THE Informed Investor

MAKING SMART INVESTING DECISIONS IN TODAY'S VOLATILE MARKET

BY GORDON J. BERNHARDT, PRESIDENT

BERNHARDT WEALTH MANAGEMENT

Letter from Gordon Bernhardt

For many investors, this is both a confusing and an exciting time in the investment world. Investors today are facing difficult choices in achieving their financial goals and, as well they should, are asking serious questions.

Our goal with *The Informed Investor* is to help investors see through the "noise" of the marketplace so that we can systematically help them make smart decisions about their money. Because educated investors are the most successful investors, we have created this guide to show, step by step, a Nobel Prize-winning approach to investments that has been proven as a sound strategy for optimizing investment portfolios over time. We have designed *The Informed Investor* specifically to help investors preserve what they have and, equally important, to efficiently capture the market's returns for their investments.

We believe in empowering investors to make the best decisions for themselves or, if they wish, to carefully choose a financial advisor who can implement sound investing principles. And we believe in sharing our own knowledge with investors who want to make smart, informed decisions about their finances—so they can achieve their most important personal goals.

At Bernhardt Wealth Management, we are pleased to present *The Informed Investor* to our clients and prospective clients. We sincerely believe that it will provide a framework for an intelligent approach to investing that will help investors achieve their financial dreams.

Sincerely,

Gordon J Bernhardt

President
Bernhardt Wealth Management

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The Informed Investor: Making Smart Investing Decisions in Today's Volatile Market

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Achieving All That Is Important to You

MONEY MEANS DIFFERENT THINGS TO DIFFERENT PEOPLE. We all 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-notch 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 that lives on by leaving something for your favorite charity that will enable it to continue its good work. ¶ Whatever your dreams are, they are important to you, and that makes them extremely worthwhile. We believe that money is simply a tool that empowers you to achieve the quality of life you deserve. This resource guide will better enable 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

We're all poorly wired for investing. As human beings with emotions, we sometimes find ourselves letting these powerful forces—fear, surprise, anger, and so on—persuade us to do the opposite of what we should do. Let's take a look at the emotional side of investing.

Say you get a hot tip on a stock. 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 right away based on a hot tip from a friend or business associate. You're going to follow it for awhile to see how it does. Let's assume, for this example, that it starts trending upwards.

You watch its positive progress a little longer. How do you feel? You begin to 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 called 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 set of emotions—fear and panic. You sell the stock. And what happens next? New information emerges and the stock races to an all-time high. There's no need to discuss the range of emotions you experience at this point.

Oftentimes, emotions lead you to buy high and sell low. (Exhibit 1 on the next page depicts this emotional curve of investing.) And if you do that over a long period of time, you'll cause serious damage to not just your portfolio, but, potentially, all your financial dreams.

EXHIBIT 1
THE EMOTIONAL CURVE OF INVESTING

Source: CEG Worldwide. Analysis: Bernhardt Wealth Management

As if this emotional noise weren't enough, some investment professionals work hard to make their field extremely confusing. They have a vested interest in creating investor confusion. They use jargon designed to intimidate investors and make it difficult to understand. But investing is really 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 the types of investors, these two belief systems, and where we believe an educated investor should be.

Exhibit 2 on the next page classifies people according to how they make investing decisions in terms of the two major beliefs discussed above. 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—the sellers of newspapers, magazines, and television shows—play into this thinking. 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 high-tech information systems who can find undervalued securities and add value for their clients.

EXHIBIT 2
THE INVESTMENT DECISION MATRIX

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

Source: CEG Worldwide. Analysis: Bernhardt Wealth Management

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 allocation quadrant*. Investors in this quadrant 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 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. Prudent investors are not 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 they follow a rational course of action based on empirical evidence. Academic studies indicate that the investments in the other three quadrants, on average, do no better than the market after fees, transaction costs, and 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 *information quadrant* (prudent investor). This is where you should be if you want to increase the potential of achieving all your financial goals.

Six Key Concepts to Investment Success

WHILE INVESTING CAN, AT TIMES, SEEM OVERWHELMING, THE academic research can be broken down into what we call the *Six Key Concepts to Investment Success*. If you examine your own life, you'll find that it is the simpler things that consistently work.

Successful investing is no different. However, our attention is easily 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 six concepts and then explain how successful institutional investors incorporate each of these concepts into their investment plans, no matter which direction the markets are moving at the moment.

Concept One: Utilize Diversification Effectively

Most people understand the basic concept of diversification: Don't put all your eggs in one basket. However, no matter how sophisticated an investor is, 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 recent downturn. Even though they understood that they were probably taking on 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 to take off. Often, investors are so close to a particular stock that they develop a false sense of comfort. Over the last several years, many an investor has felt the pain of not being a prudent investor.

