Intelligent Investing

FIVE KEY CONCEPTS FOR FINANCIAL SUCCESS

JEFFREY A. GREEN
REGISTERED PRINCIPAL

Letter from the Advisor

Many people today are facing difficult choices in achieving their financial goals and, as well they should, are asking serious questions. Our goal with *Intelligent Investing* is to help you see through the noise of the marketplace in order to systematically make smart decisions about your money.

Because educated investors are the most successful investors, we are offering *Intelligent Investing* to show you an approach crafted to optimize your investment portfolio over time. We have designed it specifically to not only support you in your efforts to preserve what you already have, but to also efficiently capture the market's returns for your investments.

In addition, because we recognize that reaching your financial goals requires more than just good investment management, we have also described an approach—comprehensive wealth management—that systematically addresses your entire range of financial issues.

We believe in empowering people to make the best decisions for themselves or, if they wish, to astutely choose a financial advisor who can implement sound wealth management principles. And we believe in sharing our own financial knowledge with everyone who wants to make wise decisions about his or her money.

Green Financial Group is pleased to present *Intelligent Investing* to our clients and prospective clients. We sincerely hope that it will provide you with a framework for an intelligent approach to making financial decisions that will help you to achieve all your most important dreams.

Sincerely,

Jeffrey A. Green
Founder, Green Financial Group
Registered Principal, RJFS

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Taking a Comprehensive Approach to Your Financial Life

MONEY MEANS DIFFERENT THINGS TO DIFFERENT PEOPLE. Each of us has 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-flight 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 want to leave behind an enduring legacy that will enable your favorite charity to continue its work.

Whatever your dreams are, you need a framework for making wise decisions about your money that will help enable you to achieve all that is important to you. Chances are good that you have a wide range of financial goals, as well as diverse financial challenges.

Common sense tells us that such a broad range of issues requires a broad, comprehensive outlook. It's for this reason that most affluent clients want their financial advisors to help them with more than just investments. They want real wealth management—a complete approach to addressing their entire financial lives.

As you've probably noticed, many financial firms these days say that they offer wealth management. The trouble is that many of these firms just provide investment management and offer a couple of extra services—such as college education planning and estate planning—and call that wealth management. So the challenge for anyone who wants help addressing all his or her financial needs is finding a firm that provides true wealth management.

We define wealth management as a formula:

WM = IC + AP + RM

1. **Investment consulting (IC)** is the astute management of investments over time to help achieve financial goals. It requires advisors to deeply understand their clients' most important challenges and then to design an investment plan that takes their clients' time horizons and tolerance for risk into account and that describes an approach that will maximize clients' probability of achieving their goals. It also requires advisors to monitor

both their clients' portfolios and their financial lives over time so that they can make adjustments to the investment plan as needed.

2. **Advanced planning (AP)** goes beyond investments to look at all the other aspects that are important to your financial life. We break it down into four parts: wealth enhancement, wealth transfer, wealth protection and charitable giving. In our experience, very few financial advisors offer these services.

3. **Relationship management (RM)** is the final element. True wealth managers are focused on building relationships within three groups. The first and most obvious group is their clients. To address their clients' needs effectively, they must foster solid, trusted relationships with them. Second, wealth managers must manage a network of financial professionals—experts they can call in to address specific client needs. Finally, wealth managers must be able to work effectively with their clients' other professional advisors, such as their attorneys and accountants.

Our focus in this resource guide will be on the first element of wealth management—investment consulting. But bear in mind that managing your investments are just one part of a comprehensive approach to your financial life. At the end of this guide, we'll describe what you should expect from a true wealth manager so that you can make an informed decision when choosing which financial professional to work with.

Let's turn now to our discussion of the concepts that can make you a more successful investor.

