Evidence-based investing

12 principles for growing your wealth over the long term

Contents

Introduction

There are many paths to investing your money, and the successful ones require patience, an understanding for how financial markets work, and a respect for human behavior.

This paper breaks down what we believe are **12 fundamental principles of growing your wealth over the long term**—the ones we apply every day in managing your money here at Modera Wealth Management LLC.

We have broken these principles into bite-sized, easy-to-read, understandable segments, distilled from decades of historical research and performance results. We have also highlighted other key takeaways along the way.

We hope you find this paper both instructive and insightful. Read on...

The market and security prices

You have probably heard the phrase "buy low and sell high." You can apply this simple and potentially profitable logic across many aspects of your life—from buying a home to collecting art or baseball cards...and yes, to investing in stocks as well. If there is a market for an item, there is the potential to make a profit.

What makes a "market"?

The concept of a "market"—or where buyers and sellers exchange goods or services at an agreed-upon price—has existed as long as human beings have put a value on anything they owned, desired or traded, including essential items like food, clothing, or the sweat off their brow.

Unlike prior centuries though, markets today are real time, global, and electronic, and allow exchange of goods or services to occur over items both physical and virtual, all thanks to the Internet. As a result, there are more markets available today with greater participation and daily exchange of value than ever before in history.

Principle 1: Supply and demand dictate market prices

The price set by any market is a function of supply and demand at any given point in time. All else equal, prices tend to fall when there are more sellers than buyers—especially where supply is abundant—and they rise when multiple buyers compete against each other for more scarce items.

As an example, let us consider the COVID-19 pandemic experience:

Prior to the outbreak, you could go to just about any department or drug store and easily purchase a container of Clorox or Lysol or a bundle of toilet paper for only a few dollars because the supply of these products generally was more than sufficient to meet demand. But after the initial onset of the virus here in the U.S., the demand for these products spiked as people across the U.S. began to stockpile reserves of these items well in excess of their current needs due to fear of the pandemic and how long it could last.

What happened? Supply could not keep up with demand. Many store shelves were emptied, and any remaining sellers who did have some supply of these goods could demand much higher prices than perhaps ever before for these basic household items.

Financial markets are essentially no different: The supply and demand for investment securities ultimately dictates prices.

Principle 2: Markets are efficient

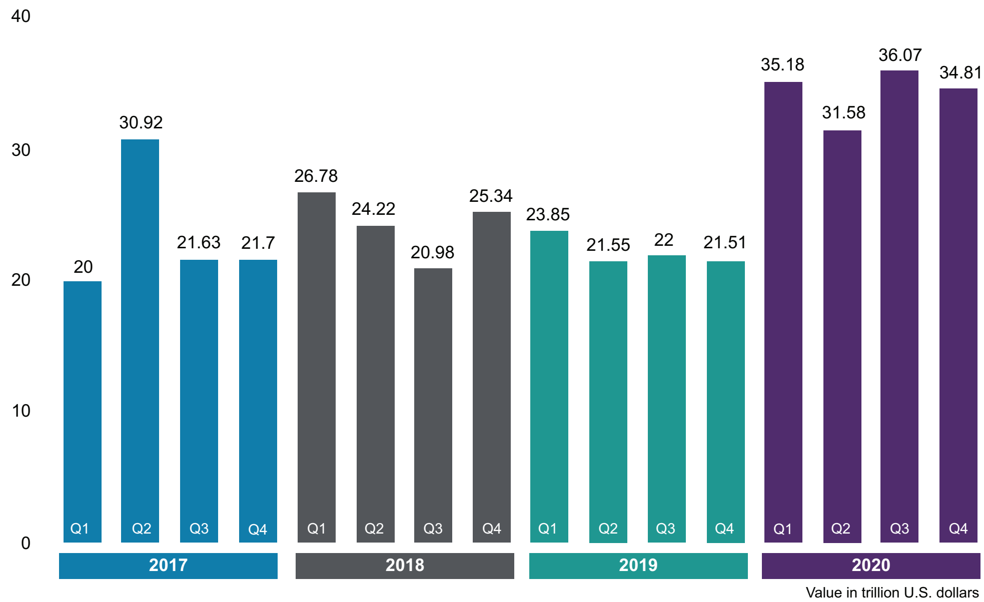
Whether you are buying or selling investment securities—such as stocks or bonds—the objective is to make a profit. However, many financial markets are extraordinarily large. For example, the total value of global equity trading worldwide was over $34 **trillion** in the fourth quarter of 2020 alone![1]

In prior centuries, it was common to make money by outwitting others when bartering for essential goods or services. Information was hard to obtain and did not readily flow to all market participants, many of whom often could be counted on one hand and needed to be physically present.