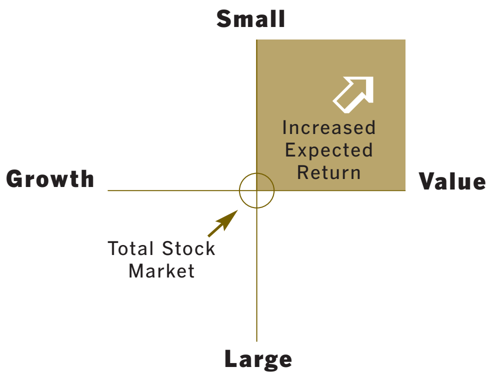
Other investors believe that they have effectively diversified because they hold a number of different stocks. They don't realize that they may be in for an emotional roller-coaster ride if these investments share similar risk factors because they belong to the same industry group or asset class. For example, "diversification" among many high-tech companies is not diversification at all.

Let's take a closer look at industry research and get a clearer understanding of the factors that drive equity performance.

Concept Two: Understand Factors that Drive Equity Performance

What drives equity performance? Most investors don't realize this, but leading research shows that differences in equity returns are best explained by company size

EXHIBIT 3
FACTORS THAT AFFECT EQUITY RETURNS



Three Factors

Equity Market
(complete value-weighted universe of stocks)

Stocks have higher expected returns and risk than fixed income.

Company Size
(measured by market capitalization)

Small company stocks have higher expected returns and risk than large company stocks.

Company Price
(measured by ratio of company book value to market equity)

Lower-priced "value" stocks have higher expected returns and risk than higher-priced "growth" stocks.

Source: Eugene F. Fama and Kenneth R. French, The Cross-Section of Expected Stock Returns, Journal of Finance 47, no. 2 (June 1992): 427-65.

and price characteristics, along with broad stock market exposure. You can see how this works in Exhibit 3. The Three-Factor Model (equity market, company size, and company price) defines risk with a precision that has made it the modern research standard. Within equities, size and price characteristics are the major explanatory variables in equity returns.

The notion that stocks behave differently from fixed income is widely accepted. And we believe that because they are riskier, financially less healthy "value" companies have higher costs of capital than financially healthier "growth" companies. When borrowing from a bank, value companies pay higher interest rates, and when issuing stock, they receive lower prices. A company's cost of capital is the investor's expected return.

Thus, small value companies have higher expected returns than large growth companies. Long-term increases in expected return can only be achieved through accepting greater small cap and/or value risk since the prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

Therefore, we tend to manage portfolios that increase exposure to value stocks (rather than growth stocks) in an attempt to increase return potential. And while we lean toward mostly large company stocks, we often complement them with smaller company stocks for their extra return and diversification potential.

Now that you understand the concept behind this model, we're ready to discuss real diversification.

EXHIBIT 4
CONSISTENCY BEATS VOLATILITY

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

Source: CEG Worldwide. Analysis: Bernhardt Wealth Management

Concept Three: Use Dissimilar Price Movement Investments to Enhance Return Potential

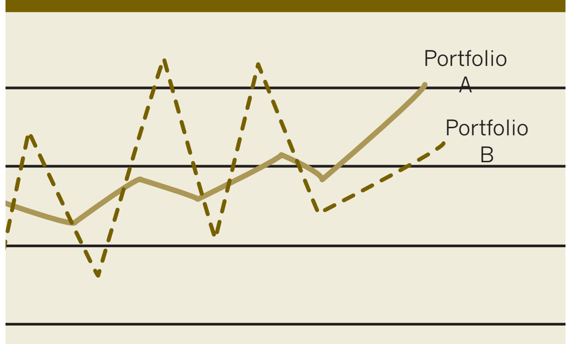
If you have two investment portfolios with the same average or arithmetic return, the portfolio with less volatility will have a greater compound rate of return. For example, let's assume you are considering two mutual funds. Each of them has had an average arithmetic rate of return of eight percent over five years. How would you determine which fund is better? You would probably expect to have the same ending 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 4. Two equal investments can have the same arithmetic rate of return but have very different ending values because of volatility. Therefore, you want to design your portfolio so that it has as little volatility as necessary to achieve your goals.

Exhibit 5 further illustrates the concept of volatility and return. The graph depicts 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

EXHIBIT 5
TWO PORTFOLIOS WITH THE SAME AVERAGE RETURN



Source: CEG Worldwide. Analysis: Bernhardt Wealth Management out the emotional curve, but, more importantly, because you increase your potential to obtain the wealth you need in order to achieve your financial goals.

