OUR PHILOSOPHY AND STRATEGY FOR INVESTMENT SUCCESS

At Practical Financial Planning, we believe investments should work. They should function in a way that makes your life better in the long run, without becoming difficult in the short run. At the same time, investments should be as simple and straightforward, and as inexpensive, as they can be. And they should be selected, bought, maintained, and sold in the best interest of the investor.

That philosophy is the foundation of everything we do for our clients' investments at Practical Financial Planning. If it helps our clients' investments to work—to function properly without undue complication—it's the approach we want to take.

ABSTRACT

So what makes investing work? Not for hedge funds, or for corporations, or for pension plans, but for real people, like you? Misinformation abounds, because the strategies most often discussed in the media can be inappropriate for households and families.

At Practical Financial Planning, we begin by assessing how much risk is appropriate for you. From there we develop an asset allocation—a target for the amounts you should have in various kinds of investments. This asset allocation is your guide, whether the markets are rising or falling, to making sure you have the right amount of money in the right places. And if you follow it faithfully, your asset allocation will automatically help you to buy low and sell high.

HOW THE PROCESS WORKS

Our investment process begins by identifying clearly where you are starting from. We work with you to gather accurate information on your entire net worth (everything you own, minus everything you owe to others).

Once your current situation is clear, we spend some time learning about the unique circumstances of your life. We do this by asking questions like these:

- How much do you save out of every paycheck?
- How much do you know about investments?
- How much investing experience have you had?
- What kind of real estate do you own, such as your primary residence? And how does the value of your real estate compare to your overall savings and investments?
- How much cash do you have in the bank?
- Who is financially dependent on you?
- How secure is your income?

Questions like these allow us to determine an appropriate level of investment risk for you. This gives us a first impression of how much of your wealth should be in real estate, how much in stocks (and mutual funds that hold them), and how much in bonds and cash.

After adjusting for your unique circumstances, the result is a target asset allocation. This target helps you, and us, to understand how your assets should be invested. The asset allocation then can help us answer questions like these:

- Which options to select under a workplace retirement savings plan, like a 401(k), 403(b), deferred compensation plan, or federal Thrift Savings Plan.
- Which investments currently in the portfolio should be sold.
- Which investments to add to, or which new investments to buy.
- Which assets to sell, for planned expenses, or for retirement income.
- How much to keep in reserve for emergencies.

While we develop these investment recommendations, we keep taxes in mind. We look for the most tax-conscious way to get your investments to where they should be. It's important not to put too much emphasis on taxes—we don't want the tail to wag the dog. But most of the time we find that our clients' goals can be matched up with appropriate, tax-conscious investment strategies.

For example, investments that earn interest are often best in accounts like traditional IRAs, and workplace savings plans like 401(k)s, 403(b)s, 457s, and the TSP for federal employees. This way, the income tax on the interest is postponed until the money is taken out of these accounts.

On the other hand, the most aggressive investments are best in Roth accounts, when they're available. If these are the assets that are likely to grow the most, it makes sense to own them in an account which keeps all that growth out of future taxable income.

Less aggressive assets that grow by capital gain can be kept in regular accounts, like a joint brokerage account. When these assets are sold, you pay capital gains tax on the profit, but this is usually lower than the regular rate of income tax you would pay.

WHY OUR CLIENTS INVEST THIS WAY

Most of the investment world is caught up in trying to predict the future. But prediction of the financial marketplace is not something human beings do very well. Even dedicated professionals, working at it full time, can't predict investment results any more accurately than if they were trying to guess whether flipping a coin would result in heads or tails.

Why does prediction about the markets fail so often? One important reason is that predictors typically focus on the wrong time frame. Most often, they want to know what the financial markets are about to do. Without knowing tomorrow's news headlines, it's impossible to guess what the markets are about to do.

Our investment process begins with accepting this important truth: no one can accurately predict where the markets are going. And once you admit that you can't foretell the future, the right way forward becomes clear. It's not even that complicated.

Since none of us knows what the future holds, we help you prepare for a variety of possible futures. And it turns out that there are not that many different possibilities. We could experience prosperity, which we might think of as a normal, healthy economy. If the economy grows faster than is healthy in the long run, we could experience high inflation. In times of lower consumption due to poor economic conditions, we experience recession.

And that's about it: prosperity, inflation, or recession. True, inflation could turn to hyperinflation, or recession could slip into depression. But if you are prepared for prosperity, inflation, and recession, you are ready to handle the vast majority of likely financial futures.

While it's impossible to know what the markets will do in the short run, it's easy to know what will happen in the long run. In fact, you probably already know: over the long term, the economy and the markets move in cycles. Recessions, prosperity, inflation—they all come and go. Instead of the impossible task of trying to cash in on what's about to happen, we want our clients to be prepared for—and to prosper from—the markets moving up and down unpredictably.