Over time, this method of exchange has become increasingly obsolete, as markets have grown in size and information flows electronically to more and more market participants at faster speeds. In recent decades, the proliferation of real-time information through the Internet has created far greater market efficiency on a massive global scale for many markets. This is certainly the case for the stock market.

[1] *Source: Statista—https://www.statista.com/statistics/242745/volume-of-global-equity-trading/#:~:text=The%20total%20value%20of%20global,in%20the%20same%20time%20period.*

Value of global equity trading (in $ trillions):



Source: Statista

What do we mean by "market efficiency"? Simply put, the larger and more real-time the market, the more efficiently it goes through price discovery to reflect all available information.

How is this possible? The larger the market, the more participants. In the stock market, the trading price of one stock at every second of every trading day represents the supply and demand for that stock in that moment among a large group of traders. This is the case for thousands of stocks that trade in markets around the globe every day.

KEY TAKEAWAY:

An efficient market goes through price discovery quickly and accurately to reflect all available information.

Market efficiency theory implies that the collective knowledge of these traders, on average, will be more accurate than even the smartest individual in this group.

In 2007, Michael Mauboussin, a financial strategist and Columbia University Business School professor, tested this theory. He asked his 73 students to guess the amount of jelly beans in a jar. The average class guess was 1,151 compared with the 1,116 beans that were actually in the jar.[2]

[2] *Source: https://www.passageglobalcapital.com/the-wisdom-of-crowds/*

Not bad—the class overall was only off by 3.1%.

But, only two of the 73 students guessed more accurately than the group average. Put another way, **only 2.7% of the individuals had a better prediction than the collective class.**

KEY TAKEAWAY:

The stock market is pretty smart—don't try to time the market.

We can extrapolate this simple jelly-bean example about collective knowledge to any large and efficient financial market. For the stock market especially, millions of trades can occur during one day in one stock, with each trade trying to set an appropriate value for the stock. Now, multiply this activity by 250+ trading days in the year, and by thousands of different stocks available to trade in the market. The point is that this market represents an unimaginably large collection of knowledge.

For this reason, it is extremely hard to get in and out of the stock market (also known as "timing the market") and be right consistently enough to beat a simple buy-and-hold strategy.

Principle 3: Avoid information overload

As we described above, prices of securities can change every second of every day in the largest markets.

What causes security prices to change? We stated previously that it comes down to supply and demand for that security. Having more buyers than sellers increases prices, and more sellers than buyers decreases prices.

But what motivates market participants to buy and sell a security? Well, if we peel back that onion a bit more, there is a never-ending stream of news informing you and all others in the market, and there can be different interpretations of that information.

Prices for investment securities are in part a function of information. Today, information transfer is both vast and fast, though **interpretation** of that information can be inconsistent and that is what creates a market. We will discuss this dynamic more later in the section on *Human Behavior and Financial Markets*.

Information overload

The market price for any security essentially integrates and aggregates, in real time, the combined knowledge of all its participants and how they believe that information will change the value of that security in the future. All of this equates to more information than the human brain can rationally process on a minute-to-minute basis every day.

Information overload is nothing new, but information has become increasingly abundant and available to more and more people over time. Investment professionals, for example, receive hundreds of emails every day, each with detailed analysis and opinions about investment opportunities. Meanwhile, non-professional day traders are increasingly trading and successfully moving stocks based on (sometimes erroneous and random) information they find in social media. It is an overwhelming process to sift through what is important, and what is noise, and it can literally be like drinking from a firehose.

We live in a world of information overload and millisecond trading activity. There is a lot of media noise and rapid stock market action. If you watch every tick, it can be both overwhelming, and hard to ignore. But it is extremely difficult to improve your investment returns over time by jumping into or fleeing from breaking news. Remember, collective knowledge wins on average.

KEY TAKEAWAY:

It is hard to consistently increase your return on investment based on breaking news.

