Dimensional

OUTSIDE THE FLAGS

By Jim Parker
Vice President
DFA Australia Limited

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Future Testing

Much financial news purports to be about the future but is really just an account of the past. As a result, many investors project what *has* already happened onto an imagined future. There's another way of framing this problem.

It's understandable that investors, with the help of a necessarily short-term-focused media, will tend to focus most of their attention on what has happened in financial markets in the past month, week, day, or even hour.

When stocks have fallen heavily in price, for instance, this is routinely reported as, "More bad news for investors today." In fact, unless you plan to liquidate your portfolio that particular day, it is unlikely to be bad news at all.

The media could just as easily say, "Stocks went on sale today, as falling prices offered investors higher expected returns." If you are a long-term investor, the key issue is how your portfolio performs from now on, not what happened yesterday.

In this way, investment is about the future, not the past. And because the future is unknown, we should strive to manage the uncertainty by diversifying across stocks, sectors, asset classes, and countries. While diversification does not eliminate the risk of market loss, to do otherwise is to take unnecessary risk.

The second assumption the financial media makes is that the future is the same for everyone. In reality, of course, our futures diverge depending on our age, family circumstances, jobs, incomes, and other factors.

One person may be focused on paying for a college education for their children or caring for aging parents. Another may be looking toward buying a home, saving for a vacation, investing an inheritance, or changing careers.

Everyone's future is different, which means the investment strategy each of us adopts will vary. Some will want a strategy that delivers regular income; others will be more focused on capital growth. Some will be risk takers, others risk-averse.

From this, it should be evident that if the future looms differently for each of us, risk is not just one thing. It is not just the volatility of the market day to day or a simple statistical metric that can be measured. Risk can be felt differently depending on your age, your dependents, the industry you work in, the country you live in, the currency you consume in, and your accumulated assets and liabilities.

This is why an assessment of the future and the uncertainty surrounding it should not just be approached from the level of the overall market but from the needs of each individual. That is the role of a qualified financial advisor: to help connect each individual's circumstances and needs to their goals.

None of us can control the future. Risk can be quantified up to a point, but risks can vary greatly depending on the individual. In any case, there are other uncertainties that cannot be analyzed in terms of mathematical probabilities.

One response to future uncertainty is to speculate and try to position one's portfolio to take advantage of one possible outcome or another. The risk in taking that approach, apart from getting it wrong, is that we can end up acting on stale news or paying a premium to take advantage of news that is already in the price of a given security.

Another response is to stay highly diversified and to use the information in market prices to stay focused on the dimensions of expected return.

This latter response doesn't require speculation, forecasts, or second-guessing the market. It just requires an understanding of what we can and cannot control. So while we can't control the future, we can control the structure of our portfolios, we can ensure we are broadly diversified, we can manage fees and taxes, and we can regularly rebalance to ensure the risk allocation stays within our chosen parameters.

Yes, the future is unknowable, and how it unfolds has differing implications for each of us, depending on our circumstances and needs.

While we cannot prepare the future for our portfolios, we can still strive to prepare our portfolios for the future.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognized by Australia's corporate regulator in its own investor education program.