SUCCEEDING UNCONVENTIONALLY

Conventional investment strategies like stocks and bonds afford typical investors at least a temporary degree of comfort. These instruments give them the assurance of having some fundamental understanding of what they’re invested in. Additionally, thanks to the daily bombardment of the financial media, they can reasonably assess what their portfolio is doing—at least directionally.

We get it. But we also know that common knowledge suggests not putting all your eggs in one basket. That’s diversification, “the only free lunch in finance.”

So why would you put all your eggs in two baskets?

Our culture celebrates contrarians. And it’s well documented that, when they invest prudently, contrarian investors are rewarded by markets. Unfortunately, the amygdala—that part of our brains that plays a key role in processing emotions—often takes over when it comes to making financial decisions: We seek the safety of the herd. Professionals may be better at turning off their emotions or even ignoring them, but they’re by no means completely immune from them.

These behaviors are further reinforced by our confirmation bias—our natural tendency to seek information that confirms our existing beliefs. This is equivalent to patients churning doctors or searching WebMD.com until they find the diagnosis they’re looking for. All professionals, especially financial investors, need to maintain the discipline to challenge their own beliefs. So the saying goes, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

THINKING DIFFERENT: IT'S WHAT YOU'RE ACTUALLY THINKING THAT COUNTS

Apple's landmark 1997 *Think Different* ad campaign, which arguably saved the company, starts off, "Here's to the crazy ones. The misfits. The rebels. The troublemakers. The round pegs in the square holes. The ones who see things differently…"

The point we want to make here is that we're not embracing unconventional thinking for the sake of merely being rebels or misfits. But you have to start somewhere—and that's by questioning received wisdoms. *Think Different* worked because it wasn't just a branding posture. Apple walked the talk by turning out products that were revolutionary for their time.

In recent years, we've frequently discussed our "different" perspective on the current state of the investment landscape; our 2Q 2017 commentary, The Death of 60/40, was devoted to this topic. The concept is simple: With global interest rates dropping since the mid 1980s, there's been a strong tailwind driving returns in the financial markets. With rates tapering off and potentially rising, and with stock prices in the U.S. at historically-full valuations, we don't believe the returns of a traditional 60/40 portfolio of stocks and bonds will achieve nearly the returns in the future that they once provided in the past.

That's why we actively seek to add non-traditional investments to our portfolios that tap into the profits and losses of business enterprises. Think: *Many baskets*.

THE TRACKING ERROR CONUNDRUM

Just because an investment hasn't beaten the S&P 500, or perhaps even had a negative return in the recent past, doesn't necessarily mean it's a bad investment. It could simply be bad timing. Apple's own stock lost nearly 75% of its value in the five years leading up to the *Think Different* campaign. Then came the iMac, the iPod, the iPhone, the iPad, and the Apple TV.

Investors are familiar with the notion of balancing risk and return. Those looking for the highest expected returns, such as in emerging markets equities, should be prepared for values to drop 53% in a market like 2008. High risk, high return—and often, but not necessarily, vice versa. That's well understood.

What's less understood, however, is tracking error.

You can more or less own the S&P 500 easily in a mutual fund or exchange-traded fund (ETF). However, if you want to try to beat the S&P 500, you must accept the risk of underperforming the S&P 500. Do you even want to try to beat it? That's an investment decision.

> So the saying goes, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Another investment decision is: *How much are you willing to deviate?* Most investors will agree, for example, that owning international stocks is a good idea. This asset class has a risk and return profile similar to U.S. stocks and provides a diversification benefit. The developed international stock index EAFE beat the S&P 500 seven out of ten years from 2000-2010. The moment you add non-S&P 500 stocks to a portfolio, however, is the moment that your portfolio begins to deviate from the returns of the S&P 500. If half of your stocks are international, then your portfolio will no longer track well with the S&P 500.

An excerpt from the book *Reducing the Risk of Black Swans* by Larry Swedroe sums the tracking error conundrum up well:

> Tracking error is the amount by which a portfolio's performance varies from that of the total market or other broad market benchmark, such as the S&P 500 Index. By diversifying across risk factors, investors take on increased tracking error regret risk because their portfolios look less like the market. While very few investors care when tracking error is positive (their portfolio beats the benchmark), many care very much when it's negative.
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> Misery loves company. In other words, if your portfolio performs poorly because "the market" has performed poorly, at least you have company. On the other hand, if your portfolio is underperforming the market, you might begin to question your strategy, wondering why you are doing relatively poorly.

BALANCING THE RISK OF LOOKING LIKE AN IDIOT—WITH THE REWARD OF SUCCEEDING UNCONVENTIONALLY

Ben Inker, the head of asset allocation at $60-billion firm GMO has said, "The market tends to be priced in a way that if you want to try to outperform, you have to take a risk of looking like an idiot… Markets exhibit herd-like behavior, which in turn encourages momentum and other self-reinforcing behaviors, such as money flowing into whatever strategy has been doing well."

Just because an investment hasn't beaten the S&P 500, or perhaps even had a negative return in the recent past, doesn't necessarily mean it's a bad investment. It could simply be bad timing.

Investors are performance focused when markets are good, but they are risk focused when markets are bad. Advisors calibrate portfolios not only to meet their clients' objectives, but also to their risk tolerance—some advisors more than others. If a client leaves an advisor because their returns are not high enough, that's a bad outcome for the advisor – but if a client goes to cash at the bottom of the market only to miss out on the recovery, that's catastrophic for the client.

The trouble is, the more effort professional investors make in calibrating to their clients' latest comfort thresholds, the greater the risk to their process. At best, they may dilute their investment discipline to the point of simply joining the herd. At worst, they may run afoul of their fiduciary duty to act in their clients' best interests. Succinctly put, advisors cannot let their clients browbeat them into making amateur decisions.

As John Maynard Keynes said, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." Here at Halbert Hargrove, we're very conscious of bucking the "safety" of conventional "worldly" wisdom.

We firmly believe that clients look to us to help them succeed, which may, from time to time, require unconventional tactics. Therefore, doing what is right for our clients - in certain market environments - might create discomfort given they're not tracking the herd.

For us, that's a key part of what the "Fearless Pursuit of Well-Lived Todays & Tomorrows" is all about.