

# The Informed Investor

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**Making Smart Investing  
Decisions in Today's  
Volatile Market**

by Jeffrey R. Carlson, CFP®



**CARLSON**  
CAPITAL MANAGEMENT



## **MISSION STATEMENT**

Our mission is to be a trusted partner that allows our clients to feel secure in the knowledge that their retirement, investment, estate, tax and philanthropic plans are complete, efficient and organized, in order that they may understand and use their wealth as a tool to accomplish what is important to them in their lives.

# The Informed Investor:

## Making Smart Investing Decisions in Today's Volatile Market

### ACHIEVING ALL THAT IS IMPORTANT TO YOU

Money means different things to different people. All of us have different dreams. You may want to achieve financial freedom so that you never have to work again — even if you plan on working the rest of your life. You may want to make a top-level college education possible for your children or grandchildren. You might want to provide the seed capital that will give your children or grandchildren a great start in life, whether that's with a home or a business. You may dream of a vacation home on the beach or in the mountains. Or you may have achieved tremendous success throughout your career and believe that it's important to leave a legacy. You may want to leave something behind for your favorite charity that will enable it to continue on with its good work. Whatever your dreams are, they are important to you, and that makes them extremely worthwhile. The resource guide you are holding in your hands will equip you to make smart decisions about your money so that you can achieve all that's important to you. Let's get started making your financial dreams a reality.

### RISING ABOVE THE NOISE

Most investment professionals work very hard to make their work extremely confusing. They have a vested interest in creating investor confusion. They use jargon designed to intimidate you and make it difficult for you to understand.

But investing is actually not that complicated. It can be broken down into two major beliefs:

- You believe in the ability to select superior investments, or you don't.
- You believe in the ability to time markets, or you don't.

Let's explore which investors have which belief systems and where you should be with your own beliefs.

Exhibit 1 (on page 3) classifies people according to how they

make investing decisions. **Quadrant one** is the **noise quadrant**. It's composed of investors who believe in both market timing and superior investment selection. They think that they (or their favorite financial guru) can consistently uncover mispriced investments that will deliver market-beating returns. In addition, they believe it's possible to identify the mispricing of entire market segments and predict when they will turn up or down. The reality is that the vast majority of these methods fail to even *match* the market, let alone beat it, particularly after cost.

Unfortunately, most of the public is in this quadrant because the media play into this thinking as they try to sell newspapers, magazines and television shows. For the media, it's all about getting you to return to them time and time again.

**Quadrant two** is the **conventional wisdom quadrant**. It includes most of the financial services industry. Most investment professionals have the experience to know they can't predict broad market swings with any degree of accuracy. They know that making incorrect predictions usually means losing clients. However, they believe there are thousands of market analysts and portfolio managers with MBAs and hightech information systems who can find undervalued securities and add value for their clients. Of course, it's the American dream to believe that if you're bright enough and work hard enough, you will be successful in a competitive environment.

Unfortunately, as un-American as it seems, in an efficient capital market this methodology adds no value, on average. Study after study shows that capital markets work.

**Quadrant three** is the tactical **asset allocation quadrant**. Investors in this quadrant somehow believe that, even though individual securities are priced efficiently, they (and only they) can see broad mispricing in entire market sectors. They think they can add value by buying when a

**EXHIBIT 1  
THE INVESTMENT DECISION MATRIX**

		Market Timing	
		Yes	No
Security Selection	Yes	<b>Noise Quadrant 1</b>  Most individual investors Financial journalists	<b>Conventional Wisdom Quadrant 2</b>  Financial planners Stock brokers Most mutual funds
	No	<b>Tactical Allocation Quadrant 3</b>  Pure market timers Asset allocation funds	<b>Information Quadrant 4</b>  Academics 40% of institutional investors

Source: CEG Worldwide. Analysis: Carlson Capital Management

market is undervalued, waiting until other investors finally recognize their mistake, and selling when the market is fairly valued once again. We believe that it's inconsistent to think that individual securities are priced fairly, but that the overall market, which is an aggregate of the fairly priced individual securities, is not. No prudent investors are found in this quadrant.

**Quadrant four** is the **information quadrant**. This is where most of the academic community resides, along with 40 percent of institutional investors. Investors in this quadrant dispassionately research what works and then follow a rational course of action based on empirical evidence. Academic studies indicate that the average net returns of the three other quadrants are lower than the overall market return. This is due to high turnover, which results in additional trading costs and higher taxes. **Quadrant four** is where you should be, and where you'll find all prudent investors.

