Follow a Disciplined Investment Strategy

By Robert C. Doll

What distinguishes an institutional investment strategy from the approach employed by many individual investors? While there are many differences, one of the biggest is that institutional investors typically do not let their emotions influence their investment decisions. By contrast, individual investors often react emotionally, buying overvalued stocks in bull markets and selling shares when they have plummeted in bear markets. Individual investors would benefit from employing some of the highly disciplined investment habits of institutional money managers.

In both bull and bear markets, money managers who oversee billion-dollar funds for foundations, pension funds, college endowments and corporate profit-sharing plans follow strict guidelines - called asset allocation policies - that divide portfolios into set percentages of stocks, bonds and cash based on the institution's goals and time horizon. By adhering to these guidelines, institutional investors buy stocks when their portfolios' equity weightings slip below a target range, typically when stock prices are depressed. And they have to trim their stock positions when the percentage of equities swells - generally when valuations are extreme.

Institutional investors review and rebalance their holdings to ensure they remain consistent with their asset allocation policies. To follow through on developing a similar approach to investing, individuals must first identify their investment goals and time horizons. Are they investing to preserve their wealth for a long period or are they preparing for a major life event, such as buying a second home or starting a business? Investors in their 20s or 30s, for instance, should consider holding a large stake in stocks while remaining diversified. But investors closer to retirement age have to decide how much stock they can afford to own and how much income they will need to maintain their lifestyle.

Staying on Track

Having well-defined investment parameters can make it much easier for individual investors to remain disciplined with their investments. To help ensure that their portfolios remain on track, investors should ask themselves the following questions at least once a year:

1. What is my investment time horizon?

Invest with specific goals in mind, such as retirement, college education or establishing a charitable endowment. Longer-term portfolios without a pressing need for steady income can typically accommodate a higher percentage of equities and equity-like assets that promise higher returns but also carry higher risk. Portfolios with shorter time horizons and regular income requirements should preserve capital with more-stable, income-producing investments.

2. What kind of investment return do I expect?

Portfolio performance from year to year will depend on the economic climate and investors' individual asset allocations. Institutions, as a matter of policy, determine realistic minimum portfolio returns. Institutions also have clear contingency plans if performance falls short. Individuals would be wise to work with a financial advisor to help them take a similar approach.

3. What is my tolerance for risk?

Different investment categories have different risks associated with them. For example, equities have a higher potential of return but also have a higher risk of losing principal. On the other hand, cash has a very low risk of losing principal but does not generate much in the way of returns. Diversifying among different types of stocks, bonds and cash allows investors to control investment risk over time.

4. Which investments match my goals?

Investment professionals look for long-term portfolio returns above inflation, employing a blend of stocks, bonds and cash, as well as alternative investments, if appropriate, such as real estate and equity investments in privately held companies that are not traded on a public exchange. Once an investment goal is established, institutions then determine an asset mix that is designed to deliver a specified return for an acceptable amount of risk.

5. Why rebalance?

Regular assessment helps keep a portfolio in sync with both its asset allocation and its risk/reward profile. Rebalancing annually or even quarterly is not market timing. Regular rebalancing helps investors ignore the powerful emotions of fear and greed. Although investors will rarely sell at market highs with this strategy, they are less likely to sell at market lows.

Staying Focused

Investors should take time to talk with their financial advisor about rebalancing, re-establishing their investment objectives, and developing and monitoring a plan that is rooted in these goals and honestly reflects their risk tolerance. A disciplined approach protects against impulsive buying and panic selling. For most people, holding emotions in check is easier said than done. Financial advisors and professional guides can help remind clients of their goals, time frames and asset allocations while also helping them make portfolio changes under calm conditions. And a solid strategy can give individual investors many of the advantages that institutional investors enjoy and help them make progress toward their investment goals.

This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investing involves risk.

© 2005, Merrill Lynch, Pierce, Fenner & Smith Incorporated. Member, Securities Investor Protection Corporation (SIPC).