Be Careful When Playing the Performance Game

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Jeremy Glaser: For Morningstar, I'm Jeremy Glaser. I'm joined today by Tadas Viskanta. He is an author and blogger of Abnormal Returns. We're going to talk about sifting through the news flow and figuring out what's really important.

Tadas, thanks for joining me today.

Tadas Viskanta: Jeremy, it's a pleasure.

Glaser: In your recent book, you talked a little bit about how investors need to have more of a liberal arts focus. Can you talk a little bit about what you mean by that?

Viskanta: Sure. I think a large part of that has to do with time horizon. Most investors have time horizons much longer than what you see in the news media. Investors have horizons that you measure in years and decades, not in minutes and hours and days. So, I think in that regard, spending a lot of time on the day-to-day or even the minute-to-minute gyrations in the market really is not necessarily a great use of people's time, and I think focusing on the bigger picture as it were and taking a little bit longer time horizon makes a lot more sense. I think that's one area where individual investors have an advantage over institutional investors.

Institutional investors are to a large degree caught up in a performance game. They're worried about performance over the days and weeks and quarters. That's how they get measured by their clientele. Whereas individual investors, they are in fact their own clients. They really are their own portfolio managers and their own clients, and so in that regard, they really should have a longer-term time horizon.

Worrying about what's on CNBC today or what's necessarily in the headlines, doesn't necessarily make a whole lot of sense for them because almost every academic study that's ever been has done in terms of individual investor behavior, you see overtrading. You see individuals when they trade, they don't necessarily make the best decisions. Having the longer time horizon, trading less makes sense for them.

Glaser: But certainly, what's happening in the news, you see that affecting your portfolio. You kind of get those statements. You see how much things could be changing potentially over a short period of time. How do you kind of really focus on what's important then and really filter out some of that noise?

Viskanta: Well, I think a big part of it is really having a strategy. I think most individual investors really need to focus on having if not a clear and concise sort of investment plan, and for a lot of people that's even having written investment plan. Institutional investors oftentimes have specific objectives and processes that they're going to use as to how they're going to manage their portfolio, and I think that makes sense for individuals, as well.

If you have that sort of plan and you see that you're taking behaviors or looking at things that don't necessarily have to do with that plan, that tells you that you're

kind of getting off course, that you kind of need to really think about what it is that's important for your portfolio, your strategy and your goals down the road.

Glaser: Now an area that we have gotten a lot of news on recently is Europe. It seems like you could read about Europe all day long and still not exhaust the articles out there. How would you think an investor should approach a big macroeconomic concern like that that could have a bit long-term impact when they're analyzing that news?

Viskanta: I think there are two things that people really need to keep in mind. Most of what's written is about what should happen. These are analysts, these are politicians talking about how it is that Europe should play out. What it is and what goals they should have. Really that's all well and good, and that's a part of a big broader public-policy sort of discussion, but it really doesn't have a whole lot to do with how you should manage your portfolio. You really need to focus on the reality of what's going on. In most cases, it really shouldn't have a ton of an impact on what it is that you're doing.

If you have decided at some point that you need to have an allocation to international equities or to international fixed income, it's likely the case that Europe is a part of that. So, in that regard, you do need to think about whether Europe rightfully should be a part of your portfolio. But if you think that you're going to be able to adjust your allocations day-to-day or week-to-week [based on] what's happening in Germany, Greece, or Spain, I think that's to a large degree a folly.

Glaser: But at what point do you decide [that such holdings] should not be part of your asset allocation and you really do need to make a fundamental change to my plan? How do you decide that it's time to make that change?

Viskanta: Well, I think it has to be a part of your process. Again, where individuals oftentimes fall down and where they make mistakes is they make decisions in the heat of the moment. The market is up a bunch today; it's down a bunch tomorrow. And making decisions based upon what the market is doing on a day-to-day basis is likely going to lead you into mistakes. It's kind of what people talk about as the behavior gap. People chase returns to the upside, and when things fall they tend to sell, as well.

I think it's perfectly normal to adjust your portfolio strategy over time, but I think doing it in a systematic fashion and not doing it in the heat of the moment makes far more sense. Believing that you're going to somehow make the right decision this week and make the right decision in the next couple of weeks is probably a mistake for most investors.

Glaser: Another area that we hear a lot of people saying what should happen, but we don't know what's going to happen is with tax policy in the United States. I know you've written that taxes are an incredibly important part of your investment return. How should people think about investing in taxes when investing, when they just don't know as there is just so much uncertainty surrounding rates?

Viskanta: I think that you made a couple of great points. Taxes are an important

part of individual investors' portfolios and their strategies, and I think it's something that's probably underplayed in the media if anything. We talk about it from a policy perspective, but from an individual's perspective, both on the fixed-income side and on the equity side, it can play a very large role in your eventual returns. Given the fact that we've had a decade plus of pretty poor market returns in regard to the domestic equity market, being able to add incremental returns on an aftertax basis is important. But again, I think tax policy is like what we just talked about in Europe.

We were talking about public-policy questions. We're talking about what should be, what might be. I think individual investors really have to, again, have that a part of their strategy. We know that there is an election coming up. We know that there are potentially big changes in tax law coming. Knowing that those things are on the horizon I think is important. But making decisions today about things that might happen in the next three or six or nine months I think is resorting to essentially forecasting. You are trying to decide what's going to happen in the election. You're going to decide what's going to happen in Congress.

We really don't have a very clear picture on what's going to happen. So, until there is a greater amount of certainty, making big changes that are essentially irreversible in your portfolio is, again, kind of resorting to forecasting, and as we know, forecasting is difficult at best.

Glaser: Then what's your suggestion? That people should have diversified tax assets? They should just kind of sit tight and wait? What can you do then?

Viskanta: Again, it's a part of your portfolio strategy. So whether you review your portfolio every quarter, half year, or annually, I think that should be a part of the process. So, if you know that there are changes coming to how dividends are going to be taxed, or maybe how municipal-bond interest is going to be taxed, I think that's something that you need to take into account. Especially, again, that's something that should be a regular part of your process because obviously tax laws do change, but we usually do have a little bit of time before we know what's going to happen.

Again, regarded your individual situation, you know what your income is this year. You're have some idea of what your capital-gains situation is going to be. So, that's really all the part of that process. There are a lot of parts of that equation. Saying just one part of it, which is tax law, just focusing on one part, I think is a mistake. It's really one piece of that broader puzzle.

Glaser: Tadas, I appreciate you taking the time today.

Viskanta: Thanks. It's a pleasure.

Glaser: For Morningstar, I am Jeremy Glaser.