

IN THE

KNOW

To Thine Own Self Be True (With Apologies to William)

By W. Michael McBride, JD

In Shakespeare's Hamlet, the character Polonius offers a final piece of advice to his son Laertes:

"This above all: to thine own self be true."

While literary interpretations vary, part of the context did involve money, albeit in a different context than used here. All of the investment advice in the world may be meaningless if an individual fails to answer two core questions:

1. What is your investment time horizon?
2. What type of investor are you?

Both of these questions seem elementary. Yet many investors either do not give it thoughtful consideration or fail to revisit their assumptions from time to time. An honest self assessment that incorporates the answers to these two questions is critical, especially in periods of market volatility and economic disruption. Nevertheless, during the market disorder of the last two years, many investors abandoned their long-term investment strategies in many cases because they were not true to themselves. After all, it is easy to be an "aggressive investor" in a bull market. It is a bit more challenging to retain that strategy during difficult market conditions.

Time Horizon

The longer an investor's investment time horizon, the greater the ability to turn off the day-to-day noise in the market and use pull backs to acquire assets at prices that may be attractive in the long-term. Other things being equal, an investor with a long-term time horizon has the flexibility to be more aggressive in their investment strategy as they have time to let market cycles play out over several years.

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Type of Investor

The categories can vary, and can be subdivided, but essentially can be distilled down to aggressive, moderate or conservative classifications. Risk profile questionnaires and advisors can assist in this element, yet they are only effective tools if you are honest with yourself. Failure to conduct a candid assessment of who you really are in your role as an investor can result in abandoned or shifting strategies in response to market conditions. Investors without a firm grasp on their style and tolerances are vulnerable to be whipsawed in and out of the market at the most inopportune times. Typically this is how the average investor finds themselves buying high and selling low. An honest understanding of who you are as an investor in conjunction with keeping your time horizon in mind can help you stay the course of your master strategy.

A Case Study

Using a real life example, we can illustrate the importance of honest assessments in a portfolio.

We advise Client X on his investment portfolio. This particular portfolio is a qualified retirement account, and, based on Mr. X's age, has a time horizon of 20 years. During our initial strategy assessment Mr. X defined himself as an aggressive investor and concurred with our desire to address specific long term concerns. During the summer of 2008 stress fractures were beginning to show in the financial and economic system. By the end of September of that year, the liquidity crises and the attending panic was in high gear and markets of all types sold off as investors ran to the sidelines or needed to raise cash for short-term needs. During the first week of December, Mr. X was unable to withstand the downward volatility and the negative atmosphere. He asked us liquidate all positions and hold a 100% cash position. If you recall, at that time the conventional wisdom, as represented by the media, was that the sky in fact was falling and we were on the verge the of 21st Century version of the Dark Ages. In my discussion with other advisors during that fall of 2008, they confirmed they too were having client conversations that amounted to repeatedly "talking people off the ledge" as the crises ensued.

By the first week of March of 2009, the decision to liquidate and convert to cash seemed to be a smart move as the broad markets fell another 20 percent from the first of December of 2008. Recall this particular portfolio had a time horizon of 20 years, so it is fair to assume that holding a cash position that length of time was never a realistic option. Mr. X, along with many others, held the position that they would reinvest their funds "when things settle down." When would that be? How would you know? What signs would you look for? What if market volatility becomes the new normal? And if you do wait for comforting signs of an "all clear" signal, doesn't that by definition mean others have already realized early gains by being in the market ahead of you? By December of 2010 the "all clear" message had reached Mr. X. There was, of course, unsuccessful prodding along the way by his advisor, but no amount of prodding would change the inertia until Mr. X redefined for himself what type of investor he was.

Opportunity cost can be defined as the difference in the return of a chosen path and the return of the one passed up. In Mr. X's case, it would be the difference of the return he received on cash during that two year period, essentially zero, and the return he would have

received on his portfolio had he left it alone and not sold. Keep in mind Mr. X's portfolio construction was aggressive in nature and thus more volatile than the average equity portfolio. That said, the aggregate return on Mr. X's now hypothetical portfolio during that specific two year hiatus from the market, had he left it alone and followed his original personal strategy, was 97 percent, which would have placed the portfolio value above its original investment amount. Opportunity cost indeed.

Did Mr. X make a wrong decision, thereby costing him an aggregate 97 percent return? In a word, NO. It was the right decision for Mr. X given his personal circumstances. In addition, Mr. X was not alone as millions of others in the investment markets followed similar paths. However, if he had been true to himself initially, and acknowledged he was not really an aggressive investor, perhaps a more suitable, less volatile portfolio may have been in place that may have altered his decision to move to 100 percent cash during major market disruptions.

Lessons Learned

Define your time horizon. Be brutally honest with yourself about what type of investor you really are. Consult with your advisor on the best strategy to pursue. Once decisions are made, check your premise on occasion as facts and circumstances change. Make sure your master goals and objectives serve as buffers to your emotions. But above all, follow the advice of Polonius.

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