

## **The Financial Navigator – June Newsletter**

With the recent return of stock market volatility, the Dow Jones Industrial Average is once again jumping  $\pm 200$  points on a daily basis, I thought the articles below would be timely and informative. In the “Art of Letting Go” Jim Parker of Dimensional Fund Advisors discusses the Wall Street investment approach that focuses on frequent and frenetic investment activity and how that might compare to a steadier, slower approach when looked at in the context of your portfolio. And we have another article on the wisdom of owning gold, which never seems to go out of style according to much of the financial press and those hawking gold on the radio and TV. But when viewed in a long-term historical context perhaps we should ignore much of that so called investment wisdom, read on for more details.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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### **The Art of Letting Go**

Jim Parker, Vice President-Dimensional Fund Advisors.

In many areas of life, intense activity and constant monitoring of results represent the path to success. In investment, that approach gets turned on its head.

The Chinese philosophy of Taoism has a word for it: “wuwei.” It literally means “non-doing.” In other words, the busier we are with our long-term investments and the more we tinker, the less likely we are to get good results. That doesn’t mean, by the way, that we should do nothing whatsoever. But it does mean that the culture of “busyness” and chasing returns promoted by much of the financial services industry and media can work against our interests. Investment is one area where constant activity and a sense of control are not well correlated. Look at the person who is forever monitoring his portfolio, who fitfully watches business TV, or who sits up at night looking for stock tips on social media.

In Taoism, by contrast, the student is taught to let go of factors over which he has no control and instead go with the flow. When you plant a tree, you choose a sunny spot with good soil and water. Apart from regular pruning, you leave the tree to grow. But it’s not just Chinese philosophy that cautions us against busyness. Financial science and experience show that our investment efforts are best directed toward areas where we can make a difference and away from things we can’t control.

So we can't control movements in the market. We can't control news. We have no say over the headlines that threaten to distract us. But each of us can control how much risk we take. We can diversify those risks across different assets, companies, sectors, and countries. We do have a say in the fees we pay. We can influence transaction costs. And we can exercise discipline when our emotional impulses threaten to blow us off-course.

These principles are so hard for people to absorb because the perception of investment promoted through financial media is geared around the short-term, the recent past, the ephemeral, the narrowly focused and the quick fix.

We are told that if we put in more effort on the external factors, that if we pay closer attention to the day-to-day noise, we will get better results. What's more, we are programmed to focus on idiosyncratic risks—like glamour stocks—instead of systematic risks, such as the degree to which our portfolios are tilted toward the broad dimensions of risk and return. Ultimately, we are pushed toward fads that the financial marketing industry decides are sellable, which require us to constantly tinker with our portfolios.

You see, much of the media and financial services industry wants us to be busy about the wrong things. The emphasis is often on the excitement induced by constant activity and chasing past returns, rather than on the desired end result. The consequence of all this busyness, lack of diversification, poor timing decisions, and narrow focus is that most individual investors earn poor long-term returns. In fact, they tend to not even earn the returns available to them from a simple index. This is borne out each year in the analysis of investor behavior by research group Dalbar. In 20 years, up to 2012, for instance, Dalbar found the average US mutual fund investor underperformed the S&P 500 by nearly 4 percentage points a year.<sup>1</sup>

This documented difference between simple index returns and what investors receive is often due to individual behavior—in being insufficiently diversified, in chasing returns, in making bad timing decisions, and in trying to “beat” the market.

Recently, one of Morgan Stanley's most frequently quoted brokers broke ranks from the industry and gave the game away on this “busy” investing. In his final note to clients before retiring to consultancy work, Morgan Stanley strategist Gerard Minack said he had found over the years that investors were often their worst enemies.<sup>2</sup> “The biggest problem appears to be that—despite all the disclaimers—retail flows assume that past performance is a good guide to future outcomes,” Minack said. “Consequently, money tends to flow to investments that have done well, rather than investments that will do well. The net result is that the actual returns to investors fall well short not just of benchmark returns, but the returns generated by professional investors. And that keeps people like me employed.”

It's a frank admission and one that reinforces the ancient Chinese wisdom: “By letting it go, it all gets done. The world is won by those who let it go. But when you try and try, the world is beyond the winning.”

## **You Have to Be in Gold**

Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.

All of us could benefit by examining our inclination to invest with our hearts rather than our heads—especially when it comes to gold.

*"We are living in a world of money printing. ... That is why I have to recommend gold again. ... Once gold surpasses \$1,800 an ounce, it will run to the low-to-mid \$2,000s."* **Quotation attributed to Felix Zuelauf, Zuelauf Asset Management. "Here's What's Cooking for 2013," Barron's, January 21, 2013.**

*"Investors can choose between artificially priced financial assets or real assets like oil and gold, or to be really safe, cash. ... My first recommendation is GLD – the SPDR Gold Trust."* **Quotation attributed to Bill Gross, PIMCO. "Stirring Things Up," Barron's, February 2, 2013.**

*"I am recommending gold, as I have done for many years. I will continue to do so until the gold price hits the blow-off stage, which is nowhere in sight. ... The environment for gold couldn't be better. ... Gold could go to \$5,000 or even \$10,000."* **Quotation attributed to Fred Hickey, The High-Tech Strategist. "Stirring Things Up," Barron's, February 2, 2013.**

Each January, a group of prominent investment professionals gather in New York as members of the Barron's Roundtable to trade quips, stock ideas, and the outlook for markets and economic trends worldwide. Barron's—a weekly financial newspaper with a small but devoted following of professional and do-it-yourself investors—publishes a transcript of their remarks over three successive issues. The quotations above are excerpts from this year's panel discussion, and to the best of our knowledge they represent the only occasion that three of the nine participants have highlighted gold-related investments among their choices for capital appreciation during the year ahead.

