

# Investment Philosophy

## Echols Financial Services

The investment advice of Echols Financial Services is based on a disciplined, research driven approach. Our investment philosophy is summarized in ten key principles.

### 1. Investors Need Stocks for Growth

Most people can never save enough money to reach long-term financial goals. They need their savings to grow. Without growth, the rising cost of living erodes their purchasing power and renders their savings worth less and less over time. To combat this problem, investors need their savings to grow at a rate which substantially exceeds the rate of inflation.

The problem of inflation creates an extra drag which must be overcome just to maintain the same purchasing ability year after year. This inflation risk requires investors to resist overweighting their portfolios with low-yielding investments which could effectively cost the investor multiples of their savings in lost earnings potential.

For long-term goals such as retirement, it is important that investors design a portfolio that has a high probability of outpacing inflation over long periods. The growth investment that has been most effective in doing this is common stocks.

The compound annual return of stocks from 1986 to 2005 was 11.9% for US stocks and 10.0% for foreign stocks. Real estate over the same period was 8.8% and gold was 2.3%.

From 1926 to 2005, the compound annual returns for stocks compared to bonds are as follows:

<b>Asset Class</b>	<b>Compound Annual Return</b>
Small company stocks	12.6%
Large company stocks	10.4%
Junk bonds	6.8%
Corporate bonds	5.9%
Government bonds	5.5%
Municipal bonds	4.4%
Treasury Bills	3.7%

The annual inflation rate over this period was 3.0%.

The reason the majority of financial advisors recommend stocks for meeting long-term goals is because of stocks' historical double-digit average returns over long periods.

The double-digit returns shown above are averages. The question is how much variability from year to year must be endured to receive these higher returns. The issue of variability is often referred to as volatility. The goal in investing is to reduce volatility without significantly sacrificing return.

## 2. Diversification Reduces Volatility

Concentrated positions in individual stocks entail significant risk. Unlike a diversified stock fund, the price for an individual stock can fall to zero. However, by owning several companies in different industries, portfolio risk is greatly reduced.

Harry Markowitz, winner of the Nobel Prize in Economics in 1990, showed that effective diversification is achieved by combining assets whose prices do not move together. The effectively diversified portfolio provides stability and a larger long-term return. While this theory cannot be perfectly implemented in practice, since there is a growing correlation between many asset classes in an increasingly globally-integrated economic world, its principles are important in portfolio development.

By adding a more volatile asset which is not highly correlated to the existing assets, the portfolio itself can actually gain more stability. For example, adding 24% stocks (S&P 500) to an all-bond (20 year government) portfolio actually reduces the volatility of the portfolio over the long term and increases the rate of return. The reason is stocks and bonds are not highly correlated. Many periods, when bond prices are moving down, stock prices are moving up, and vice versa. The long-term average portfolio performance is thus more stable.

By diversifying the stock allocation by company size, industry, and geography, an investor can maximize his investment return for the risk he is willing to take. The object of diversification is to achieve the best risk-adjusted return for the portfolio, based on an investor's risk tolerance. Another way of viewing it is that by diversifying, a person can minimize his risk to achieve his target rate of return.

In summary, by avoiding individual stocks, unsystematic risk (unique company risk) can be eliminated. By investing in different asset classes in a globally diversified portfolio, systematic risk (market risk) can be reduced.

## 3. Asset Allocation is the Key Factor for Returns

Asset allocation, in its simplest form, means determining how assets will be divided and invested among equities (stocks), fixed income, and cash investments in order to maximize the growth of a portfolio for each unit of risk taken. This is one of the most important determinates of long-term performance of a portfolio.

In general, the higher the weighting in stocks, the higher the potential return and volatility of the portfolio will be. The lower the weighting in stocks, the lower the growth potential and volatility of the portfolio will be.

As people get older and have less time to make up market losses, they will usually desire a less volatile portfolio, made up of more bonds and less stocks. However, caution here is warranted. Longer life expectancies require that retirees as old as 60 years of age plan for at least 30 years

of income, to insure not running out of money. Without a sufficient stock weighting, a portfolio would not be able to do that adequately. The choices would be to prematurely run out of money or be forced to withdraw less income during retirement.

The investor needs to construct an optimal portfolio of well-diversified asset classes based on his goals, time horizon, and risk tolerance. This asset allocation would normally consist of equities, fixed income, and cash to give the maximum return to meet the investor's goals and needs while managing risk and volatility concurrently.