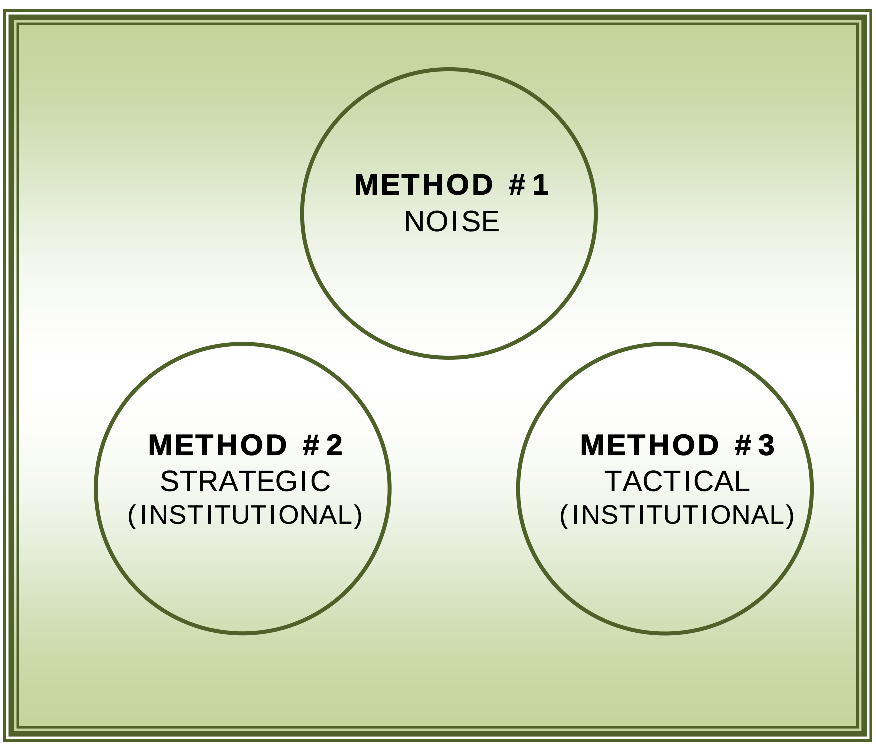
Rising Above the Noise

SOME INVESTMENT PROFESSIONALS WORK HARD TO MAKE THEIR WORK confusing. They believe they have a vested interest in creating investor confusion. They use jargon that can intimidate and make it difficult for you to understand relatively straightforward concepts.

But investing is actually not that complicated. We'll explore three different methods that investors use to make decisions about their money, and we'll talk about where you should be with your own approach to your portfolio.

Exhibit 1 classifies people according to how they make investing decisions. The first method is the *noise method*. It's used by investors who get caught up in the noise of the day and let their emotions dictate their actions. They chase after hot stocks and market sectors that are due to fall, ignore investments that are undervalued and poised to rise and, as a result, often earn poor returns that fail to get them to their most important financial goals.

Exhibit 1. Three Investment Decision Methods



Source: CEG Worldwide.

Unfortunately, it's easy to get caught up in all the noise that's out there. Most of the public uses the noise method, and much of the financial media fuels this method of investing as it tries to sell newspapers, magazines and television shows. For the media, it's all about getting you to return to them time and time again.

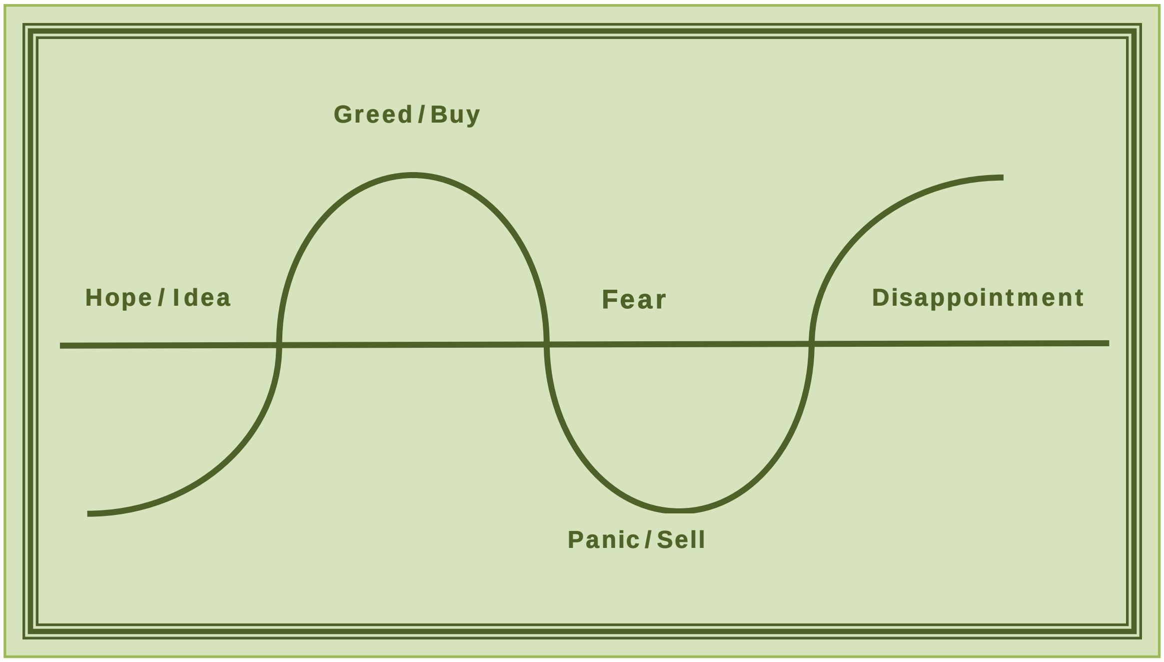
Given the sheer amount of investing noise in today's world, it's not surprising that many investors end up making their decisions based on noise. Why do these investors so consistently make the wrong decisions? Because noise drives emotions, and making investment decisions based on emotions rarely has a positive outcome. 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.