Our goal is to help investors make smart decisions about their money so that they are firmly in place in **quadrant four**. To accomplish this, we help investors move from the noise quadrant to the prudent investor quadrant. This is where you should be if you want to maximize the probability of achieving all your financial goals.

**FIVE KEY CONCEPTS TO INVESTMENT SUCCESS**

While investing can, at times, seem overwhelming, the academic research can be broken down into what we call the *Five Key Concepts to Investment Success*. If you examine your own life, you'll find that it is the simpler things that consis-

tently work. Successful investing is no different. However, it is easy to have our attention drawn to the wrong issues. These wrong issues can derail our journey as we attempt to achieve all that is important to us.

In this section, we'll walk through these five concepts and then explain how successful institutional investors incorporate each of these concepts into their investment plans, no matter which direction the markets are going at the moment.

**Concept One:  
Utilize Diversification Effectively to Reduce Risk**

Most people understand the basic concept of diversification: Don't put all your eggs in one basket. However, no matter how sophisticated you are, it's easy to get caught in a trap.

For example, many investors had a large part of their investment capital in their employer's stock during the 2000-2003 downturn. Even though they understood that they were probably taking too much risk, they didn't do anything about it. They justified holding the position because of the large capital gains tax they would have to pay if they sold, or they imagined that the stock was just about ready to take off. Often, investors are so close to a particular stock that they develop a false sense of comfort. From 2000 to 2003 many an investor has felt the pain of not being a prudent investor.

Other investors believe that they have effectively diversified because they hold a number of different stocks. They don't realize that they are in for an emotional roller-coaster ride if these investments share similar risk factors by belonging to the same industry group or asset class. "Diversification"

**EXHIBIT 2**  
**THE EMOTIONAL CURVE OF INVESTING**



among many high-tech companies is not diversification at all.

To help you understand the emotions of investing and why most investors systematically make the wrong decisions, let's look for a moment at what happens when you get a hot tip on a stock. (See Exhibit 2.)

If you're like most investors, you don't buy the stock right away. You've probably had the experience of losing money on an investment — and did not enjoy the experience—so you're not going to race out and buy that stock based on a hot tip from a friend or business associate right away. You're going to follow it awhile to see how it does. Let's assume, for this example, that it starts trending upwards.

You'll watch it a little longer to see how it does. How do you feel? You hope that this might be the one investment that helps you make a lot of money. Let's say it continues its upward trend. You start feeling a new emotion as you begin to consider that this just might be the one. What is the new emotion? It's greed. You decide to buy the stock that day.

You know what happens next. Of course, soon after you buy it, the stock starts to go down, and you feel a new combination of emotions—fear and regret. You're afraid you made a terrible mistake. You promise yourself that if the stock just goes back up to where you bought it, you will never buy like this again. You don't want to have to tell your spouse or significant other about it. You don't care about making money anymore.

Now let's say the stock continues to go down. You find yourself with a new emotion. What is it? It's panic. You sell the stock. And what happens next? New information comes out and the stock races to an all-time high.

We're all poorly wired for investing. Emotions are powerful forces that cause you to do exactly the opposite of what you should do. That is, your emotions lead you to buy high and sell low. If you do that over a long period of time, you'll cause serious damage to not just your portfolio, but more importantly, to all your financial dreams.

**Concept Two:**  
**Dissimilar Price Movement Diversification**  
**Enhances Returns**

If you have two investment portfolios with the same average or arithmetic return, the portfolio with less volatility will have a greater compound rate of return. For example, let's assume you are considering two mutual funds. Each of them has had an average arithmetic rate of return of eight percent over five years. How would you determine which fund is better? You would probably expect to have the same ending wealth value.

However, this is only true if the two funds have the same degree of volatility. If one fund is more volatile than the other, the compound returns and ending values will be different. It is a mathematical fact that the one with less volatility will have a *higher* compound return.

You can see how this works from Exhibit 3. Two equal investments can have the same arithmetic rate of return but have very different ending values because of volatility. You want to design your portfolio so that it has as little volatility as necessary to achieve your goals.