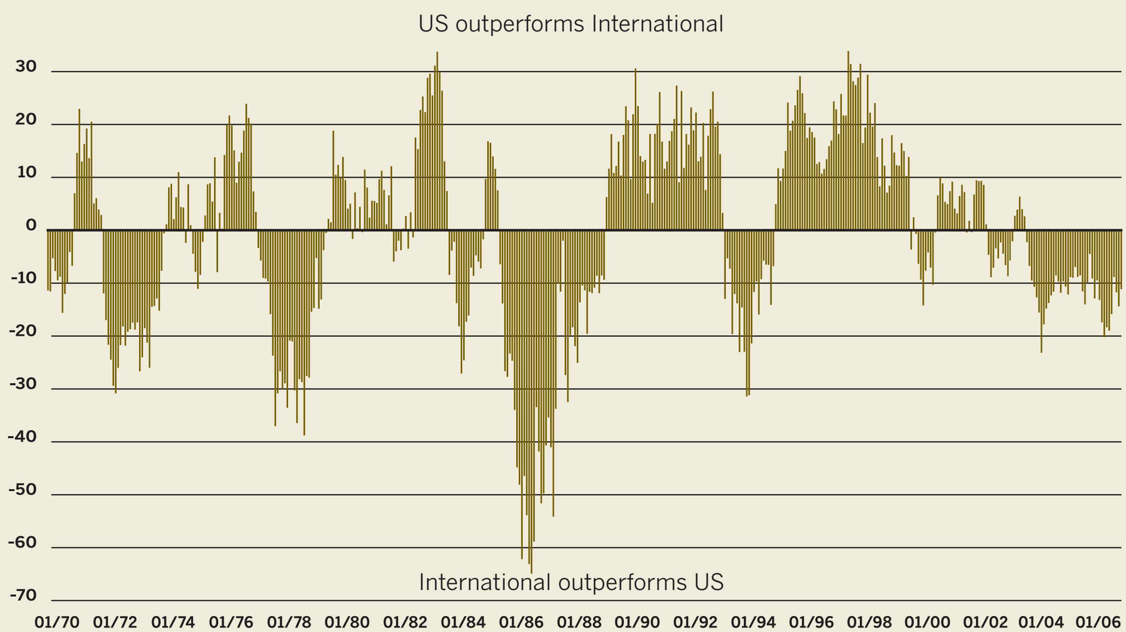
Concept Four: Know that Global Diversification Reduces Risk

We've all read about the concept of a "global village"—that the world is getting "smaller" and 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. Why, then, should a prudent investor include an international institutional asset class in his or her portfolio?

The answer is that American equity markets and international markets generally 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 6, there are tremendous dissimilar price movements between international and U.S. asset classes.

Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater share price volatility. Note the differences between the performance of the U.S. Index (S&P 500) and the International

EXHIBIT 6
U.S. AND FOREIGN MARKETS PERFORM DIFFERENTLY



January 1969–December 2006. The difference between the Standard & Poor's 500 Index and the Morgan Stanley EAFE Index. Quarterly annualized returns.

Source: CEG Worldwide. Analysis: Bernhardt Wealth Management

Index (EAFE) and you will see, for example, that the International Index outperformed the U.S. Index by about 65% for the 12-month period ending August 1986 as depicted in Exhibit 6. Past performance is not indicative of future results.

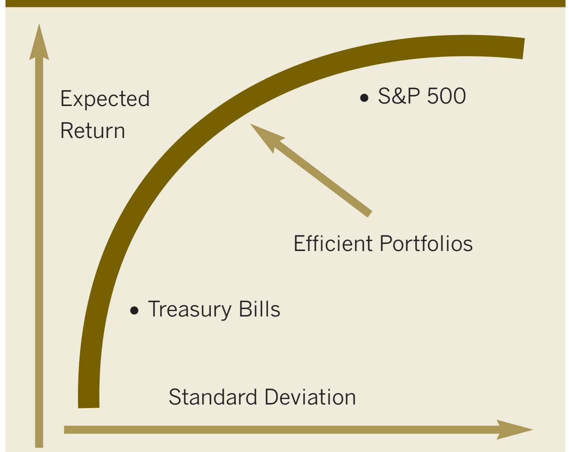
Concept Five: Design Portfolios That Are Efficient

How do you decide which investments to select 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 University 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 we examine the process, we can readily see the commonsense approach that it takes. This is counterintuitive to conventional and overcommercialized investment thinking.

