Discipline: A key to success in business and investing.

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Over the course of my career I have been privileged to work with many successful clients. These clients come from diverse backgrounds with many of them being successful business owners. I always like to ask them about their success and find out what they feel has enabled them and their business to be so successful. What I have observed is that these successful people tend to be disciplined and goal oriented with the end in mind. It is the small things that separate them from their competition.

In business and investing, the difference between great results and mediocre results is a matter of inches. For example if you look at the top money earners on the PGA tour for 2007 you see that Tiger Woods tops the list with a relative unknown by the name of Michael Boyd further down the list. The average score for Tiger Woods was 67.79 per round compared to 72.03 for Michael Boyd. That is about 6% difference in score. However the difference is their winnings was much wider. Tiger Woods earned $10,867,052 compared to $126,839 for Michael Boyd, over an 8,400% difference. As you can see a small advantage can have a significant impact on your results.

The mindset of successful people can also be applied to investing. Many investors achieve below average investment returns and consequently fail to reach their financial goals, because they lose sight of their objectives and fail to exercise discipline. This is especially true during volatile markets like we have experienced recently.

To better understand what I am to talking about, let's look at a study conducted by Fidelity Investments. Fidelity conducted a study on the performance of its flagship Magellan mutual fund during the tenure of its famous manger Peter Lynch. Peter Lynch ran the Fidelity Magellan fund from 1977-1990 delivering an astonishing 29% average annual return during his tenure. Despite his remarkable performance while running the fund, Fidelity found that the average investor[1] actually lost money during his 13 year tenure. How is this possible? According to Fidelity, investors would run for the doors during periods of poor performance and come rushing in after periods of success. Such behavior, commonly known as performance chasing, is something that affects the great majority of investors (individual and professional alike) and is one of the reasons that most investors never experience the investment returns they expect.

We can see that investor performance like that mentioned above is not limited to the investors in the Magellan fund. According to a research study conducted by DALBAR from 1985-2005 the S&P 500 index (a measure the 500 largest US publicly traded companies) returned 13.2% annually while the average stock mutual fund investor[2] earned only 3.7% per year over the same period of time. Here again we see that investors are often their own worst enemy.

How does this 9.5% annual difference translate into dollars and cents? Let's use a hypothetical example in which an investor had a $100,000 portfolio in 1985 and earned the average investor return studied by DALBAR[3] over the 20 year time period. The investor's portfolio would have grown to about $206,811. On the other hand the same investment made into the stocks that make up the S&P 500 index would have grown to about $1,193,791. An astonishing $986,000 difference.

Unfortunately it is not only individual investors that are susceptible to this sort of undisciplined behavior. Professional money managers and advisors also exhibit many of the same behaviors. We can observe this behavior from the fact that the average stock[4] mutual fund manager, as defined by DALBAR underperformed the S&P 500 index from 1984-2002. During this period the professional money mangers averaged a total return of 9.3% per year compared to a total return of 12.2% for the S&P 500. Underperforming by nearly a 3% per year over the 18 year period studied.

If a lack of discipline is a major contributor to poor investor performance, what steps should investors take to help instill self discipline? More importantly how should investors use this information to their advantage?

In designing an investment strategy, it is critical to develop an approach that is not dependent on short term market behavior. Additionally we want to design an approach based on scientific research and facts that remove as much emotion as possible from the equation.

The first approach to consider adding to your portfolio strategy is indexing. What exactly is indexing? Index investing is an investment approach that seeks to mirror the performance of a specific benchmark or index. Common examples are the Dow Jones Industrial Average, S&P 500, or Russell 2000. These indexes are very easy to replicate and because there is little human decision making involved in selecting specific holdings the costs can very low. For example a fund trying to replicate the S&P 500 simply buys the 500 largest publicly traded companies in the same proportions as the index itself.

This strategy has three major advantages when compared to traditional active money management practiced by the majority of mutual fund and pension mangers. The first advantage is cost. According to Lipper the average Large Cap actively managed mutual fund costs about 1.4% a year to operate as compared to .37% compared to the average large cap index mutual fund. This cost advantage is before comparing tax efficiency and turnover. The second advantage is performance. Over the twenty year period 1986-2005 only 18% of large cap stock fund managers beat the S&P 500 index.[5] Finally indexes if broadly diversified are not prone to the human desire to shift the portfolio into the best performing sectors of the day and chase performance. Keep in mind that market risk is prevalent in employing this strategy, since fluctuation of the underlying securities in this market is constant.

Another approach that can help instill investment discipline is an approach known as structured investing. These strategies are based on mathematical formulas that are less susceptible to emotional errors such as those explored above. This approach can be explored through a variety of investment vehicles including unit investment trusts, exchange traded funds (ETF's), separately managed accounts, and mutual funds.

Structured investment strategies seek out investments that meet strict criteria to determine when to buy and sell. Examples of these criteria include price to earnings ratios, price to sales, or accelerating earnings growth. Again with this approach costs are often relatively low, but come in a wide variety of choices.

When designing your investment and portfolio strategy it is important to keep several things in mind that may improve your long term results.

1. Minimize expenses. Over time high expenses can significantly reduce your investment performance.
2. Avoid fads. Don't get sucked into the latest hot investment of the day.
3. Diversify, Diversify, Diversify. You've heard many times before, yet many investors often forget this cardinal rule.
4. Don't time the market. Missing a few days of market performance can greatly hurt your performance. Just ask the shareholders in the Fidelity Magellan fund.
5. Risk and return are related. Remember to balance your desire for returns with the amount risk you are willing to accept. There is no free lunch. More potential upside requires more risk.

Implementing a few of the simple strategies outlined above may help instill investment discipline and can potentially have a profound impact on your investment results.

For more information on this topic contact Tuve Investments at 1-800-373-8883 or visit us at www.tuveinvestments.com.

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1-Fidelity calculated the average shareholder return based on weighted average buy/sell data
2-DALBAR data based on weighted average fund flows for all equity funds monitored by Lipper
3- DALBAR data based on weighted average fund flows for all equity funds monitored by Lipper
4-Average stock mutual fund calculations based on Lipper equity fund data using weighted average fund flows
5-Source A Random Walk Down Wall Street by Burton Malkiel

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Investing in mutual funds involves risk, including possible loss of principle. Investments in specialized industry sectors carry additional risks, which are outlined in the prospectus.

Mutual funds are offered with a prospectus. Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. You can obtain a prospectus from your financial representative. Read the prospectus carefully before investing.

Time periods illustrated assumes all income is reinvested.