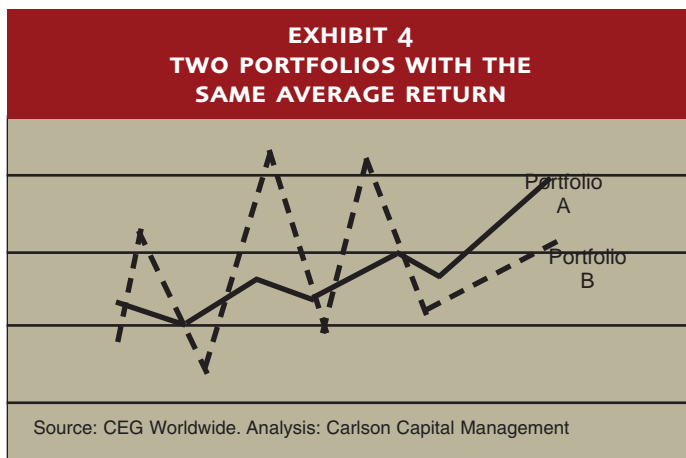
Exhibit 4 shows two portfolios with the same average return. As a prudent investor, you want the smoother ride of Portfolio A not only because it helps you ride out the emo-

**EXHIBIT 3  
CONSISTENCY BEATS VOLATILITY**

Beginning Value	Consistent Investment		Volatile Investment	
	Rate of Return	Ending Value	Rate of Return	Ending Value
		\$100,000		\$100,000
Year 1	8%	\$108,000	30%	\$130,000
Year 2	8%	\$116,640	-20%	\$104,000
Year 3	8%	\$125,971	25%	\$130,000
Year 4	8%	\$136,049	-20%	\$104,000
Year 5	8%	\$146,933	25%	\$130,000
Arithmetic return	8%		8%	
Compound return		8%		5.39%

Source: CEG Worldwide. Analysis: Carlson Capital Management

tional curve, but more importantly, because you will create the wealth you need to reach your financial goals.



**Concept Three:  
Employ Asset Class Investing**

Many investors feel that they could have executed better than they did during the last few years. Unfortunately, most investors are using the wrong tools and put themselves at a significant disadvantage to institutional investors. The average investor who uses actively managed mutual funds is trying to fix a sink with a screwdriver, when they really need a pipe wrench. You need the right tools.

Almost all investors would benefit by using institutional asset classes. An asset class is a group of investments whose risk factor and expected returns are similar. Originally, institutional asset class funds were not available to the great majority of investors. Often the minimum investment for these

mutual funds was in the millions of dollars, effectively keeping them beyond the reach of all but the wealthiest investors. That was their goal because these funds were for institutional accounts, such as large pension plans.

There are four major attributes of institutional asset class funds that attract institutional investors:

1. Lower operating expenses
2. Lower turnover resulting in lower costs
3. Lower turnover resulting in lower taxes
4. Consistently maintained market segments

We'll look at each one in turn.

**1. Lower Operating Expenses**

All mutual funds and separately managed accounts have expenses that include management fees, administrative charges and custody fees. These are expressed as a percentage of assets. According to Morningstar, the average annual expense ratio for all retail equity mutual funds is 1.45 percent. In comparison, the same ratio for institutional asset class funds is typically only about one-third of all retail equity mutual funds. All other factors being equal, lower costs lead to higher rates of return.

**2. Lower Turnover Resulting in Lower Cost**

Most investment managers do a lot of trading, thinking that this adds value. The average retail mutual fund has a turnover ratio of 97 percent. This means that, on average, 97 percent of the securities in the portfolio are traded over a 12-month period. This represents \$97,000 of traded securities for every \$100,000 invested.

Higher turnover is costly to shareholders because each time

a trade is made there are transaction costs, including commissions, spreads and market impact costs. These hidden costs may amount to more than a fund's total operating expenses if the fund trades heavily, or if it invests in small company stocks for which trading costs are very high.

Institutional asset class funds have significantly lower turnover because their institutional investors want them to deliver a specific asset class return with as low a cost as possible.

### **3. Lower Turnover Resulting in Lower Taxes**

If a mutual fund sells a security for a gain, it must make a capital gains distribution to shareholders because mutual funds are required to distribute 98 percent of their taxable income each year, including realized gains, to stay tax exempt at the corporate level. They distribute all their income annually because no mutual fund manager wants to have his or her performance reduced by paying corporate income taxes.

