

FIRST QUARTER 2017 - DISCIPLINED EQUITY

Lacking Clarity, Go with What You Know

An ocean of ink will be spilled trying to divine the Trump policy agenda for trade, international relations more broadly, taxes, regulations, what the election will mean for this or that sector, and so on. These are important questions, to be sure, and we will be monitoring events carefully. But we don't think these issues will be the primary determinants of your financial success. Rather, given the tremendous uncertainty in markets, we suggest a focus on time-tested practices where we have a high degree of conviction—diversification, rebalancing, and above all, patience.

Decision-Making Under Uncertainty

In a famous paper titled “The Dog and the Frisbee” delivered to the Federal Reserve in 2012, two economists laid out a series of “commandments” for decision-making under conditions of uncertainty. Their paper is readily accessible and makes great reading for anyone interested in how policymakers arrive at their decisions.

We mention the paper here to highlight just one from among many interesting findings—under situations of uncertainty and complexity, simple rules honed from years of lived experience can in fact be far more effective than sophisticated models. This is entirely consistent with what we know about successful investment practices. When uncertainty is high, stick with what works. Specifically, a well-diversified portfolio with systematic rebalancing has historically produced better risk-adjusted returns than any one asset class alone, and increases the odds that an investor will stick with their investment plan and not bail out when times are tough. Faced with uncertainty, go with what you know.

Diversification—a “Known Known”

Diversification is a marriage of modern portfolio theory¹ and behavioral finance—using carefully thought out strategies to manage risk, reduce the likelihood of the permanent loss of capital, and improve financial outcomes. The best way to deal with uncertainty, with risk, is to spread your assets across different markets, sectors, and geographies to minimize the effects of market volatility on your portfolio. To be clear, diversification is a strategy to help *manage* investment risk, not *eliminate* risk.

Finally, diversification is attractive at such times precisely because it does not require an accurate forecast to succeed.

(Re)balancing Act

We've been doing a lot of work lately on the debate around active management versus passive, index-replicating approaches. One of the interesting findings is that a simple equal-weight portfolio has historically outperformed traditional capitalization-weighted passive portfolios. Why? Because of regular rebalancing. Rebalancing refers to the process of selling winning assets and buying underperformers in order to return to your predetermined asset targets. Rebalancing is doubly powerful because not only does it enforce this value discipline across your portfolio, it also addresses one of the most common and costly mistakes investors make—badly timed buy and sell decisions.

Stick to the Plan

Finally, we would encourage investors to focus on the certainties—your specific financial goals, your saving and investing plan, your risk tolerance, and your time horizon. Research and experience tell us that the key to financial success is to develop an appropriate saving and investing plan that is consistent with your anticipated future financial needs and that you can sustain and adhere to over time.

Diversification, rebalancing, patience—this is not “sexy” advice or some sort of hot stock tip, but sticking to simple, time-honored strategies is likely to be the best approach in the face of considerable uncertainty heading into 2017.



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¹ An investment approach used to identify the expected amount of risk and return in a portfolio.

Diversification does not assure a profit nor does it protect against loss of principal.

Rebalancing allows you to keep your asset allocation in line with your goals. It does not guarantee investment returns and does not eliminate risk.

The opinions expressed are those of Scott Wittman, CFA, CAIA, and are no guarantee of the future performance of any American Century Investments portfolio.

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