Your Investment Strategy

There is no “one size fits all” when it comes to investment strategies. The idea is to develop something that works for you—a goal-oriented strategy with which you are comfortable and that fits your needs. To get to that, you have to ask yourself a few key questions.

1. Do I Really Want To Do This?

To be, or not to be? That is the question. Indeed, the very first question. Irrespective of all else, if you honestly do not have the desire to manage your own money, don’t even think about it. Get someone to do it for you. Just realize that you aren’t entirely off the hook— you still have to pick your advisor, and that isn’t always as easy as it may sound. If investment management isn’t your cup of tea, skip the rest. Otherwise, proceed to question 2.

2. Can I Do This?

Desire is essential to getting started, but in all endeavors, reality intrudes quickly. The ability to pull something off depends on the person and on the endeavor. On the personal side, investment experience and education are important to success, but less so than the willingness to learn. The most important personal limitation is time. The more time one can make available to any pursuit the greater the likelihood of success. It is important to distinguish between the time you are “willing” to spend and the time you “have available” to spend. To do that you need to realistically assess your current investment behavior. If other interests and obligations always seem to push investing onto a back-burner, any different outcome is going to require a lifestyle change-- and as a perennial dieter, I can assure you, those are never trivial.

Be realistic about the time you can devote to your strategy. It’s easy to be enthusiastic at the outset, but paying regular attention once the long slog begins, is another matter. The good news is that some strategies require more modest time commitments than others. Passive diversification, for example, may require more set-up time, but once in place, “buy-and-hold” by its very nature only requires infrequent adjustments. Active strategies, on the other hand, can require constant attention, but some folks prefer that. It is important that your investment strategy fit your personal style and the time you can put in.

Apart from personal considerations, the size, scope, complexity, and objectives of the investment portfolio will also determine whether you can do it. In general, the larger the portfolio is as a percentage of overall net worth, and total liquid (investable) assets, the more critical it is to your financial wellbeing. Large portfolios also have more moving parts. Be cognizant of possibly biting off more than you can chew. Size matters. If you aren’t comfortable managing a large portfolio, carve out a piece that works for you.

Portfolio objectives also matter. For example, trading decisions in taxable accounts have an added layer of complexity (after tax gain/loss) compared to those in tax-deferred retirement accounts. Laddered income portfolios are also more complex than other “buy and hold” strategies. Hedging a portfolio with options can provide still another layer of complexity. If you aren’t comfortable with certain complexities, or don’t have time to manage them, you can always split the account and leave the complexities to the experts.

I’d like to think that my readers are smart and dedicated enough to put in the time and work necessary to successfully manage some or all of their own money. But that could be hubris on my part. It might be true in most cases, but probably isn’t in every case. It is important not to overestimate your abilities, or underestimate the difficulties you face in the investment world. Human nature doesn’t always work that way, but if you think you can manage it, you can probably manage money.

2. Where Do I Start in Picking a Strategy?

In the broadest sense, there are three types of investment strategy: active, passive, and combinations of the two (active/passive). On this site, the three basic investment strategies are called— momentum, passive diversification, and dynamic diversification.

Momentum refers to the Index Moose model. Passive diversification refers to portfolios comprised of several non-correlated equity and income index ETFs. The percentage attributed to each ETF in the portfolio is fixed and is determined by the investor’s willingness and ability to accept risk. Dynamic Diversification applies active management principles to a diversified portfolio in real time to reduce exposure to the weakest assets while maintaining exposure to the strongest. It is an amalgam of active and passive strategies.

Step 1 in selecting a strategy that is right for your situation depends on the personal and portfolio issues discussed above— interest, experience, education, type of account, relative size/importance of account time for maintenance, investment time horizon, etc.

CRITERIA	Momentum	Passive Diversification	Dynamic Diversification
Experience Required	Moderate/High	Low/Moderate	High
Maintenance Required	Moderate	Low	High
Time Horizon	Short/Medium	Long/Medium	Long/Medium
Taxable Account	Moderate trading costs	Low trading costs	Very high trading costs
Tax-Deferred Account	Low trading costs	Minimal trading costs	Moderate trading costs
Account % of Total Assets	Low/Moderate	Moderate	High/Moderate

In general, passive strategies require less time, effort, cost, and expertise than active strategies. They are best employed when the time horizon is greater than 5 years, however.

3. What's The Next Step?

In addition to personal and portfolio issues, the willingness and ability to accept risk plays a key role in selecting a strategy. The best investment strategies balance expected return with the amount of risk the investor can realistically accept. Ability to accept risk is a function of the investor's financial condition (net worth, liquid assets, etc.) and personal condition (age, health, investment experience, amount of time to devote to investing, etc.) These factors also play into the decision to seek professional help or not.

Ability to accept risk is a relatively objective, fact-based judgment, then. Willingness to accept risk is a different animal-- more a function of investors' personal sensitivity toward volatility. Volatility raises portfolio risk and asset risk. Portfolio risk can be lowered through diversification, while lowering the allocation toward risky assets in the portfolio can dampen asset risk. The trade-off to less risk, however, is less return.

"Willingness to accept risk" is basically trying to figure out how much portfolio damage is too much. It is an attempt to balance one's fear with one's greed. As such it is entirely subjective. What's more it can change with the individual's personal circumstances, and with external conditions as well. Assessing ability and willingness to accept risk yields an investor's risk profile— conservative, moderate, or aggressive. It is usually determined through an interview or questionnaire. (Click here for an example.)

CRITERIA	Momentum	Passive Diversification	Dynamic Diversification
Risk Profile	Aggressive/ Moderate	Moderate	Conservative/ Moderate
Asset Volatility	Moderate	Moderate	Moderate
Portfolio Volatility	High	Moderate	Low/ Moderate

In short, purely active strategies are more appropriate for investors at the aggressive end of the risk spectrum. Active/passive hybrids are more attractive to those at the conservative end of the spectrum.

4. Anything Else?

In theory, personal strategy development usually ends at this point. In reality, there is a final step. Right or wrong, everything else aside, the first thing investors look for in a strategy is performance. Some strategies outperform in bear markets and others in bull markets. In addition, relative strategic performance can vary as different exogenous forces come to bear on the financial markets. These forces can affect success. For example, the last eight years of Fed financial engineering have made passive investment strategies and dynamic diversification viable alternatives to a momentum strategy from a performance standpoint.

Investors can get impatient, wondering "What has my strategy done for me lately." The answer is not solely about current performance, it is also about what can happen at the extremes. How a strategy behaves in secular (long term) bull and bear markets is as pertinent as what it is doing at the moment.

CRITERIA	Momentum	Passive Diversification	Dynamic Diversification
Bear Market: Loss Risk	Low	Moderate/High	Low/Moderate
Bull Market: Gains	Low/High	Moderate/High	Low/Moderate
Recent Performance	Poor	Moderate	Moderate

Deciding whether recent performance will continue, or whether a bear market is imminent, for example, can have a bearing on one's strategic choices. To help make those decisions, this site will track several highly simplified portfolio strategies and report their relative performance.