In one study, Stanford University economists John B. Shoven and Joel M. Dickson found that taxable distributions have a negative effect on the rate of return of many well-known retail equity mutual funds. They found that a high-tax-bracket investor who reinvested the aftertax distribution ended up with an accumulated wealth per dollar invested of only 45 percent of the fund's published performance. An investor in the middle tax bracket realized just 55 percent of the published performance.

Because institutional asset class funds have lower turnover, they have significantly lower taxes.

### **4. Consistently Maintained Market Segments**

Most investment advisors agree that the greatest determining factor of performance is asset allocation—how your money is divided among different asset categories. However, you can only accomplish effective asset allocation if the investments in your portfolio maintain consistent asset allocation. That means your funds need to stay within their target asset classes. Unfortunately, most retail funds effectively have you relinquish your control of your asset allocation. On the other hand, because of their investment mandates, institutional asset class funds must stay fully invested in the specific asset class they represent.

Fortunately, these institutional asset class funds are now available to investors through fee-based financial advisors. You can gain the same advantages that previously only large institutional investors received.

### **Concept Four: Global Diversification Reduces Risk**

We've all read about the concept of a "global village"—that we're getting closer and closer together. Technology is creating a new paradigm in which businesses around the world are tied together, just as markets are now tied together. Then why should you include an international institutional asset class in your portfolios?

The answer is that American equity markets and international markets do not move together. Individual stocks of companies around the world with similar risk have the same expected rate of return. However, they don't get there in the same manner or at the same time. As you can see from Exhibit 5, there are tremendous dissimilar price movements between international and U.S. asset classes.

### **Concept Five: Design Portfolios That Are Efficient**

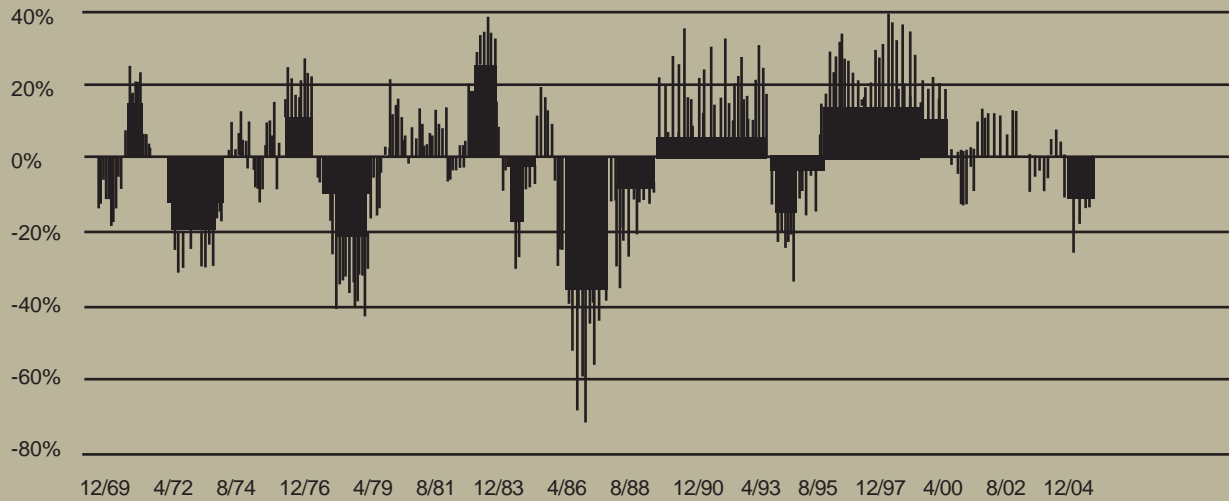
How do you decide which investments to use and in what combinations? Since 1972, major institutions have been using a money management concept known as Modern Portfolio Theory. It was developed at the University of Chicago by Harry Markowitz and Merton Miller and later expanded by Stanford professor William Sharpe. Markowitz, Miller and Sharpe subsequently won the Nobel Prize for Economics for their contribution to investment methodology.

The process of developing a strategic portfolio using Modern Portfolio Theory is mathematical in nature and can appear daunting. It's important to remember that math is nothing more than an expression of logic, so as you examine the process, you can readily see the common sense approach that it takes—which is counter-intuitive to conventional and over-commercialized investment thinking.