Some of the most common asset classes are large cap value stocks, large cap growth stocks, mid cap stocks, small cap value stocks, small cap growth stocks, developed foreign stocks, emerging market stocks, short term bonds, intermediate term bonds, long term bonds, and cash equivalents.

There are a number of combinations of asset classes that fall along the line which is called the "efficient frontier". This means the portfolio maximizes the return for a given risk level. Many more possible combinations fall below the efficient frontier, meaning an investor is *not* getting the most return for the risk taken. Modern Portfolio Theory (MPT) recommends portfolios be optimized by combining asset classes in a way that positions the portfolio somewhere on the efficient frontier, based on the clients goals and risk tolerance.

#### 4. Markets are Efficient, but not Perfectly Efficient

"Efficient" means that stock prices accurately reflect the knowledge and expectations of all investors, and markets assemble and evaluate information so effectively that the price of a stock is usually the best estimate of its intrinsic value. Though prices are not always correct or perfect, markets are so competitive that it is unlikely any single investor can routinely profit at the expense of all other investors.

Eugene F. Fama is widely regarded as the "father of modern finance". He has brought an empirical and scientific rigor to the field of investment management, transforming the way finance is viewed and conducted. Regarding market efficiency, Fama comments, "Prices are not always perfect, nor is that a condition of market efficiency. The only condition efficient markets require is that a disproportionate number of market participants do not consistently profit over other participants. Since 'mispricings' tend to occur in both directions and managers over- and under-perform with random frequency when adjusted for risk and cost, markets seem to be efficient."

More and more academic research points toward a mostly efficient market, albeit not perfectly efficient. The semi-strong efficient market hypothesis should therefore be adopted. This means that technical analysis based on historical price movements is of little value to an investor. Picking "hot" stocks is a loser's game without insider information--and that is illegal. It is also concluded that market timing using techniques such as technical analysis doesn't work. The only way to maximize return for risk is to eliminate underperforming

inefficiencies in a portfolio and exploit the over-performing inefficiencies, or anomalies, which are few.

The College of Financial Planning in their investment curriculum identifies eight over-performing anomalies. The following five of the eight can be effectively used.

Dividend-yield anomaly	Buy stocks with high dividend rates
Low P/E	Low P/E stocks outperform high P/E stocks
Size effect	Small-cap stocks outperform large cap stocks
BV/MV effect	Stocks with high book to market prices outperform stocks with low book to market prices
Weekend effect	Buy stocks on Mondays

By using this information, particularly, the first four, the efficient frontier for stock allocations can be raised to produce higher returns without the equivalent addition of risk.

## 5. A Long-term, Buy-and-hold Strategy is Superior to Market Timing

The body of evidence on the failure of market timing efforts is so overwhelming that Fortune magazine said this: “Let’s say it clearly: No one knows where the market is going—experts or novices, soothsayers or astrologers. That’s the simple truth.” The short term moves of the market are unknowable. Fortunately they are irrelevant to the long-term success of a well diversified investment plan.

Market timing requires many decisions regarding how much and what to *sell* when, and then how much and what to *buy* when. To consistently be right when making these decisions has eluded the brightest analysts. Warren Buffet said, “The only value of stock forecasters is to make fortune tellers look good.”

Technical analysis with its charting techniques to predict future market movements was clearly denounced by Burton Malkiel in his best-selling book, *A Random Walk Down Wall Street*. He comments,

*Technical analysis is anathema to the academic world. We love to pick on it. Our bullying tactics are prompted by two considerations: the method is patently false; and it’s easy to pick on. And while it may seem a bit unfair to pick on such a sorry target, just remember it’s your money we are trying to save.*

From 1926 to 2005, \$1 invested in large company stocks would have grown to \$2658. Had the investor missed the best 39 months, his return would have been \$17.12. There is great opportunity cost risk by being on the sideline with cash when the market makes its powerful

rallies. The best strategy is to design a well-engineered portfolio, rebalance when needed, and stay the course. While volatility can be reduced, it cannot be eliminated. Volatility must therefore be viewed as the price an investor must pay for the excess return of stocks.

Stocks are especially volatile in the short run. So while stocks are appropriate for long term goals, they are inappropriate for short term goals. Typically, only money that is earmarked for goals five years out or longer should be invested in stocks.

