Faith, Patience and Discipline

With a risk-adjusted strategy, these three attributes will help your clients gain consistent investment returns.

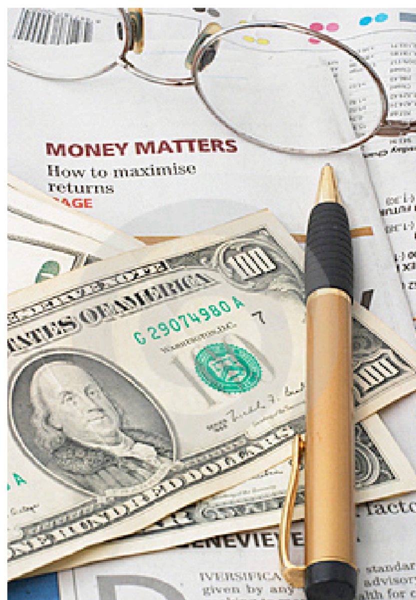
Jonathan DeYoe

Virtually all financial-product marketing is based on past performance. Marketers obviously have determined that touting past performance while simultaneously issuing the mandated caution that "past performance is no guarantee of future results" is the best way to motivate investors.

The irony is that data relating to previous performance holds little value for advisors and investors. The ubiquitous disclaimer ostensibly warns investors not to assume a connection between past and present but implies such a correlation does indeed exist.

There is no shortage of data illustrating the propensity of top-performing funds to wither the following year (see chart below); yet, investors regularly base their investment choices on recent results, and typically the wrong short-term results at that.

As financial advisors, our challenge is to help our clients resist the pernicious effects of omnipresent past-performance marketing. Performance is important, but short-term performance is virtually meaningless as it relates to investment consistency. Instead, we should encourage our clients to seek risk-adjusted performance—a strategy that can deliver consistent performance regardless of market conditions—while reminding them that no strategy can ensure success or protect against loss.



PAST PERFORMANCE NOT INDICATIVE OF FUTURE RESULTS

	1994-1997	1998-2001
1st Quartile	129 managers	36
2nd Quartile		27
3rd Quartile		41
4th Quartile		25

(Of the 129 top-performing managers during 1994-1997, more than half (66) dropped to the bottom half of the ranking during the ensuing four-year period.)

While the fundamental principles of a risk-adjusted strategy involve sound asset allocation, diversification and portfolio rebalancing, these behaviors are difficult to maintain when investors are continuously distracted by performance sound bites. Investment principles aside, unless investors have faith, patience and discipline, they are almost certain to fall prey to the incessant barrage of short-term performance-marketing hype. Here is why faith, patience and discipline are so paramount:

Faith is imperative. How does someone invest in the future without having faith that his investment decisions are prudent?

Patience is the belief that one's faith will be rewarded. Investors need to be reminded that it's not market timing; it's time in the market.

Without discipline, faith and patience are fruitless. Investors must have the discipline to set money aside, regardless of economic or market conditions and to ride out short-term market fluctuations.

The psychology of risk

Most advisors measure risk-adjusted performance using the Sharpe ratio, which is rooted in the assumption that the markets are inherently efficient and that investors are entitled to a certain level of return in exchange for accepting a certain level of risk. While advisors are unlikely to get much argument from their clients on this point, most product marketing highlights performance to the exclusion of how much capital was at risk. If advertisements were required

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to include a ratio of principal at risk, we would have a completely different environment. Investors would be able to make more informed judgments. That's not to say they would, but at least the risk data would be mentioned.

Investors tend to lose money when they make big changes in their portfolio. But if you have taught your clients to expect occasional drops and to remember that markets go down as well as up but that you have a process to manage that vacillation, they are less likely to panic at the first sign of a downturn.

Similarly, if you have educated them well, when a piece of their portfolio is doing exceptionally well, they are less likely to get excited and want to sell off assets doing poorly to buy more of what is soaring. As advisors, we should provide the ballast to offset investor emotion.

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History lessons

The dot-com implosion was a prime example of a complete loss of discipline, as was the recent subprime real-estate collapse. The latter didn't occur because the underlying packages of mortgage securities no longer had value. What caused the loss of discipline was that markets didn't know how to value the securities and so abandoned them. Their underlying assets are still intact and will not disappear. However, instead of waiting for the inevitable rebound and return of value, what most investors did was to lose faith and dump the securities.

Suppose we are riding in a car going at 60 miles per hour. There's a 10,000 foot cliff coming up some 60 miles ahead and we know if we fail to brake, we will reach that cliff and plunge to our deaths. But we have an hour to take action to avoid that tragedy.

Investors similarly tend to focus on the cliff and forget that we have ample time to brake or turn the car. They lack the patience to wait for someone to figure out what to do to calm the market volatility, determine values and move forward.

A lack of investor discipline relates to the emotional content of decision making. When an investment class provides an outsized return, such as real estate had

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for the past few years, the majority of investors will first chase it until they bring it down to an average return and then over-commit capital to it until it becomes a below-average return. This is one reason why risk-adjusted returns, not merely performance, should be the principal analytical piece of portfolio design. Once a sector displays phenomenal returns, it is usually no longer available.

Another reason to avoid basing decisions exclusively on past performance is that while historical returns are unreliable indicators of future returns, historical risk often has a strong relationship to future risk. Over time and despite wavering market conditions, the riskiest funds generally remained the riskiest; the least volatile tend to remain the most stable.

Client acceptance

If as advisors we adhere to the concepts of strategic asset allocation, diversification across various asset classes and minimal annual rebalancing, we can help investors avoid making decisions based on marketing hype or exclusively on past performance. If as advisors we set an example of maintaining our faith, patience and discipline, we can help our clients achieve superior long-term returns using a risk-adjusted strategy.

RISK-ADJUSTED RETURNS, NOT MERELY PERFORMANCE, SHOULD BE THE PRINCIPAL ANALYTICAL PIECE OF PORTFOLIO DESIGN.

That said, convincing clients to sign on to this strategy can be thorny when pervasive marketing hype encourages them to do the opposite. The effort is well worth it, however. Once clients embrace faith, patience and discipline and adhere to a process of asset allocation, diversification and rebalancing, their lives become easier and as their advisors, ours as well.

Jonathan DeYoe of DeYoe Wealth Management in Berkeley, Calif., is a registered principal with, and securities are offered through Linsco/Private Ledger, Member FINRA/SIPC. His background includes investment-management responsibilities at Morgan Stanley, UBS PaineWebber and Salomon Smith Barney. You may reach him at ---.

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