
5 Keys to Investment Success

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Ideally, an investment portfolio should mirror your success, provide for you and your family, and reflect your personal values. But achieving this is easier said than done. We are all unique. In today's marketplace, challenges can result from the emotions we experience as investors, the methods we use in selecting investments, and how we connect to and implement the financial planning process.

Through our experience working with successful clients, we have identified five key ideas that can help you take command of your investment portfolio and the wealth management process:

#1. Recognize and manage the emotions of investing.

#2. Use an approach to investment selection that is built upon research offering feedback beyond recent market prices and performance.

#3. Become personally connected to the investment process through a relationship with an investment manager.

#4. Keep from getting stuck in the planning and investment process by returning to and clarifying your values to guide your decision making.

#5. Don't be afraid to seek outside help to put the pieces together.

Let's investigate each key idea:

Key #1. Recognize and manage the emotions of investing.

In late 2007, unannounced, a client walked into my office. He said he'd like to talk. After he rushed through a minimum of pleasantries, he said, "I want out of the market completely. Go to all cash. It has nothing to do with you. I just think the market is in serious trouble."

After asking a few questions, I quickly learned that my client had been reading lots of articles in the financial press. Authors were banging the drums of doomsday scenarios.

"Yes", I agreed with him, "market volatility has increased." My client was reacting naturally to negative feedback the markets and the press were offering. The combination of adverse price movements, increased volatility and fevered market commentary prompted an emotional reaction. He felt vulnerable. His emotions told him to fight or flee.

Most of us, professional investor and individual alike, know how he felt. We have been there. While this impulse is understandable, yielding to it accounts for much of the poor investment performance for which individual investors are known.

It's important to acknowledge that our emotions are part of the way the mind is wired to protect us. "Peel away the thoughts at the surface layer," as organizational psychologist Dr. Marcia Reynolds would suggest, and take the time to get to a place mentally where reason can prevail.

The urge to flee danger is not the only emotion that can lead to poor investment decisions. Sometimes our ego and the need to be right can also get in the way of progress. For example, being unwilling to address a losing position when it should be reckoned with is a common difficulty.

Yet another example is an investor that might be reluctant to sell a position due to concern over taxes. Keeping capital gains taxes as low as possible can keep us from taking a profit or overlooking better investment opportunities.

Returning to the client story, I asked if, instead of going to all cash, he would like his portfolio's volatility exposure to return to what it had been before volatility in the markets soared. Rather than sell everything and disregard why we had chosen the portfolio investments in the first place, we agreed to work to reduce his equity market exposure by selling a few stocks to take some tax losses and raise some cash. We then decided to meet again in a month.

At our next meeting, the goal was to determine further steps to continue to adjust the portfolio's risk. He said, "I realize I was a little emotional a month ago when I came to see you. But I feel much better now."

The key is to realize that the further investment outcomes are from expected results, or the greater the market ups and downs along the way, the higher emotions run. Work to acknowledge these emotions, keep them in check, and examine ways to move forward.

Key #2. Use an approach to investment selection that is built upon research offering feedback beyond recent market prices and performance.

Research doesn't guarantee right answers and prevent investment mistakes, but it does help prevent the pitfalls of emotionally driven decision making. It can keep you from relying too heavily on a stock's current market price as primary feedback at any given time.

The real key is to be able to process and understand enough about a company so that you can differentiate the investment opportunity it offers from other investment opportunities. Then, it is simply a matter of doing the math to identify which opportunity makes the most sense in combination with your financial needs and repeating this process over and over.

There's no best way to do this. But here's an example of what Fidelity Investments, the large mutual fund company, has told its analysts to concentrate on when researching a company:

- Assess the condition of the industry.
 1. What are the trends in the industry?
 2. What are the drivers of profitability in the industry?
 3. What is the competitive landscape like?
- Analyze the company's operations
 1. How efficient is the company relative to its competitors?
 2. Is it a low cost producer?
 3. Assess how well the business is run.
- Assess the quality of management
 1. What is their track record?
 2. How well do they understand their business?
 3. Where do they want to take the company and does that make sense?
- Financial statement analysis
 1. Look for trends in key ratios and margins.
 2. Look for hidden problems.
 3. Conduct full analysis of the relevant financial issues.