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. You're cautious, so you decide to follow it for a while to see how it does. Sure enough, it starts trending upward.

You follow it for a while as it rises. What's your emotion? Confidence. 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 do it again. You don't want to have to tell your spouse or partner about it. You don't care about making money anymore.

Exhibit 2. The Emotional Curve of Investing



Source: CEG Worldwide.

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? All too often, new information comes out and the stock races to an all-time high. (See **Exhibit 2**.)

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 not just to your portfolio, but more important, also to your financial dreams.

The good news is that there are superior methods you can use to tune out that noise and build an investment plan that will enable you to achieve consistent investment success. These methods are the ones used by the world's best institutional money management firms to serve their clients—which include Fortune 500 companies and endowments with billions of dollars to invest. At our firm, we believe that individual investors such as you should have access to the same institutional-class investment approaches as these companies and endowments enjoy.

As **Exhibit 1** shows, there are two institutional-class approaches. The first is the *strategic method* of making investment decisions. Strategic investors use a process based on Nobel Prize–winning research to build portfolios that provide the best possible returns for a given level of investment risk. Strategic investors rebalance those portfolios on a disciplined quarter-by-quarter basis to ensure that they constantly maintain the optimal combination of return and risk.

The second institutional-class approach is the *tactical method.* Tactical investors also base their portfolio decisions on Nobel Prize–winning academic research. However, they manage their portfolios differently. Instead of regularly rebalancing each quarter, tactical investors look to add value by emphasizing certain asset classes or market sectors that their research efforts tell them are undervalued and offer an above-average potential for strong returns. Tactical investors then de-emphasize those asset classes or sectors once they become fairly valued by the marketplace. Tactical investors are therefore more opportunistic than strategic investors.

The strategic and tactical approaches are where most of the academic community resides, as do the top institutional investors. Investors who use strategic and tactical investment methods dispassionately research what works and then follow a rational course of action based on empirical evidence. This allows them to ignore the noise created by the media.

Our passion is to help investors make smart decisions about their money. To accomplish this, we help investors move from the noise to making smart decisions about their money by using these prudent investment strategies: 1) strategic investing, 2) tactical investing or 3) a combination of the two approaches. We believe that these strategies will help you maximize the probability of achieving all your financial goals.

Five Key Concepts for Financial Success

BEFORE YOU CAN DETERMINE WHICH INSTITUTIONAL INVESTMENT method is right for you, it's useful to take a step back and examine the concepts that will empower you to achieve consistent, long-term investment success. These are the concepts that will guide you regardless of which institutional approach you select.

While investing can at times seem overwhelming, the academic research can be broken down into what we call the *Five Key Concepts for Financial 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, it is easy to have your attention drawn to the wrong issues. These wrong issues—the noise—can derail your journey.

In this section, we'll walk through these five concepts and then explain how institutional investors incorporate each of these concepts into their investment plans, no matter which direction the markets are going at that moment. These plans both meet their fiduciary responsibilities and achieve their financial goals. You owe yourself and your family nothing less than what the institutional investors have.

It's important to note here that while these concepts are designed to maximize return, no strategy can eliminate risk, which is inherent in all investments. Whenever you invest, you have to accept some risk. It's also important to remember that you're responsible for reviewing your portfolio and risk tolerance and for keeping your financial advisor current on any changes in either your risk tolerance or your life that might affect your investment objectives.

