DIRECTIONS
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Investing Success: Temperament is More Important Than IQ

Plus, A Grab-Bag of Questions from Investors

In this quarter's Directions newsletter, CLS's Chief Investment Officer, Rusty Vanneman, CFA, CMT explains why being in tune with your emotions and overcoming behavioral biases is more important than your intelligence. Mr. Vanneman then goes on to answer a few key questions commonly asked by 401(k) investors.

*Mr. Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, he served as Chief Investment Officer and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial.*

Learn more about Rusty here.

The world-renowned investor, Warren Buffett, has famously said that temperament is more important than intelligence when it comes to investing success. Below is an excerpt from a 2013 *Fortune* interview with Buffett and his long-time partner, Charlie Munger. It's a wonderful excerpt, not only touching upon the value of discipline, but also the distinctly human attributes of curiosity and social connections.

Buffett: *Temperament is more important than IQ. You need reasonable intelligence, but you absolutely have to have the right temperament. Otherwise, something will snap you.*

Munger: *The other big secret is that we're good at lifelong learning. Warren is better in his 70s and 80s, in many ways, than he was when he was younger. If you keep learning all the time, you have a wonderful advantage.*

Buffett: *And we have a wonderful group of friends, from whom we can learn a lot.*

When two sages agree that discipline and emotional control are the keys to staying balanced and on track to reaching our investment goals, we should take note. But, that's easier said than done. After all, we are human beings and we have behavioral biases, especially when our money is involved. Being aware of these behavioral biases is more important than staying abreast of the latest financial news. It will help prevent, or at least slow or minimize, wrong moves with our portfolios.

Recently, CLS Portfolio Manager Josh Jenkins, CFA wrote a short commentary piece summarizing the major behavioral biases. He introduced the subject by discussing a recurring dream (or, really, nightmare) about taking the CFA exam, the gold-standard credential for investment management professionals, even though he passed the exam some time ago.

Below is what Josh wrote (slightly modified for this letter):

I woke up in the middle of the night recently in a cold sweat. I had just had a dream that seems to recur every couple of months. I had failed one of the CFA exams and needed to retake it. Anyone who has been subjected to the CFA program knows that it is indeed a terrible nightmare. For whatever reason, when I awoke I could not stop repeating a mnemonic in my mind. It was an acronym for the 15 behavioral biases taught for the Level III exam: Losers.

Loss-aversion bias

People tend to strongly prefer avoiding losses over achieving gains. While a rational investor should take risk to improve returns, paradoxically, many investors take risk to limit losses. This behavior manifests itself in what is known as the disposition effect: the tendency for investors to hold onto positions that are down and sell positions that are up (lock in profits). Doing this can limit potential portfolio upside and cause investors to hold positions that are too risky.

Overconfidence bias

People demonstrate unwarranted faith in their own intuitive reasoning, judgments, and/or cognitive abilities. Because of this bias, investors tend to underestimate risk while overestimating potential returns, hold poorly diversified portfolios, trade excessively, and ultimately underperform the market.

Status-quo bias

People are generally more comfortable keeping things the same, and thus do not necessarily look for opportunities where change is beneficial. People with this bias will typically do nothing rather than make a change. A consequence is investors unknowingly maintain portfolios with risk characteristics that are inappropriate for them.

Endowment bias

People tend to value an asset more when they hold rights to it than when they do not. Endowment bias is inconsistent with standard economic theory, which asserts that the price a person is willing to pay for a good should equal the price at which that person would be willing to sell the same good. This may prevent selling off certain assets to be replaced with more appropriate ones because holding familiar asset classes adds to the perceived value. A result is holding an asset mix with inappropriate risk characteristics.

Regret-aversion bias

People tend to avoid making decisions that will result in action, out of fear that the decision will turn out poorly. Simply put, people try to avoid the pain of regret associated with bad decisions. Regret-aversion bias may lead to herding behavior and/or being too conservative in investment behavior and not taking on enough portfolio risk.

Self-control bias

People often fail to act in pursuit of their long-term, overarching goals because of a lack of self-discipline. There is an inherent conflict between short-term satisfaction and achievement of some long-term goals. A consequence of this bias would be insufficient saving for the future. Upon realizing this, individuals will often take on too much portfolio risk to make up the difference.

These definitions are a handy reference and can be used to help guide decisions about investments and general consumption. You might be surprised at how often they appear.

A Grab-Bag of Questions from Investors

Recently, I asked an advisor who works with 401(k) investors to inquire about the key topics and questions investors want to discuss. Below are the topics they chose and some short (and hopefully sweet) answers:

1. **Why is it important to increase contributions to meet retirement goals?**

The best way to build wealth is to live within one's means. Then, money that is not consumed should be saved. Once an adequate safety net has been established, that money should be invested.