Markowitz has stated that, for every level of risk, there is an optimum combination of investments that will give an investor the highest rate of return. The combinations of investments exhibiting this optimal risk/reward trade-off form what is known as the efficient frontier line. The efficient frontier is determined by calculating the expected rate of return, standard deviation, and correlation coefficient for each asset class. We then use this information to create a portfolio at the highest expected return for each incremental level of risk. Exhibit 7 illustrates the efficient frontier relative to the "market."

EXHIBIT 7
THE RANGE OF EFFICIENT PORTFOLIOS



Source: CEG Worldwide. Analysis: Bernhardt Wealth Management

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." The emerging line forms the efficient frontier. It's important 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 rate of return with an asset class portfolio with much less risk or a higher rate of return for the same level of risk.

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 efficient frontier so that you can increase the potential of achieving your financial goals.

Concept Six: Employ Asset Class Investing

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

Almost all investors would benefit by using institutional asset class funds. 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, which effectively kept them beyond the reach of all but the wealthiest investors. These funds were reserved for institutional accounts, such as large pension plans.

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

- **Lower operating expenses**
- **Lower turnover resulting in lower costs**
- **Lower turnover resulting in lower taxes**
- **Consistently maintained market segments**

We'll look at each one in turn.

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 approximately 1.4 percent. In comparison, the same ratio for institutional asset class funds is typically less than one-third of all retail equity mutual funds. All other factors being equal, lower costs lead to higher rates of return.

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 approximately 80 percent. This means that, on average, 80 percent of the securities in the portfolio are traded over a 12-month period. This represents approximately $80,000 of traded securities for every $100,000 invested.

But trading stocks—especially small cap stocks—is expensive. The 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. Most managers, however, are only too willing to pay the costs associated in order to meet a forecast or follow an index. The costs they generate are buried in financial statements and corporate ledgers, but the investor may pay in the form of lowered returns.

Careful trading can help reduce (or even reverse) the costs borne by traditional managers. The savings, of course, should accrue directly to the investor's return. 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.

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. This is 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 their income annually because no mutual fund manager wants to have his or her performance reduced by having to pay 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 after-tax 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.

Consistently Maintained Market Segments

Most investment advisors agree that the most significant determining factor of performance is asset allocation—how your money is divided among different asset classes. 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 investors relinquish their control of their 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 some fee-based financial advisors. You can gain the same advantages that previously only large institutional investors received.

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 determine where you need to go to realize your financial goals. Your plan 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. As we saw, most of us are not wired—from an emotional standpoint—to effectively develop and maintain our own investment plan. Therefore, 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 six concepts we've discussed here.

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*.

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

What to expect from a consultative advisor

The most successful consultative advisors use a systematic process, usually over a series of meetings, to design an investment plan that increases the potential 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 your goals.
- **An investment plan meeting.** The advisor, using the information he or she gathered at

your first meeting, will give 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). At these meetings, the advisor reports 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 within 24 hours, and 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. The uncertainty of the financial markets around the world will make the next few years extremely rewarding—if you design your investment plan to be successful.

As an informed investor, you owe it to your family and to 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 opportunities to increase the potential of achieving your financial goals.

We wish you nothing but success in achieving all that's important to you.

About the Author

Gordon Bernhardt has dedicated his career to helping individuals and families make smart decisions about their money. He founded Bernhardt Wealth Management in 1994 so that he could offer his clients independent and objective financial advice that would help them achieve their financial goals.

Bernhardt is dedicated to offering his clients the highest level of expertise and service. In addition to his degree in commerce from the University of Virginia, he has earned designations as a CERTIFIED FINANCIAL PLANNER™ (CFP®), Certified Public Accountant (CPA), and Personal Financial Specialist (PFS).

Outside of work, Bernhardt is a board member of CrisisLink and a volunteer mentor for the Orphan Foundation of America (OFA); he previously served as a board member of OFA.

About Bernhardt Wealth Management

Bernhardt Wealth Management, Inc. is an investment advisory firm that serves individuals and families primarily in the Washington, D.C. area. We offer our clients a unique combination of professional competence, a passion for helping individuals and families achieve their financial dreams, and a dedication to the highest ethical values.

Bernhardt Wealth Management relies on two proprietary systems, the Strategic Client Consulting Process™ and the Strategic Investment Management Process™, to help us achieve three very important goals:

- To get to know each client so that we thoroughly understand their motivation, values and goals
- To develop a long-range strategy and implement a portfolio that is true to those values and goals
- To systematically review each portfolio to ensure that it stays on course as the client's life situation and the markets change.

In every aspect of our work, we make an uncompromising commitment to providing world-class service and to developing unique solutions to each of our client's financial needs.

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