Concept One: Leverage Diversification to Reduce Risk

Most people understand the basic concept of diversification: Don't put all your eggs in one basket. That's a very simplistic view of diversification, however. It can also get you caught in a dangerous trap—one that you may already have fallen into.

For example, many investors have a large part of their investment capital in their employers' stocks. Even though they understand that they are probably taking too much risk, they don't do anything about it. They justify holding the position because of the large capital gains tax they would have to pay if they sold, or they imagine that the stocks are just about ready to take off. Often, investors are so close to particular stocks that they develop a false sense of comfort.

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" among many high-tech companies is not diversification at all. [1]

But truly diversified investors—those who invest across a number of different asset classes—can lower their risk, without necessarily sacrificing return. Because they recognize that it's impossible to know with certainty which asset classes will perform best in coming years, diversified investors take a balanced approach and stick with it despite volatility in the markets. Diversification does not assure a profit or protect against a loss.

Concept Two: Seek Lower Volatility to Enhance 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 stocks. Each of them has had an average arithmetic rate of return of 8 percent over five years. How would you determine which stock is better? You would probably expect to have the same ending wealth value.

However, this is true only if the two stocks have the same degree of volatility. If one stock 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 3. Less Volatility = Greater Wealth

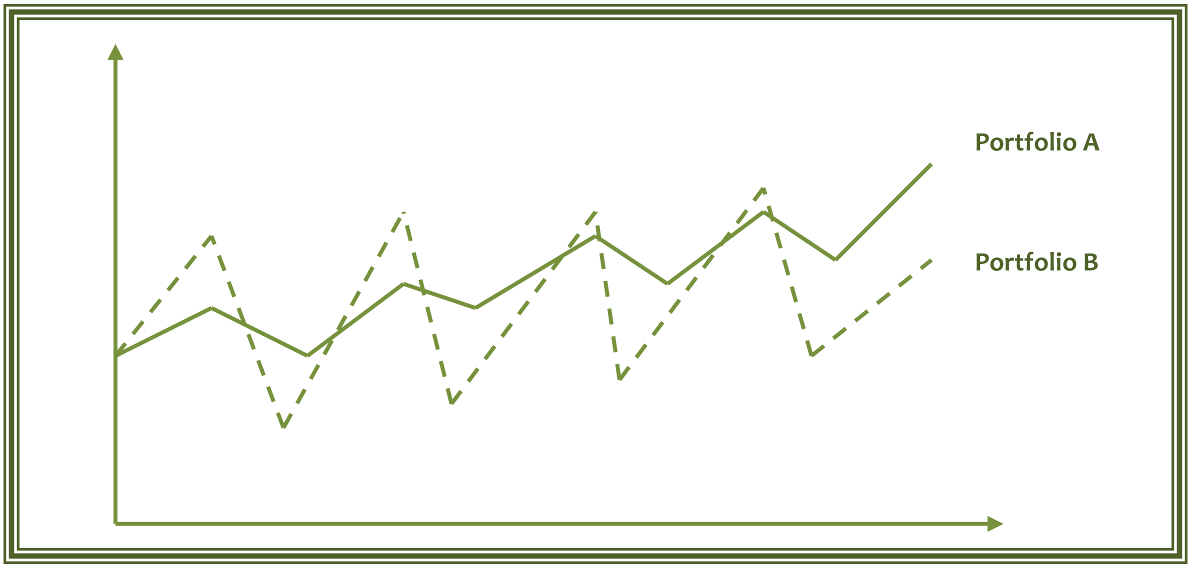
	Consistent Investment		**Volatile Investment**	
Year	Rate of Return	Ending Value	Rate of Return	Ending Value
1	8%	$108,000	30%	$130,000
2	8%	$116,640	-20%	$104,000
3	8%	$125,971	25%	$130,000
4	8%	$136,049	-20%	$104,000
5	8%	$146,933	25%	$130,000
Arithmetic annual return	8%		8%	
Compound annual return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

Source: CEG Worldwide. This is a hypothetical illustration not intended to reflect the performance of an actual security.

[1] Diversification does not assure a profit or protect against a loss.

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 emotional curve, but more important, also because you will create more wealth to reach your financial goals.

Exhibit 4. Two Portfolios with the Same Average Return



Source: CEG Worldwide.