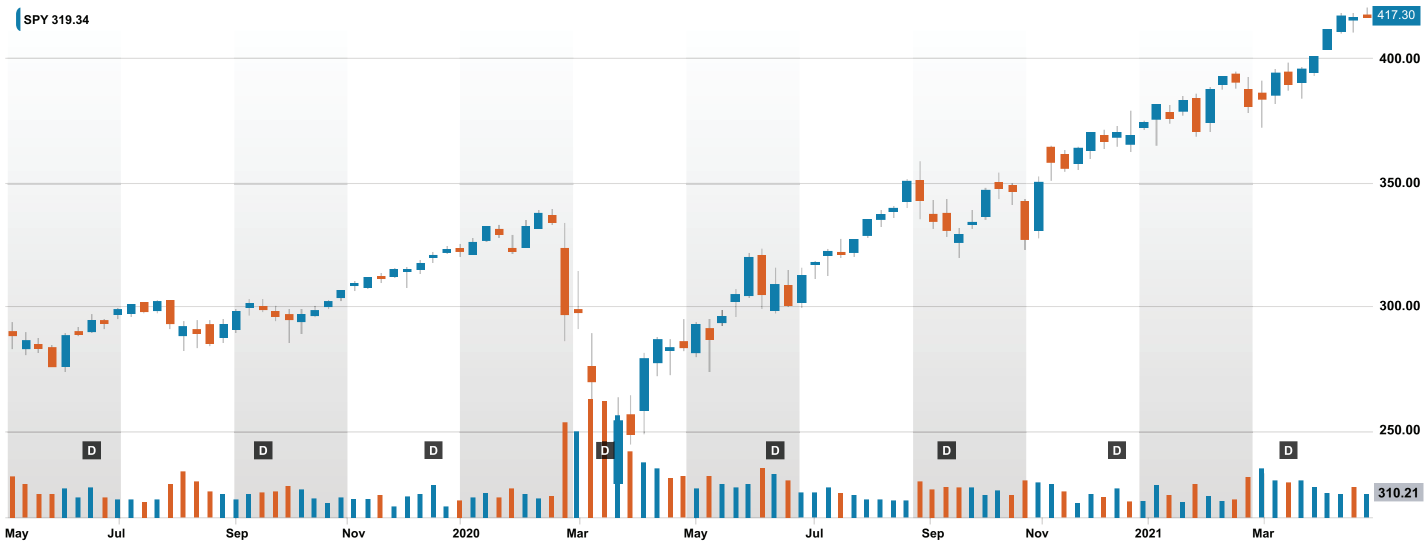
Case Study: The COVID-19 Pandemic

Let us use the example of the COVID-19 pandemic again. When it first hit hard in early 2020, global economies shut down as people sheltered in place.

Investors faced the proverbial information firehose at full force in February 2020, as they were dealing with something new and unknown, namely a pandemic.

As the news quickly worsened here and abroad, investors sold first and asked questions later. As a result, the entire stock market, as measured by the S&P 500, plummeted by 32% between mid-February and mid-March 2020 on heavy volume:

S&P 500 (SPY (two years through 4/26/21):

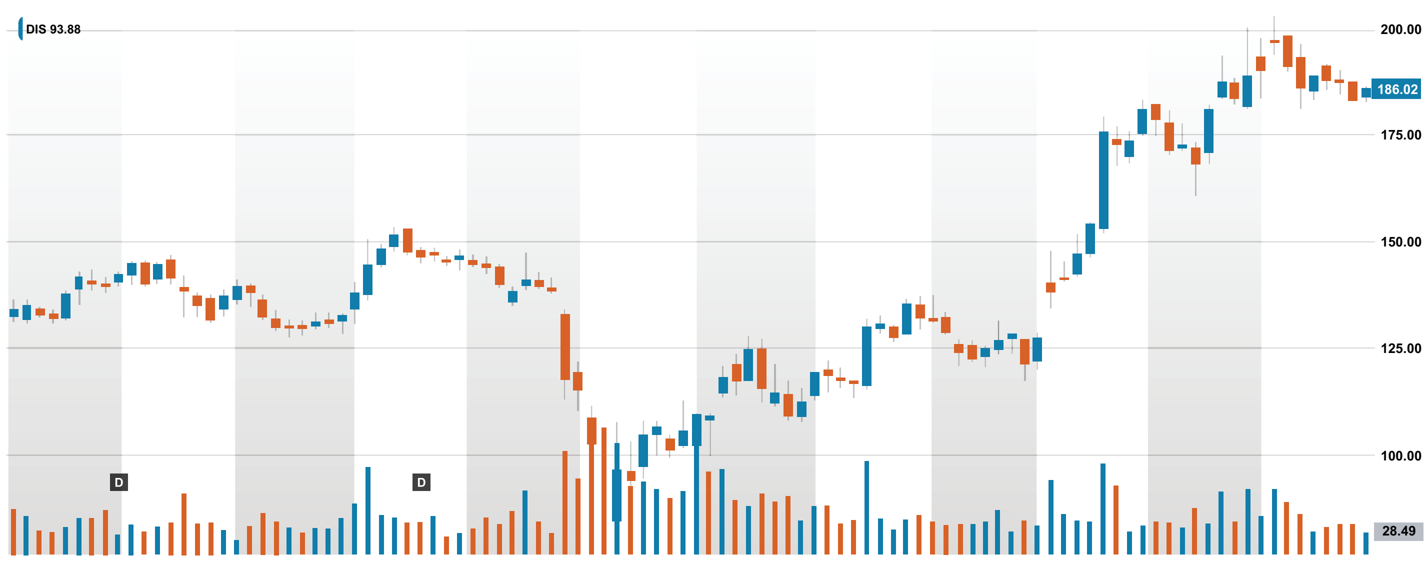


Source: Yahoo Finance

Some of the hardest-hit industries were travel, leisure, and entertainment. Purchases of airline tickets, hotel rooms, and Disneyworld trips came to a screeching halt with no visibility on when they might resume, or at what level. The flow of information was fast and furious due to this very serious situation.

