HMV WEALTH ADVISORS

Monthly Client Letter
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In recent years, U.S. stocks have outperformed international stocks and growth stocks have outperformed value stocks. This has led many to question the benefits of diversification and ask what they should do when an investment strategy performs poorly. We should begin with a look at the appropriate lens through which to view investment strategy performance. Then we will address several issues that work to fog our lens and challenge our ability to stay the course. Taken together, we believe an understanding of these topics fosters the mindset necessary to remain disciplined in the face of adversity.

Our investment strategy is grounded in three key principles. First, we believe markets are highly efficient pricing mechanisms. This leads us to conclude that active management is a loser's game. Second, because we believe markets are highly efficient, it must follow that all unique sources of risk have similar risk-adjusted returns – not similar returns, but similar risk-adjusted returns. Third, because all unique sources of risk have similar risk-adjusted returns, we also believe portfolios should be diversified across many unique, or independent, sources of risk and return. Moreover, the premiums associated with these unique sources of risk and return should be persistent, pervasive, robust, implementable, and have intuitive risk- or behavioral-based explanations. These three principles form the foundation of an investment process that culminates in a portfolio fine-tuned to provide you the greatest odds of achieving your life and financial goals.

Having a process in place, however, is the easy part. Sticking to it is the real challenge. As Warren Buffett noted, "Investing is simple, but not easy." While diversification has been called the "only free lunch in investing," it doesn't eliminate the risk of losses. It also requires you to accept that parts of your portfolio will behave entirely differently than the portfolio itself. And it may underperform a broad index for a long time. The result is that diversification is HARD. And, because misery loves company, losing unconventionally with a portfolio that doesn't look like the broad U.S. market, on which the media reports daily, is harder than losing conventionally. In addition, living through difficult times is harder than observing them in back tests – another reason it's so hard to be a successful investor.

Which leads us into how we're wired to react when times get tough. First, hindsight bias, or the tendency after an outcome is known to see it as virtually inevitable, contributes to the mistake of resulting. To avoid this mistake, John Stepek, author of "The Sceptical Investor," advised: "You must accept that you can neither know the future, nor control it. Thus, the key to investing well is to make good decisions in the face of uncertainty, based on a strong understanding of your goals and a strong understanding of the tools available to help you achieve those goals. A single good decision can lead to a bad outcome. And a single bad decision may lead to a good outcome. But the making of many good decisions, over time, should compound into a better outcome than making a series of bad decisions. Making good decisions is mostly about putting distance between your gut and your investment choices." The bottom line is that because we live in a world of uncertainty, where at best we can only estimate the odds of investment outcomes, the quality of a strategy should be judged before, not after, the outcome is known. Otherwise, you risk the mistake of confusing strategy with outcome.

Next, the recency effect – in which more recent observations have a larger impact on our memory and, thus, perception – is a well-documented cognitive bias. It leads investors to focus on the most recent returns and project them into the future. This can result in buying what has done well recently at high prices, when expected returns are lower, and selling what has done poorly recently, at low prices, when expected returns are higher. Buying high and selling low is not a prescription for investment success. Yet the research shows that this is exactly what many investors do, presumably because of recency bias.

When it comes to investing, Warren Buffett believes that temperament, a source for the discipline to adhere to a well-thought-out plan, is more important than intelligence. While achieving diversification is simple, living with it is hard. Knowing your level of tolerance for tracking-variance risk, and investing accordingly, will help keep you disciplined. Conversely, taking more tracking-variance risk than you can stomach is a prescription for failure. As Michael Mauboussin noted, "A quality investment philosophy is like a good diet: It only works if it is sensible over the long haul and you stick with it." If you have the discipline to stick with a globally diversified, passive asset class or factor-based strategy, you are likely to be rewarded for it.

Sincerely,
HMV Wealth Advisors, LLC