Markowitz has stated that, for every level of risk, there is some optimum combination of investments that will give you the highest rate of return. The combinations of investments exhibiting this optimal risk/reward trade-off form the efficient frontier line. The efficient frontier is determined by calculating the expected rate of return, standard deviation and correlation coefficient for each institutional asset class fund and using this information to identify the portfolio at the highest expected return for each incremental level of risk.

By plotting each investment combination, or portfolio, representing a given level of risk and expected return, we are able to describe mathematically a series of points or "efficient portfolios." This line forms the efficient frontier. It's impor-

**EXHIBIT 5  
U.S. AND FOREIGN MARKETS PERFORM DIFFERENTLY**



January 1969-December 2004. The difference between the Standard & Poor's 500 Index and the Morgan Stanley EAFE Index. Quarterly annualized returns.

Source: CEG Worldwide. Analysis: Carlson Capital Management

tant to note that, while a portfolio may be efficient, it is not necessarily prudent.

Most investor portfolios fall significantly below the efficient frontier. Portfolios such as the S&P 500, which is often used as a proxy for the market, fall below the line when several asset classes are compared. Investors can have the same rates of return with an asset class portfolio with much less risk, or higher rates of return for the same level of risk.

Exhibit 6 illustrates the efficient frontier relative to the “market.” Rational and prudent investors will restrict their choice of portfolios to those that appear on the efficient frontier and to the specific portfolios that represent their own risk tolerance level. You want to ensure that, for whatever risk level you choose, you have the highest possible return on the effi-

cient frontier so that you can maximize the probability of success.

**YOUR NEXT STEPS**

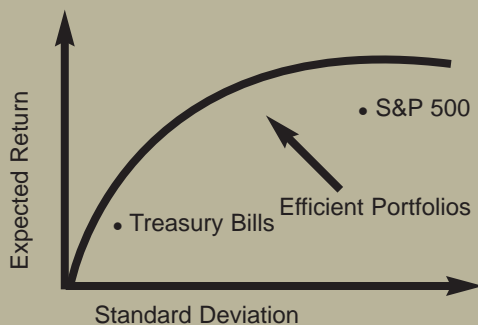
Given today's market volatility, one of the most important things you can do as an investor is to ensure that your investment plan is current. Your plan should examine where you are now and where you need to go to realize your financial goals, and should also identify the gaps you need to overcome.

It's important to recognize that it's very difficult to be good at all things. Because most of us are not wired, from an emotional standpoint, to effectively develop and maintain our investment plan, you may want to consider working with a qualified financial advisor. One major survey of affluent investors found that 90.2 percent of them want to work with financial advisors. The key is to find an advisor who will implement the five key concepts we've discussed here.

If you do choose to work with a financial advisor to update and implement your investment plan, you should be aware that not all advisors will approach your investments in the same way. There are two types of advisors: those who are *transactional* and those who are *consultative*.

The difference? Transactional advisors are primarily focused on recommending a variety of investment products to their clients. Consultative advisors, on the other hand, are prima-

**EXHIBIT 6  
THE RANGE OF EFFICIENT PORTFOLIOS**



Source: CEG Worldwide. Analysis: Carlson Capital Management

rily concerned with offering their clients a consultative approach that will help them meet their clients' investment needs.

Because consultative advisors are committed to uncovering your true financial needs and goals, and crafting a long-range investment plan that will meet those needs and goals over time, we recommend that you choose the consultative approach.

And what should you expect from a consultative advisor? The most successful consultative advisors use a systematic process, usually spread over a series of meetings, to design an investment plan that maximizes the probability of achieving your financial goals. These meetings typically involve the following:

- **A discovery meeting.** The advisor will determine your current financial situation, where you want to go and the obstacles you face in achieving what is important to you.
- **An investment plan meeting.** The advisor, using the information he or she gathered at your first meeting, will present to you a complete diagnostic of where you are now and specific recommendations for how you can bridge the identified gaps in order to achieve your goals.
- **A mutual commitment meeting.** At this meeting, assuming that the advisor can truly add value, both you and the advisor will decide to work together. You will now officially become a client.
- **Follow-up meetings.** These meetings are typically held quarterly (but can be more or less often, depending on your specific needs) and are when the advisor reports to you the progress you're making towards achieving your goals.