Concept Three: Use Global Diversification to Enhance Returns and Reduce Risk

Investors here in the U.S. tend to favor stocks and bonds of U.S.-based companies. For many, it's much more comfortable emotionally to invest in firms that they know and whose products they use than in companies located on another continent.

Unfortunately, these investors' emotional reactions are causing them to miss out on an effective way to potentially increase their returns. That's because the U.S. financial market, while the largest in the world, still represents less than half of the total investable capital market worldwide. By looking to overseas investments, you greatly increase your opportunity to invest in superior global firms.

Global diversification in your portfolio also reduces its overall risk. 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 always get there in the same manner or at the same time. The price movements between international and

U.S. asset classes are often dissimilar, so investing in both can increase your portfolio's diversification.[2]

Concept Four: Use Different Investment Approaches in Different Markets

In the stock market, extended periods of upward price movements are called *secular bull markets.* Lengthy periods of downward movements are called *secular bear markets.*

Regardless of whether the market is in a secular bull or a secular bear period, investors still need to achieve their most important goals. They need a way to succeed consistently during both the good times and the bad. At first glance, it may seem impossible for you to achieve success during a protracted period when stock prices are down.

The key to successfully navigating the ever-changing market environment is to adapt your investment approach to take advantage of the specific forces at work during secular bull and bear markets.

Let's look first at what tends to work during secular bull markets. In these markets, the rising tide of stock prices lifts all boats. Success comes mainly by being invested in the broad market. These investments typically outperform managers trying to add value through superior stock selection and other forms of fundamental research.

During secular bull markets, you'll likely be best served by using the strategic method of investing, taking a buy-and-hold approach and keeping turnover low—essentially getting on the horse, grabbing the reins and riding as hard as you can.

And what does it take to succeed when the market is gripped by a long-term secular bear market? A secular bear calls for a fundamentally different approach. When the broad market is in a deep slump, there's no rising tide to lift all boats. Success requires superior active research and management efforts to uncover those investments capable of swimming against the tide and delivering strong returns.

We believe that the best active approach to take during secular bear markets is to have a concentrated but still well-diversified portfolio. That's because the value that comes from active management gets "boiled down" into an investor's very best ideas. By focusing on those investments that can do well in tough times and sidestepping the rest, concentrated portfolios have a distinct advantage.

[2] International investing involves additional risks such as currency fluctuations, differing financial and accounting standards, and possible political and economic instability.

A tactical approach to asset allocation is another key to secular bear success. That's because certain market segments and asset classes tend to stay healthy even when the broader market is ill. Having the freedom to emphasize those areas of the market that offer the best prospects will help keep your investment plan on track during a secular bear.

The very best institutional investors, which recognize the various forces at work in secular bull and secular bear markets, do not rely on one investment approach. Instead, they adopt both strategic and tactical strategies and use them accordingly to effectively manage risk, enhance returns and build greater wealth over time.

Concept Five: Design Efficient Portfolios

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 in Economic Sciences 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 commonsense approach that it takes—which is counter-intuitive to conventional and over commercialized investment thinking.

Markowitz stated that for every level of risk, there is some optimum combination of investments that will give 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 asset class and using this information to identify the portfolio with the highest expected return at each incremental level of risk.

KEY DEFINITIONS

Expected rate of return is typically calculated as the risk-free rate of return plus the risk premium associated with that equity investment.