## 6. Stocks Revert to their Mean

There is a debate among analysts and advisors regarding the value effect (Low P/E and P/B) anomaly. Some would not call the value effect an anomaly at all, but contend that the markets are 100% efficient and the reason value stocks outperform growth stocks is due to the higher risk of out-of-favor value stocks. Others see the value effect as a market inefficiency and that value stocks outperform because overpriced stocks will always be categorized in the growth stock asset class. Thus when their prices eventually correct downward, the return of the growth stock category suffers.

The latter view lends credibility to the observed tendency for assets to revert back to their averages (mean) over time. MIT finance professor Jonathan Lewellen has given much credibility to the theory of mean reversion. According to Lewellen's findings, up to 40% of the market's annual returns are temporary, and will usually reverse within the next 18 months. Curiously, he also found that stocks' 3 and 5-year trailing returns are negatively correlated to the subsequent 12 to 18 month period. In other words, tomorrow's stock prices will often move in the opposite direction of yesterday's.

This pattern is not a new discovery. Dr. Jeremy Siegel is the professor at The Wharton School of the University of Pennsylvania and author of classic investment works such as *Stocks for the Long Run* and *The Future for Investors*. Professor Siegel documents that stocks have consistently gravitated toward their long-term moving average since 1802.

Investing in a concentrated portfolio of individual stocks according to the mean reversion theory could be disastrous. Individual stocks can get in financial trouble and prices decline for years, or sink to zero. However the mean reversion theory can be applied effectively to *asset classes*. The basic stock asset classes have all had their strong and weak periods of performance. They cycle. The stock asset classes which are depressed now often have the greatest potential for growth in the future. The asset classes which have had strong performance above their mean for an extended period have the greatest potential for larger declines.

One of the best examples was the recent tech bubble of the late 1990s. Even the large company US technology stocks in the cap-weighted S&P 500 index were affected. Some P/E ratios were multiples of the stock market's long term average. In March 2000, the declines began and didn't end until March 2003, when the market again began to surge. Had investors underweighted or avoided these unsustainably high-priced technology stocks, and stayed with

more moderately priced asset classes such as small cap value stocks at the time, they would have weathered the bear market without significant losses.

This paper has discussed the *science* of portfolio management. Decision-making surrounding mean reversion is the *art* of portfolio management. The conclusion is that it may not be best at *all* times to weight the asset allocation along the efficient frontier with asset classes that have extremely high price-to-earnings multiples above their historic mean.

Investor behavior (fear and greed) can result in a bandwagon effect, which can set investors up for a sharp or extended reversal. Ex-Federal Reserve Chairman Alan Greenspan referred to the late 1990s technology stock run-up as “irrational exuberance”. Remembering mean reversion can help an investor underweight, or avoid altogether, assets which have had an extended period of excessive over-performance.

Mean reversion should be remembered in the initial design of a portfolio and in the ongoing maintenance and rebalancing process. This approach is conducive toward accomplishing the goal of every investor, which is to buy low and sell high. To forget this principle and “chase returns” as many do, results in buying high and selling low.

## 7. Dividends Increase Returns and Dampen Volatility

As stated above (item 4), the dividend yield anomaly allows investors to capture extra current income which can boost total return while reducing volatility. Professor Siegel has done extensive back-testing and concludes that dividend-weighted indexes produce excess returns, and the long-term excess returns of domestic dividend-weighted indexes over capitalization-weighted indexes were almost identical to the difference in dividend yields between the indexes. In other words, the extra dividend yield gives the investor extra dollar for dollar total return.

The six reasons for using dividends to weight a stock portfolio are given below:

- a. Dividends provide a compelling theoretical basis for stock values
- b. Dividends have historically provided the major part of the stock market’s real return
- c. Dividends are an objective measure of company value independent of accounting schemes
- d. Paying dividends indicates that management is focused on increasing shareholder value
- e. Dividends are far more attractive today for taxable investors because of the recent legislation that lowered tax rates on qualifying dividends, and
- f. Dividends dampen the volatility of an equity portfolio, as they are relatively stable and are not directly affected by market fluctuations

The third largest mutual fund company in America, *American Funds*, has developed a reputation for consistent returns and sound risk management by emphasizing dividends and dividend growth as an important part of their investment philosophy. As they say, “This

approach has proved successful through bubbles, fads, and crashes.” No wonder they call dividend investing *A 75-year-old “Fad”*.

## 8. Tax Reduction is Important

An investor cannot control the market, interest rates, or the economy. But an investor can, to some degree, control the taxes he pays. So it is a worthwhile endeavor to develop a strong tax reduction plan regarding investments.