The stock market assumed business prospects would crater for companies like airlines, hotels, and other related companies. Disney's stock lost nearly half its value in the first three months of 2020. However, a year later in March of 2021, the shares not only regained everything lost in early 2020 but had gone on to new all-time highs—well before leisure travel business fundamentals had recovered to pre-pandemic levels:

Walt Disney company (DIS) stock chart (two years through 4/26/21):



Source: Yahoo Finance

How could this happen? What the market could not accurately determine immediately after the pandemic hit was the severity and length of this change in business prospects.

After the initial panic, collective knowledge of the stock market gathered quickly and efficiently to shift thinking on this economic outlook. The market determined that recessionary pressures from the pandemic, while certainly severe, were more transient than initially feared, especially as our government provided financial relief directly to families and through massive monetary stimulus.

For Disney specifically, the theme parks while empty were not going away. Expectations started to improve again off of extremely pessimistic levels after the significant sell-off in the stock.

What does this all mean to you and your investment portfolio? The world was literally coming to an end during the first quarter of 2020. The information firehose was drowning everyone. The news panicked many to sell their stock holdings at or near the bottom of these charts above.

But this short-term thinking would have led you to the wrong conclusion. The collective knowledge of the markets quickly regained confidence in the American economy, and ultimately rewarded longer-term investors who did not panic, avoided information overload, and held their ground.

Diversification

Principle 4: Don’t put all your eggs in one basket—diversify!

We have thus far noted that market efficiency makes market timing an extremely difficult strategy for consistent success. However, market efficiency does not eliminate investment risk. This is where **diversification** can play a role.

What is diversification?

You have probably heard that old adage about not putting all your eggs in one basket. When it comes to your investments, diversification is about spreading around your investment portfolio to different securities, asset classes, and/or geographies to manage risk.

Why would you do this, especially since by diversifying, you mathematically increase your odds of being wrong on one or more of your investments?

Investments can and will go up and down in value over different periods of time. But diversification increases the probability that when some of your investments are going down in value, others might be rising at the same time. Investments do not move identically at all times.

KEY TAKEAWAY:

Investments can move in different directions and amounts. Diversification helps to potentially capture positive returns wherever and whenever they occur.

A well-diversified portfolio should have less total risk than it would if it held only one "risky" investment, and it can still potentially perform well even if a few individual holdings are underperforming. Put another way, you are more prepared to potentially capture positive returns wherever they may occur during any point in time.

Different ways to diversify

You could put all of your money into one investment, though the risk of owning only one stock (e.g., Disney) is that your net worth would be highly correlated to that company's business prospects (e.g., an event that shuts down its theme parks) and can potentially lead to much more volatility and sleepless nights. You also may be more susceptible to making emotional decisions because of this dynamic.

The good news is that there are many ways to diversify your investments.

First, you could invest in a more diversified portfolio of stocks. This might include buying multiple stocks yourself.

Another relatively easy way to diversify is to buy a mutual fund or exchange traded fund (ETF) that already owns and manages a basket of different securities on your behalf. Again, this approach reduces the risk of any single security having an outsized negative impact on your total portfolio value.

KEY TAKEAWAY:

Diversification can be multidimensional—for example, you can diversify across different securities, asset classes, and geographies.

Diversifying across asset classes means much more than just owning stocks and bonds, whose prices can move in different directions over time.

Some funds also tend to have a specific focus or "style box" within an asset class; for example, large-company or small-company stocks; growth stocks or value stocks; high-yield or government bonds; and other categories. You can further diversify your investment portfolio by owning different style categories.

The same can hold true for securities across different countries as well. International diversification can be an important contributor to investment returns and risk management over the longer term.

Principle 5: Investment risk can be reduced (but not eliminated)

There are many different types of investment risks, though when it comes to diversification, there are two that matter most: unsystematic and systematic risk. Said another way, there are risks you can reduce and those you cannot.

Unsystematic risk is risk that is specific to a particular company or industry.

Here again, let's take the example of Disney. Possible unsystematic risks of owning only Disney's stock are that Disney produces bad movies or sees lower theme park attendance due to a bad hurricane season in Orlando.

The good news is that these unsystematic risks can be diversified away by owning stocks of other companies in different industries, such as banks or technology companies, that are neither located in Orlando nor have exposure to the movie industry. Owning Coca-Cola or Exxon Mobil in this portfolio would be further examples.

