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Just the Facts: Basics of Evidence-Based Investing

For those new to the financial markets and its dizzying array of investment vehicles and methods, the prospect of deciding the best way to get involved can be intimidating. Mutual funds promise "better than market average" returns; advisors tout their ability to keep clients' funds protected from market gyrations; and scores of best-selling books from self-proclaimed experts trumpet the latest market theory, alternately promising wealth from a rising market or warning of financial catastrophe (which can warded off, of course, for the purchase price of the book).

Is there any rational, proven means of investing funds that offers a reasonable expectation of success, along with a measurable, reasoned rationale? We believe that the answer is "yes." For years, our clients have benefited, in both positive and negative market cycles, from an approach called evidence-based investing (EBI). What sets EBI apart from many other market theories is its reliance on the best available evidence from a variety of market research. EBI establishes an objective, logical approach to portfolio design and management that eliminates, to the degree possible, the rule of emotion in making investment decisions. EBI seeks to empirically and scientifically determine the best indicators of market performance, utilizes a disciplined approach to investment allocation and management, incorporates flexibility in assessing the available evidence, and endeavors to control risk through proven asset allocation strategies.

The evidence-based approach has benefited from the research and analysis of some of today's most respected economists and market scholars, including Nobel Prize laureates and others. Another benefit of EBI is that, because it is generally set within a framework of very cost-effective purchase and sales parameters and encourages buying and holding for the long term a carefully selected portfolio, it avoids much of the expense to investors of the high-velocity, active trading by which some financial professionals seek to improve portfolio performance.

In fact, this brings up one of the key pieces of evidence on which EBI is based: Most of the time, according to multiple studies, managers who trade actively fail to outperform their target market indexes. Further, because of the expense of the transactions their trading generates, they end up costing investors more: in management fees, trading costs, and tax consequences. While the money manager may make a tidy income from the fees and commissions generated, the client is not always so well served.

By contrast, evidence-based investing seeks to establish a broadly diversified portfolio, spanning a number of different types of holdings that occupy a variety of market segments. Holding "eggs in different baskets" tends to reduce the adverse consequences for an investor if any one of the "baskets" suffers a negative market event. The process of asset allocation among different market segments is one of the foundations of EBI. Evidence has also demonstrated that a more passive approach—buying and holding investments designed to reflect a broad stock index, for example—will usually show better performance, over time, than an active approach.

For example, a recent study of realized investor returns for the 20-year period ending December 31, 2014, conducted by Dalbar, a leading evaluation, auditing, and rating firm, showed that investors in actively traded stock funds (that aimed to out-perform standard stock indexes) achieved an annualized return of 5.2%. During that same period, the S&P 500 Index, a standard broad stock index, showed an annualized return of 9.9%. This points toward the evidence for the superiority of a more passive, index-based investing approach.

Evidence-based investing takes much of the emotion out of investing—another key tenet.

Study after study has shown that investors tend to buy too late and sell too early. The disciplined, index-based approach of EBI helps investors remain invested, even when emotions—either positive or negative—may be running high. By keeping investors "in the market" for the long term, EBI provides significant protection against the two principal mistakes that individual investors tend to make, when left to their own devices.

EBI also incorporates regular assessment and rebalancing, when necessary. After all, assessment of results is an essential part of any objective or scientific inquiry, and this is no different in the "science" of portfolio management. This means that clients are not simply enrolled and then forgotten. Instead, their portfolios are regularly reviewed in light of their goals and any changes in their situations. Moreover, their asset mix is systematically re-evaluated in light of market action, the client's stage of life and funding needs, and current market research. Any re-allocation among asset classes is then made according to the strategy agreed upon in advance by the client and the advisor. This reasoned, logical approach helps to assure that the client's needs, along with the portfolio design and investment strategy, are constantly being reviewed in light of emerging developments.

As advisors, we seek to assist our clients in distributing and managing their assets in a way that incorporates their goals, tolerance for risk, and short- and long-term funding needs. Because the fiduciary rule under which we operate requires us to place clients' needs ahead of our own, such a structured, disciplined, low-cost approach also provides our clients the maximum consideration and benefit. We believe that evidence-based investing gives us a means to provide our clients with the best, most objective advice, taking advantage of leading-edge research and market information. We further believe that it allows us to serve our clients in a cost-effective way that helps them achieve their goals and preserves their peace of mind.

Providing these benefits to our clients is our principal aim. EBI keeps us on target.

Stay Diversified, Stay the Course!

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