SMART INSIGHTS FROM PROFESSIONAL ADVISERS

What's Your Investing Philosophy? Is It the Best One for You?

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Do you park your money in an index fund and forget it or pay a manager to go all out to beat the market? Consider an alternative to help you ride the waves without wiping out: The Sunset Beach Portfolio.

Nothing is more important to long-term investment success than a clear investment philosophy and nothing is more controversial.

There are, no doubt, numerous investment philosophies and countless investment strategies. Investors and investment professionals attempt to protect themselves with philosophies aimed at extracting gains while normalizing the risks inherent in the market.

Yet, we all know financial markets have a propensity to behave erratically.

It reminds me of my college days in Hawaii catching waves as they relentlessly pounded the North Shore of Oahu. After calm, even serene, summer months the surf kicks up in the fall. Big-wave surfers flock to the beaches forming camps, each attempting to devise methods to ride the biggest waves without paying the ultimate price. Unfortunately, every so often a rogue wave rolls in and takes out not just the surfers, but also a fair number of spectators as well.

What a great analogy to our financial markets, right?

What is a mere investor or even an independent investment adviser to do? Which camp should we pitch our tent? Of course, there are pros and cons to all investment philosophies, including these much-debated approaches to investing:

PASSIVE ASSET MANAGEMENT

Sometimes called passive investing, indexing or "set it and forget it" investing, passive portfolio management generally involves tracking a market-weighted index or portfolio in order to generate a return consistent with the index.

• **The Pros:** It's typically less expensive to go this route, and it's easier for the average investor to understand.

• **The Cons:** If the market goes up, your portfolio is going to go up; and if the market goes down, your portfolio is going to go down. No one is typically "watching" this portfolio.

• **What You Should Know:** Passive strategies tend to outperform others when markets are strong, as they have been since 2009; and it's easy to become complacent when times are good. But as we've seen time and again, markets are volatile. If you're in or near retirement, you probably don't have the luxury of waiting for your portfolio to recover from a major loss. Your focus should begin to shift to preservation of what you have worked so hard to earn and accumulate.

ACTIVE ASSET MANAGEMENT

With this type of portfolio, a manager typically attempts to outperform a given benchmark index. The manager watches market trends, changes in the economy and other factors to make buying and selling decisions.

• **The Pros:** In periods of volatility or when markets aren't rising, you have professionals who dig deep for investments that might in fact outperform the market.

• **The Cons:** The extra effort that goes into this type of investing — research, frequent trading — can make it more expensive.

• **What You Should Know:** In a worst-case scenario, you have managers who are focused on finding value and may still be able to bring in returns, but the wins need to offset both the losses and the cost, and investors must be willing and able to "manage" the managers.

TACTICAL ASSET MANAGEMENT

A tactical manager pays attention to certain triggers and actively adjusts a portfolio's asset allocation from stocks to bonds or even into cash in order to preserve capital. The tactical manager is merely attempting to take what the markets will give him or her at a given level of risk, i.e. focusing on risk-adjusted returns.

• **The Pros:** This type of strategy is well-suited to investors with a lower risk tolerance (as long as your goal isn't to outperform the markets). You may find a significant portion of your portfolio sitting in cash as the markets fall.

• **The Cons:** It's difficult to time the markets and some would say impossible. You may find yourself frustrated if you have money sitting in cash while the market rallies without you.

• **What You Should Know:** This type of investing has the potential to boost returns (in a bull market) while lowering risk when certain signals say a correction — or worse — is on the way.

The debate over which philosophy is best has been going on for years.

THE BEST CHOICE FOR YOU COULD BE A HYBRID APPROACH

Why not consider an investment philosophy that includes all three of these strategies? There's nothing that says you can't modify your investment philosophy, by taking the best of what each camp has to offer.

You could, for example, use our "Sunset Beach Portfolio," coincidentally named after one of Hawaii's big wave beaches:

1. Push Passive Asset Management to become "Strategic."

Start by placing your long-term holdings in a managed core portfolio. The primary goal of the core is to use lower-cost investments, which will have a better chance of keeping up with market indices. By using a manager, you're just trying to avoid the worst – a large wave that wipes out a significant portion of your portfolio. Hire someone experienced, an independent investment committee for example, to position your portfolio for long-term growth and to make strategic changes when dictated by market forces.

Make sure it's understood that you don't want to see a lot of trading in your core. In short, you're looking for cost-efficient, passive investments that track major market indices that are strategically managed by an actual person or persons, as opposed to a machine. Thus, our living breathing strategic manager allows us to take advantage of market opportunities while sidestepping market adjustments that an experienced institutional manager would recognize.

2. Include Tactical Asset Management.
Place moderate-term holdings into numerous tactical strategies, which will serve as satellites to your core portfolio. Tactical strategies will move to safety, either bonds or cash, based on timing or due to the activation of risk triggers. For example, one tactical algorithm may trigger a movement to cash based on recession signals, while another may merely move from stocks to bonds in May and return to stocks from bonds in October.

Tactical algorithms should not be confused with simple stop-loss trading. Rather, such triggers are typically designed and managed by institutional wealth managers based on years of study and experience. Finally, ensure that your tactical satellites do not correlate and therefore, move to cash simultaneously. While Tactical Asset Management may not outperform any given market (and you should be on guard for salespeople who say they can or will), the primary purpose of these investment strategies should be to lower your risk.

3. Set Aside Some "Safe" Money.
To be sure, safe money should be part of one's core portfolio. As the old saying goes, don't invest it if you can't afford to lose it. The debate gets particularly tough when it comes to how to invest money "safely." To be classified as safe, keep in mind that investments must, nevertheless, grow hedged for inflation. If you have savings in money markets, CDs or Treasuries while interest rates are low, you're doomed to lose money slowly due to taxes and inflation eating away at your buying power.

For these reasons, investors should consider using a no-risk structured note, also known as a fixed-index annuity, to grow their money safely as well as hedged for inflation. Simply put — structured notes allow investors to potentially benefit from market increases, but be protected from downside market risk. Some may argue, and rightfully so, that structured notes will likely never outperform a market index. Yet, these investments should not be compared to the market they track. Rather, they should only be compared to other safe investments.

Finally, keep in mind that these types of investments can be used to structure guaranteed lifetime income plans and, therefore, can be quite useful for both retirees and financial planners attempting to create a portfolio safety net.

The ***Sunset Beach Portfolio*** is a hybrid approach to portfolio construction designed to keep costs down, fight inflation and minimize exposure to market volatility — all things that are especially important to retirees and pre-retires.

Talk to an adviser who understands your individual risk tolerance and can build an investment plan that works best for your needs. Remember: The right investment philosophy will make it easier to stick to your investment plan and strategies in good times and bad.

Kim Franke-Folstad contributed to this article.

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