HOW OUR CLIENTS INVEST

Since there are essentially three possible states for the economy—prosperity, inflation, or recession—we want our clients to be prepared for each possibility. Leveraged real estate is your best hedge against inflation (and many people don't need any real estate other than their own homes). Stocks are best for periods of prosperity. And bonds and cash are most valuable during periods of recession.

So almost every client should have some of each category. We find out how much by asking you questions about you and your life (*endogenous* factors). We don't concern ourselves with outside forces (*exogenous* factors) like the direction of the stock market or of interest rates, or what Congress or the International Monetary Fund are about to do. Focusing on endogenous rather than exogenous factors allows us to make decisions based on what you can actually control, what you personally can change or keep the same.

Since real estate is usually the most difficult asset to add to (or subtract from) a household's financial picture, we begin there. And don't worry, we don't want you to become a landlord. There are much simpler ways to invest in more real estate if that's appropriate for you. We usually look for mutual funds that invest in real estate investment trusts, called *REITs* (rhymes with "beets").

Then we decide how much of your savings and investments should be in the stock market, and how much should be in safer interest-earning options. For stocks, we favor inexpensive, broadly-diversified mutual funds or exchange-traded funds (ETFs). For bonds and cash, safety is more important than yield. So we look for FDIC-insured accounts, and the safest bonds (or the most reliable bond mutual funds) that can be found. Having enough cash and bonds means that regardless of when you experience the inevitable downturn in the stock market, you'll know there's no need to panic and sell stocks when they're down.

If you follow this process, you'll have enough cash to handle emergencies, and to reduce reliance on consumer debt (like credit cards). And you'll have participation in the stock market through a short list of mutual funds, giving you broad diversification, very low cost, and a process for ongoing management that is so simple, some clients follow it without needing our ongoing guidance. (Others prefer to have continued assistance from our office, which we are happy to provide.)

The reason we split up your money into different kinds of savings and investments is that we want different dollars to perform different functions for you, depending on what the economy has in store. Any one dollar you have can perform a number of different functions for you: it can protect you against inflation or against deflation, or it can be positioned for growth. But any one dollar can perform only one of these functions at a time. We refer to this process, of allocating some money to one function and other money to other functions, as *Functional Asset Allocation.* (You can read more about Functional Asset Allocation in Chapter 8 of Bert Whitehead's book, *Why Smart People Do Stupid Things with Money.*)

MAKING UNPREDICTABLE MARKETS WORK FOR YOU

So how does this process allow you to benefit from shifting economic cycles, and the unpredictable investment markets they bring about? Let's take a look at a simplified example.

Suppose we determine the right asset allocation for you is half mutual funds that own stocks, and half bonds and cash. (For simplicity, we'll just call them "stocks" and "interest-earning" for now.) When you reach that 50/50 target balance, it's not the end of the story. The financial markets are always moving, and those natural movements will pull your savings and investments away from your 50/50 target.

Suppose it starts with what most of us consider bad news—the stock market drops. This is often accompanied by interest-earning investments going up. Now you have less than half of your investments in stocks, and more than half in bonds and cash. So if you follow the guidance of your asset allocation, you would take some of your interest-earning dollars, and use them to buy some stocks while they are cheap, buying just enough to get you back to your 50/50 target. (In reality, we may just adjust where your new investment money is going until you get back to 50/50.)

Eventually, things always turn around, and stocks would grow again. But if you'd already gotten back to your 50/50 balance by buying more stocks, the recovering market then will mean you now are taking too much risk in stocks. So you sell some stock and use the proceeds to shore up bonds and cash, until you're back to 50/50. Again, this is sometimes accomplished by re-directing new investment money.

This also works when you're taking money out. Suppose you need money from your investments to pay for a car, or a trip. If nothing has changed in your life that calls for a new asset allocation, we recommend you take your money first from whatever investments have grown the most (or, during down markets, those that have shrunk the least) since the last time you rebalanced your portfolio. This has the effect of helping to bring your investments back into their proper balance.

You can see how this differs from the typical approach to investing. Most of the time, those who try to beat the market spend a lot more money attempting to predict what's going to happen next. And the great majority of the time, they fail. True, you can always find someone who beat the market last year. But it's very difficult to find someone who beats it year after year. (In one survey, only 5 of about 5,000 mutual funds successfully landed in the top 25% of results for five years running.)

By contrast, our process focuses on achieving market-level returns, with expenses as low as reasonably achievable. Followed diligently over the years (along with other sensible financial choices), the result is financial independence and the serenity of knowing that you don't need to worry about money.

That's all that most of our clients want to achieve. It does require you to make a decision about how much is enough (and we can help with that). It takes diligence, and usually some patience. But you can get there.

And helping you get there—sensibly, effectively, and realistically—is why we're here. As with any aspects of your financial plan that we're assisting you with, if you have any questions about our philosophy and strategy, let us know. We're here to help you.