Step 1: Thinking That Works

The first step in building a successful portfolio is to start with an investment philosophy that is consistent at its core and matches your individual characteristics. Many investors have no investment philosophy, and the same can be said for some professional investment advisors. They adopt strategies that seem to work for others, then abandon them the first time they fall short. The negative consequences from this approach add up over time.

Without a core set of beliefs, investors are easy prey for charlatans, each claiming to have found the magic bullet that always beats the market. As you switch from strategy to strategy, transaction and tax related costs eat into profits or exacerbate losses. While different strategies might work for different people, they might not be appropriate for your objectives and risk tolerances, causing much emotional pain and discomfort.

The key to investment success is not in knowing what made Warren Buffett rich, but in knowing what makes you tick, and then finding a philosophy and strategy you can stick with. There are obviously many approaches that work, but most successful strategies have two things in common. First, they are patient strategies focused on the only time frame that matters, yours. Second, they are based on strategic asset allocation, not market timing.

The key is to start with the correct perspective. You can choose to view the investment landscape as either an investor or a speculator. As an investor, you see that true investing is a process that occurs over time periods of at least 5 years, and often over 10 to 20 years or more. Your opinions about the markets and how they work are shaped by this long-term viewpoint. As an investor, you make decisions that reflect your needs over these longer periods, not on what will happen next month, next quarter, or even next year.

Being comfortable with a longer investment horizon often means sitting tight when others are in a panic mode, or giving the capital markets a chance to work for you, rather than trading at the first opportunity to realize gains. The idea that "doing less with your portfolio is better" is often counterintuitive and difficult to accept. Investors sometimes ignore this truth in order to pursue something less important but more exciting. The problem is that excitement can be expensive, while more productive and profitable investment strategies can seem plodding and boring by comparison.

Unfortunately, the think-quick mentality of the modern information saturated world rarely endorses a true investor's view. Turning to CNBC for advice, it would seem that you should take action every time a big political or market event occurs. It could even convince you to avoid stocks altogether because of the heightened volatility associated with shorter time periods. That would be a critical mistake for most investors as over time stocks have outperformed almost all other asset classes. If you had invested $100,000 in 1992 in a diversified portfolio of common stocks similar to the S&P 500 and stayed with that portfolio, you would have gained 7.8% annually and had $449,133 by the end of 2011. But with just a few misfires, like timing the market poorly or over concentrating the portfolio and you could have easily cut that return to half or less. In fact, missing the 20 best days (20 out of 5,042) would have reduced your annual returns to those of U.S. Treasury Bills and left you with just $140,094. Sound investment strategies don't change with the daily news. A long-term commitment is essential – you have to be there.

Something to Believe In

Our basic philosophy is continually tested, but we are not convinced there is a better approach offering any reasonable probability of success. We don't pretend to have all the answers. Any approach may need to evolve over time and adjust to structural changes in the markets. The important thing is that you are grounded by a basic set of beliefs that are suited to your personality and world view, that can sustain you through the inevitable ups and downs in the markets.

We continue to believe:

1. Fundamentally, investing is a long-term process. In the short-run financial markets fluctuate and overreact to current events and crises. History has consistently proven that investors are rewarded for sticking with a long-term strategy.
2. Investments should be allocated among different asset classes, i.e., stocks, bonds, and other assets, depending on individual financial objectives and tolerance for risk. To manage risk within each asset class, investors should own a diversified portfolio, well-balanced among different companies, industries, and countries.
3. Over the long-term, owning stocks and other equity securities will provide investors higher returns than owning bonds or other forms of debt, after inflation and taxes.
4. Broad market timing or attempting to drastically change basic allocations based on economic or market predictions, while an appealing concept in theory, in reality is an unproductive exercise that rarely produces satisfactory long-term results.
5. Administrative and transactions costs should be kept to a minimum to produce the highest net return after all costs. Investment relationships should be structured to avoid the "hidden costs" of investing.

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