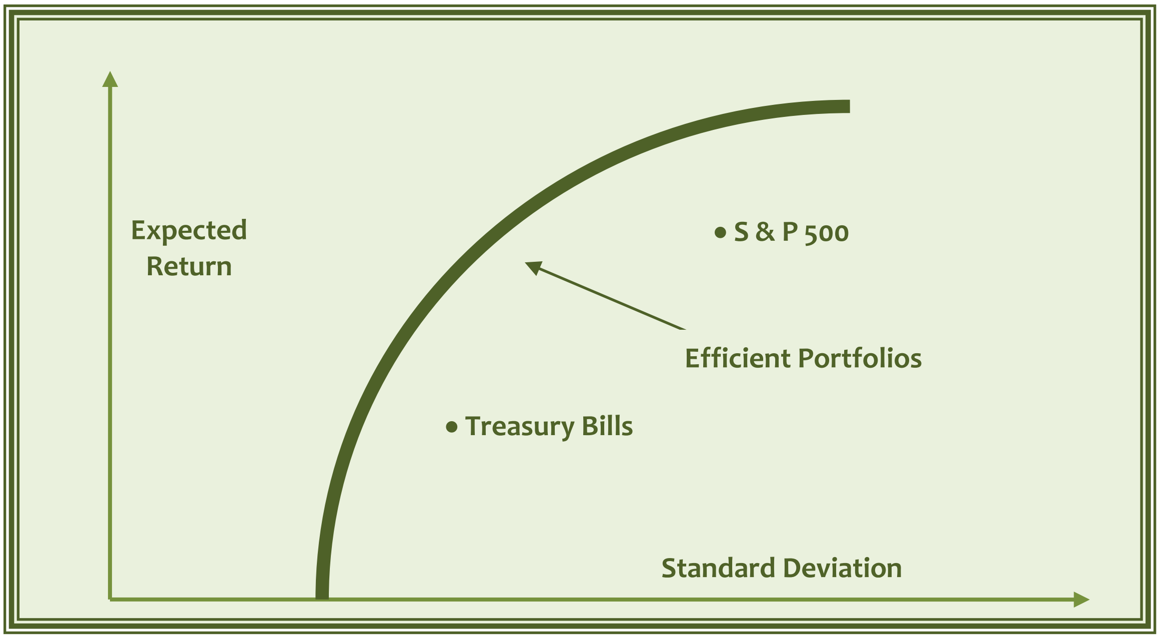
Standard deviation is a description of how far from the mean (average) the historical performance of an investment has been. It is a measure of an investment's volatility.

Correlation coefficients measure the dissimilar price movements among assets classes by quantifying the degree to which they move together in time, degree and direction.

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.

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 5 The Range of Efficient Portfolios



Source: CEG Worldwide.

Exhibit 5 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. Our job is to make sure that for whatever risk level you choose, you have the highest possible return on the efficient frontier so that we can maximize the probability of achieving your financial goals.

Your Next Steps

AS WE DISCUSSED AT THE BEGINNING OF THIS GUIDE, TAKING A comprehensive approach to achieving all your financial dreams requires wealth management. This means more than just taking care of your investments. It also means addressing your advanced planning needs, including wealth enhancement, wealth transfer, wealth protection and charitable giving.

Such a wide range of financial needs requires a wide range of financial expertise. Because no one person can be an expert in all these subjects, the best wealth managers work with networks of experts—financial professionals with deep experience and knowledge in specific areas.

Effective wealth managers, then, are experts at relationship management—first building relationships with their clients in order to fully understand their unique needs and challenges and then coordinating the efforts of their expert teams in order to meet those needs and challenges. Wealth managers must also work with their clients' other advisors—such as attorneys and accountants—in order to ensure optimal outcomes.

Many in the financial services industry today call themselves wealth managers but offer little more than investment management. How then will you know whether you are dealing with a true wealth manager?

First, the advisor should offer a full range of financial services, including the four areas of advanced planning that we mentioned above. As we've said, the wealth manager should be backed up by a network of experts to provide these services.

Second, the wealth manager should work with you on a consultative basis. This allows the wealth manager to uncover your true financial needs and goals, to craft a long-range wealth management plan that will meet those needs and goals, and to build an ongoing relationship with you that ensures that your needs continue to be met as they change over time.