Systematic risk, on the other hand, is a risk that exists for every company in a market.

A perfect example of systematic risk for all U.S. companies is higher corporate tax rates in the United States. This systematic risk is harder to diversify away by owning U.S. stocks alone because this tax law likely would apply to all companies (systemically) in the U.S. Inflation is another systematic risk that would be hard to diversify away.

However, you may be able to reduce systematic market risk by diversifying across geographies where that risk is more impactful to one geography versus another. We will discuss this in more detail below.

KEY TAKEAWAYS:

You **can** reduce **unsystematic** risk through diversification within a market.

You **cannot** reduce **systematic** risk through diversification within a market.

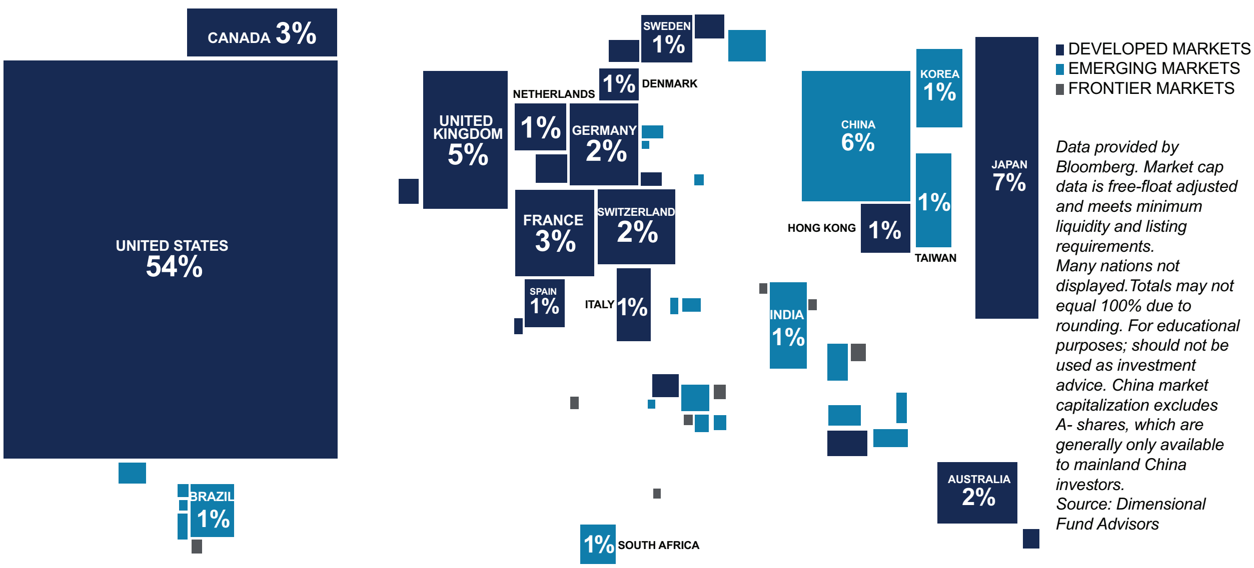
Principle 6: Investing globally—a world of opportunity

Systematic risk is not necessarily global across all markets at the same time. For example, rising corporate tax rates in the U.S. actually could make other countries more attractive for investors. This is where global diversification becomes important and many mutual funds and ETFs offer relatively easy ways to obtain international diversification.

The international investment opportunities are vast. In fact, a U.S.-focused stock portfolio today could potentially miss out on over 40% of the world's investment opportunities:

Global equity diversification

Percent of equity world market capitalization as of December 31, 2019:

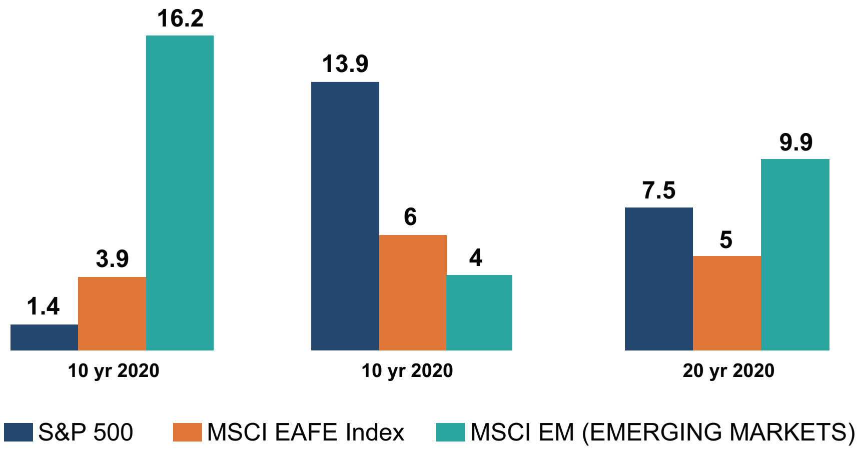


Data provided by Bloomberg. Market cap data is free-float adjusted and meets minimum liquidity and listing requirements. Many nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. China market capitalization excludes A- shares, which are generally only available to mainland China investors. Source: Dimensional Fund Advisors

No diversification strategy will completely eliminate investment risk. That said, the benefits of global diversification in a long-term investment portfolio cannot be stated enough.