- Competitors and Customers
 1. What is the competitive environment like?
 2. What is the condition and nature of their customer base?
- Capital Structure
 1. Debt issues?
 2. Liquidity issues?
 3. Will this company be able to survive a downturn in its business?
- Valuation

Using the metrics appropriate to this company, decide how attractive the valuation is relative to the company's peers, its history and its intrinsic value.

With that level of analysis, businesses become much easier to compare. Using research to identify nuance and context in investment opportunities is the mark of a repeatable process that can differentiate between investment opportunities.

Returning to the earlier client story, another month later, the client called unexpectedly on a day when the market was down. But this time, the client asked to confirm the name and ticker symbol of a company we held in his portfolio. We briefly went over again the story of why we had the stock in the client's portfolio. Working through the research at a high level:

The company in question had focused its business model on building solid state disk drives, which are replacing the older spinning disk drive technology in computers. It already had its products in tanks, trains and many other applications.

Operationally, margins were increasing as the company focused on a niche in the market at the custom, high end rather than participate in the commodity, low end products.

The company's founder continued to run the company as he had for over 15 years. Insiders owned close to 50% of the stock.

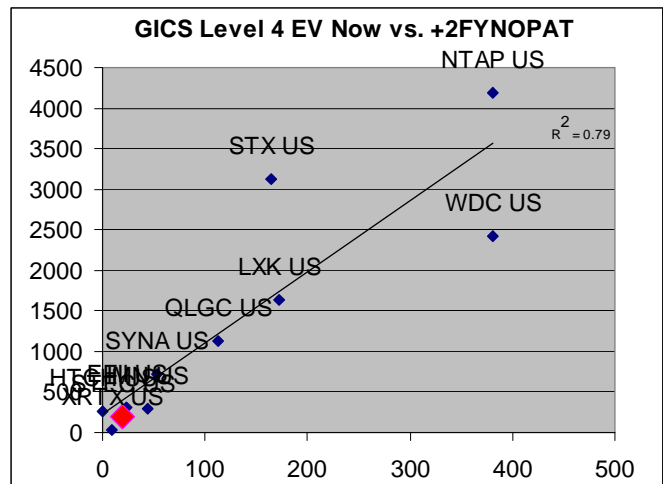
Financial statements were clean and easy to understand.

The company competed against some bigger companies. However, it seemed to have about a one year lead in getting to the market and had relationships with bigger companies in the space.

Finally, the company had no debt and appeared undervalued when run through valuation models.

We spoke for a few minutes more about the company and its opportunities. We also talked further about other companies in his portfolio, the research and valuation work we had done on each, and why we purchased them. In a weak stock market environment, it's even more important to have this work done.

To put the research process in context, the market is generally only efficient at pricing stocks vs. their respective operating earnings expectations for the near future. This is in contrast to company management that must make longer term decisions about how to run their company. That contrast is an investment opportunity that we seek to capitalize on for clients. For example, we start by looking at an industry, like technology shown below, to see how efficiently the market has priced operating earnings in the near future:



Source: Standard & Poor's GICS industry, internal models

Like a real estate comparable when shopping for a house, this offers the lay of the land, a starting point, so that the research can be put in perspective. We ultimately seek to answer the question, “What is wrong with the market’s expectations, at the company or industry level?” and “What is the catalyst that can change the market view?”

The key is to conduct enough research to differentiate and effectively discount investment opportunities, in any economic environment.

Key #3. Become personally connected to the investment process through a relationship with an investment manager.