An investor cannot ignore the cost of taxes on investment performance, particularly in taxable accounts or inherited IRAs.

The following strategies should be used to reduce unnecessary and onerous tax consequences.

1. Use tax-advantaged accounts
2. Use tax-efficient investments in taxable accounts
3. Match investments with accounts
4. Harvest in the most tax-efficient order
5. Harvest losses each year if possible
6. Gift securities versus cash
7. Avoid unnecessary taxes during transfers
8. Avoid unnecessary taxes during fund purchases
9. Take full advantage of tax-free investing
10. Eliminate taxes on Social Security benefits

## 9. High Quality, Short Duration Bonds Reduce Volatility

The primary reason for using bonds is to reduce the volatility of a common stock portfolio. So safety of principle is the main concern. Therefore there should be an emphasis on credit quality and maturity (or duration). Another reason for investing in bonds is to produce interest income. Price appreciation may also be a reason if interest rates are anticipated to decline.

All publicly traded bonds are assigned a quality rating based upon the financial stability of the issuing corporation, institution, agency or government. There seems to be no merit in a bond fund that is comprised primarily of fixed income instruments that are rated below “Investment Grade.” While the promised interest return is slightly higher, the risk is inconsistent with safety and the return is usually below the historical returns of common stocks. Bond funds therefore should be weighted toward investment grade quality.

Also longer maturity instruments are riskier than short. Yet returns are not consistently greater. Longer term bonds have much more volatility, since they are more sensitive to interest rate movements. So keeping maturities to around five years or less seems to

produce the highest return per level of risk. Short-term bonds also have a lower correlation with stocks than do long-term bonds.

## 10. Independent Advice is the Best

Most people do not have the time or desire to research the detailed financial data necessary to be a good investor. Therefore, a financial advisor who specializes in investments can be of great value.

Independent advice for a fee has advantages over sales-based or transaction-based advice. Fee-based advice obligates the advisor to be a fiduciary to the client. The advisor is not pressured by any financial bureaucracy to push certain products that may not be best for his client. An independent advisor is free to recommend what he believes are the best products available. He will not be paid more for recommending one product over another. Nor should he be compensated or penalized for making trades for clients. While an advisor may be trustworthy, it is always good policy to remove as many conflicts of interest as possible.

An advisory fee based on the assets' periodic market value provides incentive for the advisor to continually do his best to grow the clients' investments while managing risk, now and for the long run. This arrangement aligns the advisors' interests with the client's interests. A quarterly advisory fee such as 0.25% is typically deducted directly from the account and reported on that month's statement to the client. Fees deducted from tax-deferred IRAs are paid with pre-tax dollars, significantly lowering the effective cost to the client.

By paying-as-you-go, based on the market value of the assets, the more the client earns over time, the more the advisor earns--and the client is never locked into something he cannot get out of. In contrast, a commission model often pays the advisor up front for the sale and there is little incentive for ongoing service or investment performance management. The pay-as-you-go fee model motivates the advisor to provide ongoing, long-term value and service to his clients.

Independent fee-based advisors can also keep clients' costs low by using only no-load or load-waived funds, and by using discount brokerage firms to custody the assets. This can provide the client savings in excessive trading and administration fees often charged by large financial institutions.

Independent advisors also can operate more cost efficiently by having less overhead. Financial bureaucracies require a significant portion of their advisors' revenue with very little if any value to the client. This burdens the advisor and often forces the advisor to raise his fees or take on too many clients. This is another reason the trend in the financial industry is moving toward the independent advisory model. The lower the overhead for the advisor, the more cost savings and attention can be given to the client.

By using third-party brokerage firms to custody the assets, the client would not be abruptly affected if the advisor became unable to perform his duties. If the advisor was incapacitated

for a long period, the brokerage firm could recommend another advisor or the client could seek another advisor on his own.

In summary, a good advisor seeks to bring greater simplicity, freedom, and confidence to his clients' lives. He will most likely net his clients a significantly greater risk-adjusted rate of return on their investments than they would have earned otherwise. An advisor can achieve this by maximizing portfolio efficiency, capturing opportunities of observed market anomalies, and taking advantage of mean reversion rather than being hurt by it. Investors who pay a reasonable fee for good investment advice are more than compensated over the long run.

Historical data from Morningstar 2007 Principia Presentations and Education library

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