering its defined mix. Rebalancing is the process of regaining the pre-determined alignment. When a mechanism for rebalancing is built into the process, the investor obtains the investment holy grail of buying low and selling high. For example, let's assume a portfolio is comprised of $50,000 of US stocks and $50,000 of international stocks. If the US stocks increase to $65,000 and the international stocks decrease to $45,000, the portfolio no longer is in balance. Rebalancing simply involves selling $10,000 worth of the US holdings – selling high and locking in the gains – and purchasing $10,000 worth of international ones – buying low – resulting in $55,000 in each asset class, resuming the defined ratio while maintaining the original risk tolerance. Effective portfolio management involves having a systematic approach to rebalancing, based on academics.

REMAIN DISCIPLINED

If people did what was in their best interest, health clubs would remain crowded all 12 months and fast food restaurants would disappear from street corners. Humans have emotions. When something feels good, we want more; when something feels bad, we want less. Emotions lead to dysfunctional behavior, as we behave in a way that is not in our best interest. As supported by DALBAR's annual studies, people jump in and out of the market in response to "greed and fear". Much of this is a reaction to the "sky is falling" messages in media and from friends and family. These messages are all around us, from the financial entertainer on TV to the national columnist in our favorite magazine, from the co-worker with a hot stock pick to the sibling with the can't-lose hunch. This is exacerbated by financial institutions, which offer active trading tools because, after all, isn't each of us a unique trader?

We have an opportunity to apply evidence-based medicine principles to the investment world, to approach it from a scientific and academic perspective. This entails strict adherence to the aforementioned steps. Investing involves science and art. The first four focus on science, emphasizing the implementation of Nobel Laureates' research, and the fifth focuses on art, emphasizing the management of investors' behavior.

Citations:

Sackett David, 1996.

DALBAR's Quantitative Analysis of Investor Behavior (QAIB), 2014.

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