When using an investment manager, it is easy to sit back and let the returns roll in. But when times get tough via market ups and downs, feedback from only recent prices and performance, or a lack of the ability to put the investments into context can get in the way of success.

For example, owning a mutual fund, where you generally don’t have a relationship with the mutual fund manager can lead to these potential problems. The mutual fund manager manages the fund by a prospectus and doesn’t know your personal planning needs. Most often, as an investor, the only thing you have to go on is the mutual fund’s recent performance in assessing how your portfolio is doing or reviewing semi-annual reports to see what’s actually held in the fund. Unfortunately, the mutual fund investment vehicle does not normally allow you to have access to the investment process in real time to gain feedback.

In contrast, by working in a relationship with a separate account investment manager directly, where securities are managed in your own individual account, you can have access to the investment manager and the investment process for feedback. You can also realize the tax efficiencies available in your own customized portfolio, unlike a mutual fund, where there is no opportunity to individually manage tax exposure.

What decision would our client in the earlier story have made if he was invested in a mutual fund when he initially called with concerns? It might have been more difficult to avoid the ramifications of the fight or flight mentality with only the recent performance and semi-annual reporting feedback that a mutual fund investor receives.

Working personally with an investment manager, a hierarchy of decision making can be put in place to connect your individual planning needs together with your investments:

1. Know what cash flow, income and liquidity needs are necessary in accordance with life events (education planning, retirement funding, etc.).
2. Develop an asset allocation strategy which fits your unique risk tolerance.
3. Make individual security selections to fit within cash flow, planning, and risk tolerance needs.
4. Make adjustments to market conditions by adjusting asset allocation, adjusting individual security positions, and offering feedback beyond current market prices.

Our client's primary issue to address was adjusting asset allocation strategy to fit his risk tolerance and doing so in a way to minimize tax exposure. Rather than getting mentally stuck in a down market with a position where he was under water, he was able to reason effectively through difficult market conditions.

In our experience working with successful clients to build custom portfolios, the key has been to open the investment process up so that clients could have access to quality feedback. Then help them adjust decision making within their broader needs.

Key #4. Keep from getting stuck in the planning and investment process by returning to and clarifying your values to guide your decision making.

Not too long ago, I received a call from a client who said, "Why should I pay \$3,000 to finish an estate plan when the laws are going to change anyway? And who says the laws won't change again thereafter?"

All too often, the wealth management process is aggravating. It is little wonder that we can get stuck with a de facto plan that fails to serve our best interests or an elaborate plan that fails to embody our beliefs and values. It's important not to let larger planning issues get in the way of investment success.

For their book, Preparing Heirs, Roy Williams and Vic Preisser surveyed 2,500 families, 80% of whom owned closely held businesses and had a net worth of \$5 million or more. The surveys indicated that 70% of families' estate plans failed. A lot of those plans were likely quite sophisticated.

Ask yourself, "Are your heirs prepared to receive the legacy you're thinking of leaving them?" Working to answer that question affirmatively can help ensure a successful estate plan, regardless of its complexity.

The key is to use the wealth management process to clarify your values and let your investments reflect that clarity. Anchor your planning and investment strategy to your values and what is most important to you.

Key #5. Don't be afraid to seek outside help to put the pieces together.

Sometimes overlooked in the success of many leaders are the contributions of the team that made the success happen. Each leader is successful individually, but they have worked to surround themselves with people who could help them achieve their mission to multiply that success.

Reaching out for help and taking a step forward is not always the most comfortable thing to do, especially when it means relying on someone else's expertise in addition to your own. But by making a commitment to work on the wealth management process, compartmentalizing the challenges with the right state of mind, and investing in relationships with people that can help, your journey can meet with great success. The key is to get started and stay on a course of progress, surrounding yourself with the people to help you get there. Mistakes can happen. Change can happen. But with the right amount of effort, success can happen as well.

We hope these ideas have offered you some perspective and can contribute to your success as you work to make progress on your wealth management journey.