There have been periods over the last 20 years where international stocks (represented by both the MSCI EAFE and MSCI Emerging Market Indexes) have significantly overperformed U.S. equities (as represented by the S&P 500), as shown in the chart below:

Annualized returns



Source: Zephyr Analytics

In fact, if we were to look at the past 100+ years between 1900 and 2010, you may be surprised to hear that U.S. markets **underperformed** in 6 out of the 11 decades during this period.[3]

If history is any guide, there will be periods in the future where U.S. securities materially underperform international securities, and vice versa. As we stated earlier, collective knowledge makes it hard to determine when those periods will begin and end. That is why it is important to diversify your investments globally so you can participate in those periods of relative outperformance while also reducing your overall portfolio risk.

KEY TAKEAWAY:

Investing globally has historically helped offset periods of U.S. underperformance.

[3] *Source: Annual country index return data from the Dimson-Marsh-Staunton (DMS) Global Returns Data, provided by Morningstar, Inc. (as reported by https://www.dimensional.com/us-en/insights/why-should-you-diversify)*

What Drives Market Returns?

Principle 7: Free markets and capitalism are critical for market efficiency

Many companies around the world are run to create profits. In a free-market economy like the United States, private owners and independent boards of directors control these businesses, rather than country or city governments, and therefore can best decide how to spend their profits and invest capital to optimize their future business prospects.

Free markets operate and determine supply and demand free from the rules of government or other authoritarian regimes. Free markets and capitalism are not perfect but are critical for market efficiency in today's economy in the United States.

Principle 8: Stockholders are owners

What does "buying a security" really mean? It means you are committing your capital to one or more companies in return for the opportunity to earn a return on that capital. It also means you are trusting those businesses to use your capital wisely.

Let us look at two classes of securities as examples, namely stocks and bonds.

When you buy a stock, you become a shareholder and partial owner of that company. The more stock you buy, the bigger percentage of the company you own. Most individual shareholders own a fraction of the more commonly known companies today. Institutional shareholders with larger sums of money to invest can often accumulate more material ownership, particularly in smaller companies. Your corporate ownership can also give you the right to vote on issues proposed by the company and receive dividends paid during the period you own the stock. Stock ownership can theoretically last forever if you never sell the stock and the company remains in existence into perpetuity.

Principle 9: Bondholders are lenders

On the other hand, when you buy a bond, you are providing a temporary loan to a company. Both individual companies and government entities can issue bonds. Unlike stocks, bonds do not offer ownership participation or voting rights in a company. Bonds also have a maturity date, meaning there is a time limit to receive your interest payments and return of principal.

Bondholders do, however, receive priority in the capital structure versus stockholders. In the case of a company failure, bondholders get paid before stockholders.

Stockholders	Bondholders:
You are a part-owner of a **company**	You are a lender to a company with no ownership **stake**
You may have voting rights at shareholder meetings	You do not have voting rights at shareholder meetings
You earn a return on investment from stock appreciation and dividends paid	You earn a return on investment from regular interest payments and the return of your principal investment
You are **less** likely than bondholders to be paid in the event of bankruptcy	You are **more** likely than stockholders to be paid in the event of bankruptcy

Principle 10: Balance risk and required rate of return

When companies do well over the long-term, stocks typically have more upside potential versus bonds because of their nature as perpetual and riskier investments. However, not all companies do well and some may ultimately fail, which is why investing in businesses is never risk-free.

With any investment of capital, the holy grail is to generate as high of a return on that capital as possible and do so with the smallest amount of risk. This is the case whether it is you (the investor) or the company who receives that capital.

In practice, there is no free lunch. You as an investor always need to consider your tolerance for risk and the time frame for your investment. Therefore, the textbook consideration for every investor is **what is your required rate of return for a given level of risk?**

Here is a simple example: FDIC-insured bank accounts pay next to nothing today in interest, yet the odds are that you have a bank account. Why? Because it is money you do not want to risk. It is your safety net and money you use every day to pay for items such as groceries, utility bills, and car payments. As a result, your required rate of return on this money is far lower than for other money you want to invest for the longer term.