There are various rules of thumb on how much one should save and invest (the best advice usually comes after sitting down with a financial advisor who understands an investor's situation). But, typically the ranges begin at 10% of income and go up to 20%. In either case, for those investing for retirement, the best way to meet retirement goals is to increase *contributions*, not *risk*.

2. What is the difference between target-date funds and managed accounts?

A target-date mutual fund, also known as a life-cycle mutual fund, invests based on age. For instance, if one expects to retire in 20 years, a mutual fund will invest with a 20-year investing time horizon and become increasingly more conservative (lower exposure to the stock market) as it nears that 20-year mark. At the target date, the portfolio is conservative. These are good investment vehicles in the broad strokes, but they only take into account one variable — time horizon.

A managed account, meanwhile, utilizes a professional money manager who takes a more customized approach to building portfolios. This includes taking into account other key variables to determine an appropriate portfolio, such as risk tolerance (financial and emotional capabilities to take risk and withstand market volatility), and other unique personal considerations.

3. What are the benefits of delaying retirement and how does that affect one's Social Security check?

Many investors don't realize they can receive increased Social Security benefits if they delay taking them beyond full retirement age. The yearly rate of increase depends on one's year of birth. For instance, if one was born in 1943 or later, the yearly rate of increase is 8%. Before 1943, the rate of increase is lower and depends on the specific year.

Does it always make sense to delay taking payments? It depends. Again, a financial advisor working with an individual investor and getting to know his or her personal situation will provide the necessary counsel to determine the best plan.

4. What is the difference between Roth IRAs and traditional retirement accounts?

A Roth IRA differs from traditional retirement accounts in that Roth distributions are tax-free. This is possible because the contributions made into Roth accounts are made after-tax. This is completely opposite from traditional retirement accounts. The IRS is going to get paid one way or the other, and with Roth accounts, it takes the money upfront. Are Roth accounts superior to traditional accounts? Again, a financial advisor will know the best answer for a specific investor, but the general rule of thumb is to invest in a Roth *in addition* to a 401(k), as no one knows what tax rates might look like upon retirement.

If you have any questions on this material, or anything outside this article, please let me know. Thank you for your time and trust.

Stay balanced.

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2017 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA

GLOBAL VALUE

This theme refers to an emphasis on value stocks around the globe that have lower valuations than the overall market. In other words, they might have a lower stock price to some fundamental unit of value ratio, such as sales or earnings. Not only do relative valuations support increasing positions in value stocks, but an improving economy also supports this theme. Value stock sectors CLS will be emphasizing: financials, natural resources, and emerging markets.

SMART BETA

Smart Beta ETFs are rules-based ETFs whose holdings aim to intentionally diverge from a broad, market-cap-weighted index. At CLS, we emphasize five equity factors and two fixed income factors when we analyze portfolios and select ETFs. Moving forward, while recognizing that all investment styles are cyclical, we believe this theme will provide a durable edge over the long haul.

Equity Factors: Value, Quality, Size, Minimum Volatility, and Momentum
Fixed Income Factors: Credit and Duration

CREATIVE DIVERSIFICATION

With interest rates at low levels compared to historical averages, this theme refers to the need to continue diversifying equity volatility to manage overall portfolio risk. CLS achieves this by being creative in the ways we actively manage our fixed income exposures, our continued use of alternative asset class segments and strategies, and through buying commodity-based ETFs.

The Market ≠ The Dow

Portfolio Manager, Grant Engelbart, CFA, CAIA

"The market is up 100 points today!"

How often do you hear that comment? Some of my family members who have no market knowledge even referenced movements in the Dow Jones Industrial Average (DJIA). There are so many questions that come to mind when I hear that comment. What market? What does 100 points mean? What is the Dow even made up of?

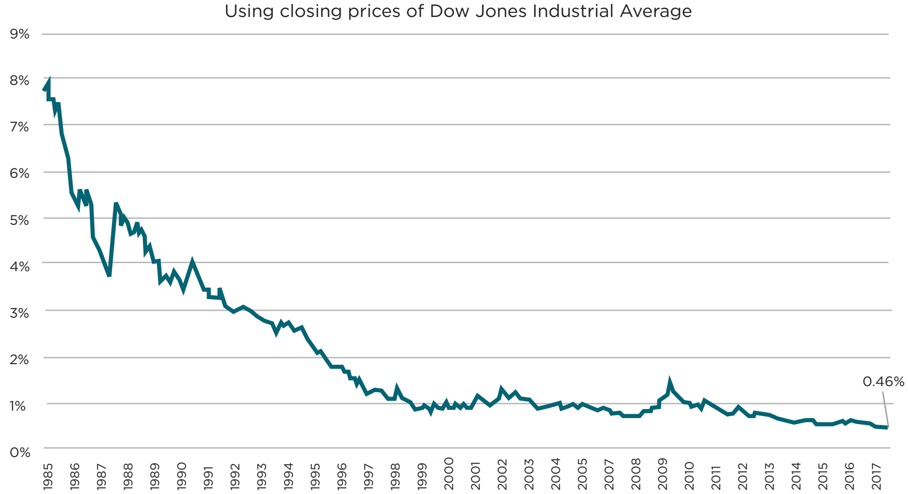
The Dow Jones Industrial Average is a price-weighted index of 30 blue-chip companies in the United States, selected by a committee. The "Dow" is named after Charles Dow, a Wall Street Journal editor and founder of Dow Jones & Co. The "Jones" is actually named after one of Dow's business associates, Edward Jones (ever heard that name?). The index was first launched in 1896, making it one of the longest running measures of stock market performance we have. Stock market history is intensely fascinating (to me at least). However, given the index's history, ties to the media, and familiar status in the minds of Americans, it's easy to see why it's remained prominent. There is no denying that an investor replicating the index over any reasonable length of time would be handsomely rewarded. But, there are still a number of flaws to consider.