Although the year is far from over, it's off to a rough start for gold enthusiasts. A sharp selloff in mid-April sent bullion prices to \$1,395 on April 15, down 15.7% for the year to date and 26.4% below the peak of \$1,895 reached in early September 2011. (Prices are based on the London afternoon fix.) For the 10-year period ending March 31, 2013, gold enthusiasts have a more positive story to tell: The annualized return for gold spot prices was 16.83%, compared to annualized total returns of 8.53% for the S&P 500 Index, 10.19% for the MSCI EAFE Index, 17.41% for the MSCI Emerging Markets Index, and 2.34% for the S&P Goldman Sachs Commodity Index.

Taking a somewhat longer view, for the 40-year period ending March 31, 2013, gold performed in line with many widely followed fixed income benchmarks, while lagging behind most equity indices. We find it ironic that the return on gold over the past four decades is essentially indistinguishable from five-year US Treasury notes, often scorned by gold advocates as "certificates of confiscation."

Considering the volatility of gold prices, even a 40-year period is too short to provide conclusive evidence regarding gold's expected return. And the issue is further clouded by shifts through time in the legality of gold ownership and its changing role in various monetary systems worldwide. In his book *The Golden Constant*, published in 1977, University of California, Berkeley Professor Roy Jastram examined the behavior of gold in England and America over a 400-year-plus period—and suggested that the long-run real return of gold was close to zero. Even with centuries of data to study, however, he couched his conclusions in cautious language.

When we last commented on gold in February 2012 (“Who Has the Midas Touch?”), the mysterious metal was changing hands at \$1,770 per ounce. We directed readers' attention to the Berkshire Hathaway 2011 annual report, which presented an engaging discussion by Chairman Warren Buffett on the long-term appeal of gold—or, in his view, the lack of it. Since that time, the role of gold in a portfolio has provoked vigorous debate in the investment community, with thoughtful, articulate, and successful investors lining up on both sides of the issue, including at least three billionaire hedge fund managers making the case for gold.

Some might argue that gold's price behavior will never succumb to rational analysis. For those seeking to try, a recently updated paper by Claude Erb and Campbell Harvey offers a useful framework for discussion without necessarily resolving the debate. Along the way, it provides the reader with a few nuggets of historical interest, including a comparison of military pay between US Army captains of today and Roman centurions under Emperor Augustus. (Apparently, little has changed over 2,000 years.)

The authors cite a number of reasons advanced in support of gold ownership, including a hedge against inflation, a safe haven in times of stress, an alternative to assets with low real returns, and its “under-owned” status across investor portfolios. Although the inflation hedge argument is likely the most frequently cited attraction for gold investors, the authors find little evidence that gold has been an effective hedge against unexpected inflation. They go on to poke holes in the assertion that gold qualifies as a genuinely safe haven or presents an appealing alternative in a world characterized by low real yields.

The most interesting argument, they believe, is the claim that gold is under-owned in investor portfolios and that a small shift in investors' allocation strategy could lead to a significant rise in the real price of gold. Putting aside for a moment the ambiguity of the “under-owned” statement (all the world's gold is already owned by somebody), the authors suggest it is plausible that individuals or central banks could choose to have greater exposure to gold. If they are insensitive to prices, this choice could cause the real price of gold to rise, particularly if gold producers are unwilling or unable to increase production. (On that note, it's also conceivable that a significant real price increase would encourage development of electrochemical extraction of the estimated 8 million tons of gold contained in the world's oceans, dwarfing the existing gold supply.)

The “gold is under-owned” argument has been advanced by a number of thoughtful investors, and only time will tell if such a shift in allocation strategy takes place with the consequences they expect. While acknowledging the bullish implications for gold prices under this scenario, the authors point out that gold prices relative to the current inflation rate are roughly double their long-run average since the inception of gold futures trading in 1975. They suggest \$800 per

ounce is a suitable target when applying this metric. Which is more plausible—that prices will gravitate closer to their historical average or that a new world order is emerging that calls for a sharply different valuation approach? No one can be sure; hence, the title of their paper, “The Golden Dilemma.”

What should investors make of all this? In our view, long-run investment results for any individual reflect the combination of available capital market returns and the investor’s behavior and temperament. As Warren Buffett has observed, excitement and expenses are the enemy of every investor, and all of us could benefit by examining our inclination to invest with our hearts rather than our heads. The decision to own gold often is motivated by an emotional response to current events, leading to abrupt shifts in asset allocation strategy and a failure to achieve capital market rates of return there for the taking. If adopting a permanent 5% allocation to gold encourages investors to maintain a buy-and-hold strategy for the remaining 95% of their portfolio, perhaps that is the most sensible solution for some. Many other investors undoubtedly will be just as content to stock their portfolios with securities offering interest and dividends—and let gold fulfill their innate human desire for rare and beautiful objects of adornment.

### **Gold vs. Benchmark 1973 – March, 2013**

<b>Index</b>	<b>Annualized Return (%)</b>	<b>Growth of \$1</b>
S&P 500	10.18	\$48.30
MSCI EAFE Index	9.05	\$31.96
S&P Goldman Commodity Index	8.21	\$23.51
Barclays US Govern. Bond Index	7.85	\$20.53
5 Year US Treasury Notes	7.69	\$19.40
Gold Spot Price	7.63	\$18.95
Consumer Price Index	4.30	\$5.39

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