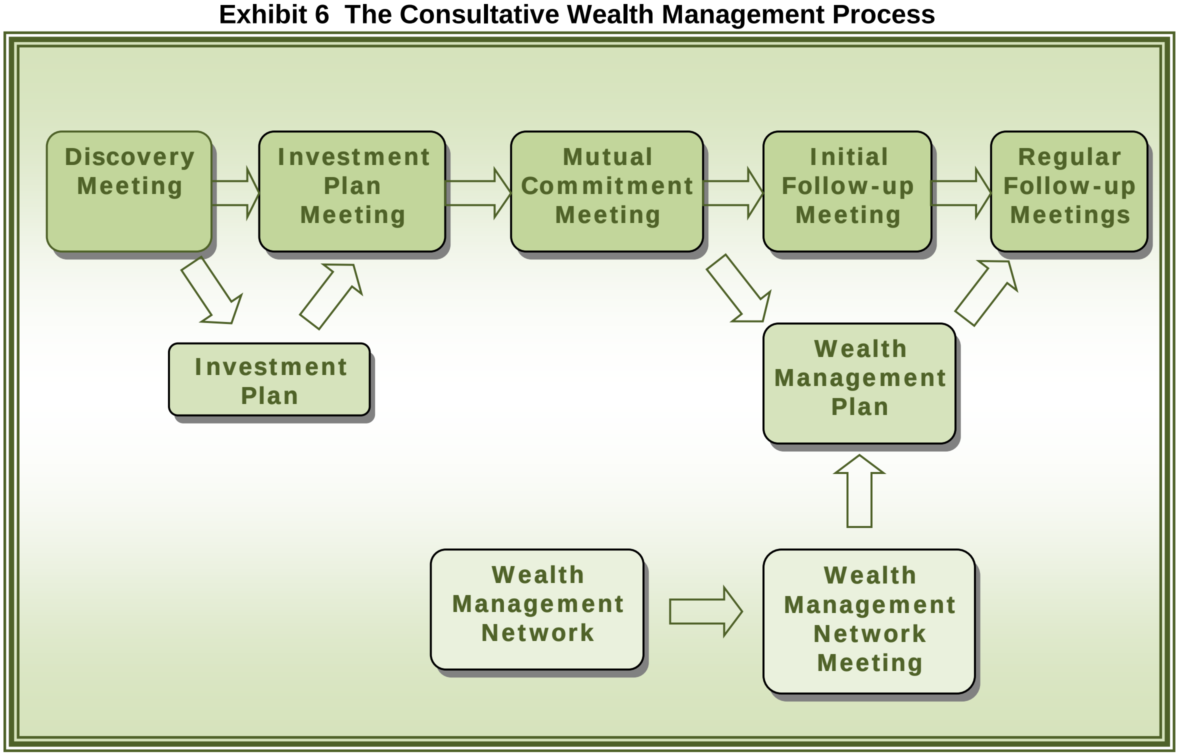
This consultative process usually unfolds over a series of meetings:

- At the **discovery meeting,** the wealth manager determines your current financial situation, where you want to go and the obstacles you face in achieving what is important to you.

- At the **investment plan meeting,** the wealth manager, using the information he or she gathered at your first meeting, presents a complete diagnostic of your current financial situation and a plan for achieving your investment-related goals.
- At the **mutual commitment meeting**, assuming that the wealth manager can truly add value, both you and the wealth manager decide to work together. You now officially become a client.
- At the **initial follow-up meeting**, the wealth manager helps you to organize your new account paperwork and answers any questions that may have arisen.
- At **regular progress meetings**, which are typically held quarterly, the wealth manager reports to you on the progress you're making toward achieving your goals and checks in with you on any important changes in your life that might call for an adjustment to your investment plan. In addition, at the first regular progress meeting, the wealth manager presents to you a wealth management plan—a comprehensive blueprint for addressing your advanced planning needs that has been developed in coordination with the wealth manager's network of experts. At subsequent progress meetings, you and the wealth manager decide how to proceed on specific elements of the wealth management plan. In this way, over time, every aspect of your complete financial picture is effectively managed.

Exhibit 6 shows an overview of the consultative wealth management process.

Exhibit 6 The Consultative Wealth Management Process



Source: CEG Worldwide.

In addition, 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 who you are—a very important client.

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

You owe it to your family and yourself to make sure that your investment plan—and overall wealth management plan—is designed to effectively address your very specific financial needs in order 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

Jeff Green, founder of Green Financial Group, an Independent Firm, has spent his entire financial services career in Houston.

Before he launched his local independent firm, Jeff served at Morgan Stanley and Banc of America Investment Services. Jeff spent more than a decade combined at the two major investment firms, where he crafted a wide variety of equity trading strategies and investment/wealth management models for his clients.

Earlier, Jeff served 3 years in the United States Army Airborne Infantry. While serving his country, Jeff patrolled the American sector of the Demilitarized Zone (DMZ) between North and South Korea. After being stationed back stateside, his unit was among the first to land in Panama for Operation Just Cause in 1989.

Afterwards, Jeff was selected for the inaugural class at the University of Houston Center for Entrepreneurship and Innovation. He earned his degree from the University of Houston after being one of only 30 students accepted into the Entrepreneurship Program from a pool of more than 200 students.

Jeff also received executive education from the Wharton Business School. Born in Memphis, TN, Jeff moved to Houston in 1984. He is happily married to Vinceanne Mandola-Green. They have 3 sons.

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