Let's break down the description I laid out earlier – **"a price-weighted index of 30 blue-chip companies in the U.S."**

The index is **price–weighted**. That means stocks with higher share values have a larger weight and impact on the index. For example, Boeing has the largest weight in the Dow (more than 7%) due to its $233/share price. Apple, on the other hand, has a 4.8% weight due to its $153/share price. Meanwhile, the market cap of Apple is *almost six times larger* than Boeing. Weighting an index by something other than market cap is a good idea (see smart beta), but share price really doesn't mean much of anything. This price weighting ends up translating into specific point moves for the index. Hearing "Dow up (or down) triple digits" is commonplace and typically elicits some kind of emotion, whether positive or negative, even to the lay person. But, the truth is triple-digit moves are now borderline insignificant. As the price of the index has risen, triple-digit moves represent less than half a percent!

Percentage Change of a Triple-Digit Dow Move

Using closing prices of Dow Jones Industrial Average

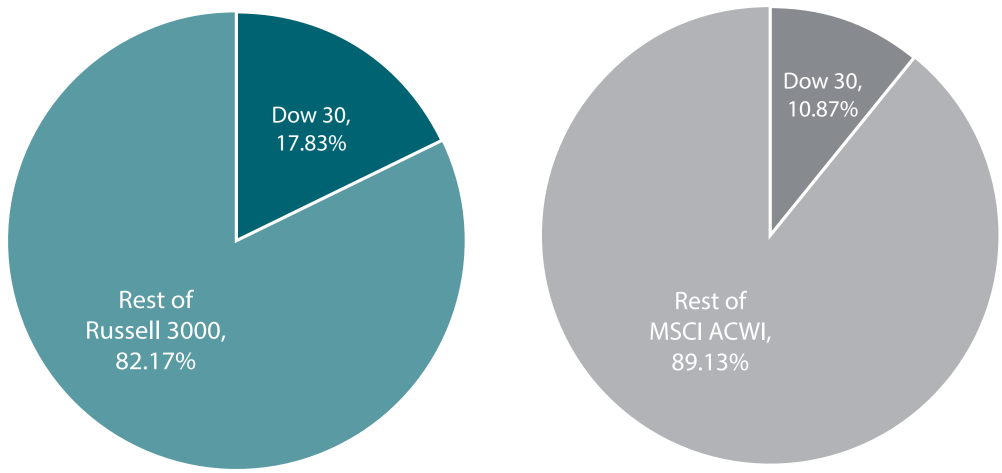


Source: Bloomberg

There are **30 blue-chip companies** in the index. Meanwhile, there are something like 4,000 listed stocks (that trade actively) in the U.S. and multiples of that number overseas! In the age of railroads and conglomerates, 30 stocks could maybe capture the full picture, but it just doesn't cut it today. Major staples of American industry, such as Google's parent company Alphabet, aren't even included! Alphabet has revenues higher than 23 Dow components and a market capitalization higher than every component except Apple. But, even more than the size of these companies, included or not, is the growth potential of small- and mid-cap firms. America is a growth story, the heart of capitalism and innovation. These blue chips are no doubt innovative too, but they may not capture the true essence of America.

There are 30 blue-chip companies **in the U.S**. It's safe to say the world has become immensely more connected since 1896. At CLS, we are *global investors* and believe the investment opportunity is tremendously broader than the 30 blue chips referenced daily. While these are certainly large companies, and still command 11% or so of global market-cap, the sheer number of investment opportunities out there in other countries dwarfs the exposure from the Dow firms.

Dow Jones Industrial Average as a Percentage of Broad Market Indices



Source: Morningstar

It's unlikely the Dow will be removed from ticker tapes any time soon – although I did hear a commentator mention some of the index's flaws recently. Coaching our investors and advisors to focus on a broader index, even just the S&P 500 (which also has its drawbacks) can go a long way. The MSCI All Country World Index may be a ways off for my family to reference as the market (although I'm training best I can), but the investing world is going that direction whether it's convenient or not.

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