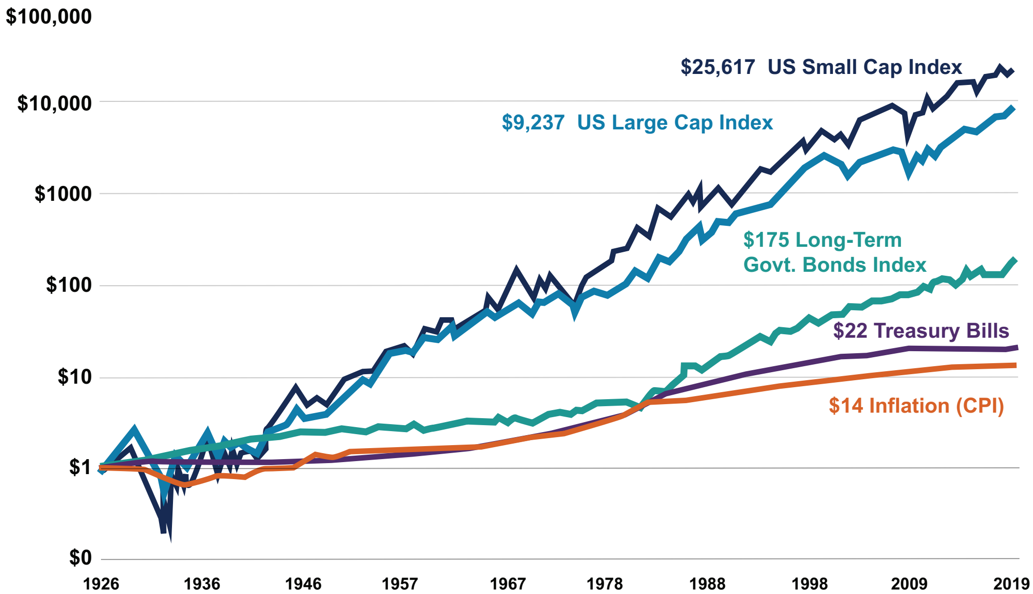
Cash for basic living expenses should never be invested in the stock market because there is always a risk of losing it, especially in the shorter term. As a result, the required rate of return for investing money in the stock market should always be higher compared with Treasury Bills. This is also known as equity risk premium.

KEY TAKEAWAY:

"Equity risk premium" represents the excess return investors require at any given time to take on the risk of investing in the stock market compared with putting that money in guaranteed safe investments like U.S. Treasury Bills.

The good news is that over the long term, stocks have historically delivered premium returns to justify the additional risk. In fact, money invested in the stock market has significantly outperformed guaranteed investments such as U.S. Treasury Bills, as shown in the graph below, though with a lot more volatility along the way:

Monthly growth of wealth ($1), 1926–2019



In US dollars. US Small Cap Index is the CRSP 6–10 Index; US Large Cap Index is the S&P 500 Index; Long-Term Government Bonds Index is 20-year US government bonds; Treasury Bills are One-Month US Treasury bills; 1-Month Treasury Bills Index is the IA SBBI US 30 Day T-Bill TR USD. Treasury Index data sourced from Ibbotson Associates, via Morningstar. Direct Inflation is the Consumer Price Index. CRSP data provided by the Center for Research in Security Prices, S&P data © 2020 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Bonds, T-bills, and inflation data provided by Morningstar. Past performance is no guarantee of future results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

There is no free lunch for corporate bond holders either, even though they are supposed to receive back all of their principal investment at maturity.

Bond investors also expect to be paid a higher interest rate for greater risk. High-yield bonds are often known as “junk” bonds because of their increased risk of default, or credit risk, on their ability to pay interest and principal. As an example, oil and gas companies often issue higher-yield debt to compensate their investors for the risk inherent in volatile oil and natural gas prices, which can impact their ability to pay back investors in the future.

KEY TAKEAWAY:

There is no free lunch when it comes to investing your money.

Bond investors also expect to be paid more for longer maturity lengths (also known as a "term premium"). For example, let's say Disney issued two bonds, one maturing in 30 years and the other maturing in three years. All else equal, you as the investor should require a higher rate of return on the 30-year bond because there is more time for something to potentially go wrong. You want to be compensated for that additional risk. As a result, Disney should also expect to pay a higher coupon rate for that 30-year bond compared with the three-year issue to entice you as the investor to take on that additional risk.

Human Behavior and Financial Markets

Principle 11: We are human. We are prone to error.

We have said a lot about efficient capital markets and given you fundamental principles to live by when you invest your money. Yet, even with this rational thought process, we cannot ignore the fact that we are still human. We as investors cannot help but sometimes act on instinct and emotion, even when our rational minds tell us otherwise.

Instinct is part of our DNA—our ancestors relied on it to survive. Even today, there are many times our instincts are correct, which can reinforce our sense of confidence in them. But there are other times impulsiveness may cause more harm than good and this is common in financial markets.