You should always expect outstanding service from any financial advisor you choose. Your phone calls should be returned on the same day, you should receive quick and complete responses to all your questions, you should be able to meet with your advisor as often as you wish, and your advisor should always take your unique needs and preferences into account. In short, you should expect to be treated like what you are—a very important client.

If you are currently working with a financial advisor and are unsure if he or she is using a consultative approach or the proven methodologies we've discussed here, you should have another advisor complete a diagnostic of your situation so that you can have a second opinion.

This is an exciting and challenging time to be an investor. There are many things going on around the world that will make the next few years extremely rewarding—if you design your investment plan to be successful.

You owe it to your family and yourself to make sure that your investment plan is designed to not only deal with the changes you've experienced during the last few years of market volatility, but more importantly, to also take advantage of the opportunities to maximize the probability that you will achieve all your financial goals. We wish you nothing but success in achieving all that's important to you.

## ABOUT THE AUTHOR

Jeffrey R. Carlson is a founding principal of Carlson Capital Management. He received his Bachelor of Arts Degree in Economics, with concentrations in finance and accounting, from St. Olaf College in 1983. Jeff began his financial planning career with IDS Financial Services. In 1985, Jeff acquired the Certified Financial Planner® designation.

Jeff is actively involved in marketing the firm's financial, estate and tax planning services. Jeff's public speaking engagements have included such topics as retirement and early retirement, estate and philanthropic planning.

Jeff is an active Rotarian and past president of the Hastings Area Rotary Club, former council member and past President of St. Philips Lutheran Church in Hastings, MN. He is also an active alumnus of St. Olaf College, and currently the Class of '83 Correspondent and Class Fund Agent. Jeff is an avid tennis player and serves as a volunteer coach to the Hastings High School Tennis Team. He also serves on the board of the following non-profit organizations: Green Lake Lutheran Ministries, MN Chapter of the Fellowship of Christian Athletes, and the Hastings YMCA. Jeff, his wife, Stacy, and their three children live in Hastings, Minnesota.

## ABOUT CARLSON CAPITAL MANAGEMENT

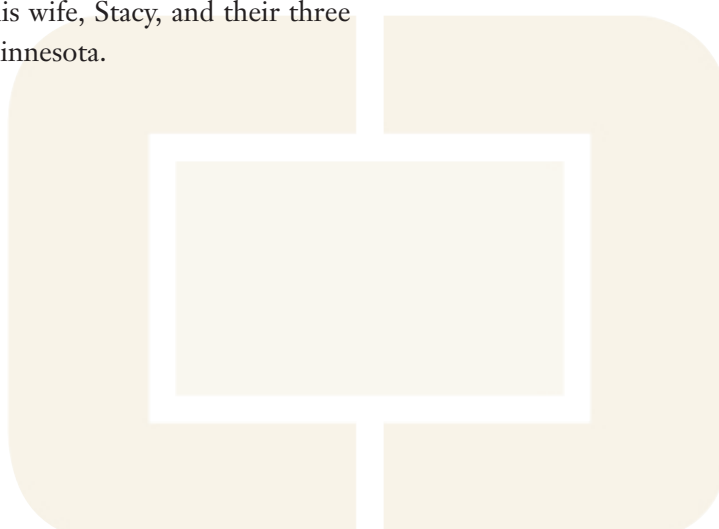
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For a complete background summary of the firm, or for more information, please visit our website at [www.carlsoncap.com](http://www.carlsoncap.com).

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## OUR PLEDGE

Our deep commitment to each client we serve is built upon foundational values like honesty, hard work, and a strong sense of personal dedication.

In an industry too often defined by short-term results and shifting values, Carlson Capital Management has stood apart as unique for more than twenty years. As financial markets have inevitably advanced and declined, the clients we've been privileged to serve have relied on our strong sense of personal dedication, and our deep, unwavering commitment to foundational values like honesty and hard work. They know that our family-owned business is grounded in an authentic care for clients, and a genuine concern for their well-being.

Each member of our team clearly understands that we are here to help our clients use their wealth to gain peace of mind, while adding significance and meaning to their lives. We have never taken for granted the fact that our clients trust us with far more than their financial assets. We know that their dreams, their goals, and the well-being of their families also depend on our expert counsel.

The deep and lasting partnerships we have forged with our clients and their families begin with trust, and are sustained by a high level of service and competency. These partnerships endure over years because in the end, what we care about most is making a difference in the lives of our clients.





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