> "The fact that a loss hurts more than an equivalent gain gives pleasure is called loss aversion.… Roughly speaking, losses hurt about twice as much as gains make you feel good."
>
> *Richard H. Thaler, Misbehaving: The Making of Behavioral Economics*

KEY TAKEAWAY:

We cannot help but sometimes act on instinct and emotion, even when our rational minds tell us otherwise.

Behavioral finance

This is where behavioral finance comes into our discussion. In many ways behavioral finance is a rational way to explain the irrational behavior of humans. It is a formal area of study in academia on how psychological biases and influences impact investors actions.

Principle 12: Behavioral biases can lead to investment mistakes

What does this all mean? There are several pillars to behavior finance that can influence your actions as an investor, each of which we briefly describe below using examples:

Loss Aversion: You may decide not to invest your money because the fear of loss outweighs the potential gain of an investment. An example of this might be hoarding cash during the 2008-09 financial crisis, which in hindsight turned out to be one of the best times to invest your cash in the history of financial markets.

Herd Behavior: You might make investment decisions mostly based on the behavior and decisions of other people around you. Using the financial crisis again as an example, herd behavior is what led to such a violent drop in the stock market in the 2008-09 period, as supply outweighed demand for stocks due to herd mentality.

Confirmation Bias: You might make investment decisions because you find information that supports your beliefs, even if it means ignoring other information that might refute your biases. An example might be buying McDonald's stock because you support their corporate sustainability efforts with the environment, even though you have seen the unhealthy nutrition facts for some of McDonald's sandwiches and as a result never eat there.

Self-Attribution: You may make an investment decision because you feel overly confident in your own ability or in information you have available to you.

Experiential Bias: If you lived through the financial crisis, your experience then may lead you to avoid investing in stocks due to fear that a similar crisis could occur again.

Familiarity Bias: Just because you are a coffee aficionado and drink coffee every day does not mean you should put all of your money in Starbucks. You may be missing out on the important benefits of diversification by only investing in what you know well.

Each of these behavioral biases can be triggers for making investment mistakes based on either your emotions or those of others in the market. Are they 100% avoidable? No, and that is because we are human.

This is why a disciplined, structured strategy works and why having a financial advisor can be critical.

One of our most important jobs as a financial advisor is to act as a rational, objective touchstone, guiding you through volatile markets or circumstantial changes that might trigger an emotional reaction or bias and cause you to consider veering off of your investment strategy. We help you take your emotions out of the equation and allow you to focus on what is really important: meeting your financial objectives.

Conclusion

We believe that these 12 fundamental principles have stood the test of time (both in the good and bad) and have proven to be successful core guidelines for building wealth over the long term.

Call or write us today to ask us any questions and to learn more about how Modera Wealth Management LLC can assist you in getting on the road to creating long-term wealth.

Key Takeaways

1 An efficient market goes through price discovery quickly and accurately to reflect all available information.

2 The stock market is pretty smart—don't try to time the market.

3 It is hard to increase your return on investment by jumping in and out of investments based on breaking news.

4 Investments can move in different directions and amounts. Diversification helps to potentially capture positive returns wherever and whenever they occur.

5 Diversification can be multidimensional—for example, you can diversify across different securities, asset classes, and geographies.

6 You can reduce unsystematic risk through diversification within a market.

7 You cannot reduce systematic risk through diversification within a market.

8 Investing globally has historically helped offset periods of U.S. underperformance.

9 Equity risk premium represents the excess return investors require at any given time to take on the risk of investing in the stock market compared with putting that money in guaranteed safe investments like U.S. Treasury Bills.

10 There is no free lunch when it comes to investing your money.

11 We cannot help but sometimes act on instinct and emotion, even when our rational minds tell us otherwise.

Worth Reading

A Random Walk Down Wall Street: The Time-Tested Strategy For Successful Investing | Paperback – Illustrated, January 14, 2020 by *Burton G. Malkiel*

The Intelligent Investor: The Definitive Book on Value Investing. | A Book of Practical Counsel (Revised Edition) Paperback – Bargain Price, February 21, 2006 by *Benjamin Graham*

The Big Short: Inside the Doomsday Machine | Hardcover – March 15, 2010 by *Michael Lewis*

Liar's Poker: Rising Through the Wreckage on Wall Street | Hardcover – October 17, 1989 by *Michael Lewis*

Winning the Loser's Game: Timeless Strategies for Successful Investing | Eighth Edition Hardcover – May 13, 2021 by *Charles Ellis* (Author), *Burton Malkiel* (Foreword)

Warren Buffett: Inside the Ultimate Money Mind | Hardcover – March 9, 2021 by *Robert G. Hagstrom*

Misbehaving: The Making of Behavioral Economics | Hardcover – May 11, 2015 by *Richard H. Thaler*

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