



ROCKWOOD WEALTH MANAGEMENT

Nobel and Vegas

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The financial media loves market volatility. Exaggerated ups and downs means higher ratings driven by unwitting investors tuning into expert after expert seeking portfolio advice from magazines and television. During bear markets there prevails such a sense of media fueled negativity that investors may begin to feel that investing is akin to gambling.

We agree, but certainly not in manner that an anxious investor approaches the issue. For a moment, let us concede that investing is just like gambling—but this time, you are the **casino owner**. We've all heard stories of people returning from Vegas and telling tales of big bets that paid off handsomely. Yet Vegas thrives not because people win, but because they lose. The casino operators are not concerned with an individual's short-term winnings—they only care that the parking lot is full. They know that the longer a person plays, the more the house will earn since the percentages are strongly in the house's favor. The identical concept applies to our investment planning.

Our investment plans are grounded heavily in the work of three gentlemen who won the Nobel Prize in Economics in 1990. Together they offer guidelines for investors to understand what they are doing and why, how they function in a capital market and how these markets function around them. Each prize was awarded separately and is a great achievement on its own, yet all three prizes are based upon research that helps to clarify the investment process.

William Sharpe reveals to us that investors get paid for taking priced risk. You can take zero risk and invest in short-term Treasuries. Or you can take on full market risk and invest 100% in the stock market. Whatever you choose, your portfolio's expected return varies singularly with its beta—its proportional relation to this priced risk. In Sharpe's model, there is just one priced risk factor: the equity premium. This is return of the stock market above the short-term Treasury rate. So if your security has a return of 1.2% relative to the market when it is up 1%, or is down 1.2% on average when the market is down 1%, then you have a beta of 1.2. The expected return is 120% of the average equity premium. This is essentially the single-factor Capital Asset Pricing Model (CAPM) that establishes the linear relationship between risk and return that underlies virtually all asset-pricing models.

The CAPM model has strong implications for investors. Every stock portfolio is a subset of the entire market; it carries its proportionate share of total market risk and is compensated with a proportionate share of the market's expected return. As a predictive model, however, it has its limitations. The further portfolios got away from looking like the market, the less the model explained returns. But further research built on this CAPM concept and led to the development of the Three Factor Model by Eugene Fama and Ken French that we use today (but that is another article!).

Harry Markowitz deepens our understanding of investing by showing that taking priced risk is only a piece of the equation. Rational investors not only invest in priced risk, but they diversify away from risks they cannot control. After all, a small handful of securities (or even one stock) can have a similar beta and therefore a similar expected return to a broadly diversified portfolio. But would it be wise to invest your entire portfolio in small number of stocks? Markowitz showed us that investing in a *large* group of

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securities with similar risk/reward characteristics does not affect the expected return, but it does serve to lower the volatility (standard deviation) and thus makes the return more predictable. The rational investor invests where he can capture the return from systematic economic risks for the lowest available standard deviation. Yet so many investors today own a handful of stocks with similar risk characteristics. Going back to our Vegas analogy – that means they are playing in Vegas and the deck is stacked against them! They have all the benefits of additional gut-wrenching volatility without the possibility of additional return! Score one for the house.

The Nobel Committee cited Merton Miller for his research with Franco Modigliani in their work in corporate finance. Miller is often noted for his thoughts on cost of capital. Companies have two ways to obtain capital from investors: they can issue bonds (borrow the money) or issue stock (surrender participation in the company's earnings). In either case, **the company's cost of capital is the investor's expected return**. The company promises an interest rate to the bond investor or an expected return to the equity investor. When a company issues stock it forever forgoes the return on that stock – a return it would have otherwise kept had it not needed the operating capital. The return on the stock, even several stages removed from the initial offering, reflects the current riskiness of the capital venture and is the rate it costs the company to get capital.

This simple “cost of capital” notion offers a powerful glimpse into the workings of the capital markets. Capital markets compete for investment capital and rewards investors for risking their capital. Riskier companies need to pay a higher cost of capital than the overall market and the investor should expect a higher rate of return. If these companies did not provide this higher rate return, people would not invest in them! Because capital markets work, we can target the portions of the global markets that provide the highest reward for investment capital within the constraints of an individual's risk tolerance. Furthermore, we can gather all securities together with similar risk characteristics and target these as a distinct asset class. Great things happen when you target securities with a higher expected return and diversify the risk amongst hundreds or even thousands of securities. You have positioned yourself to capture the risk premiums while dramatically lowering your standard deviation (risk).

We owe a great deal to these Nobel Prize recipients for showing us how markets work and what it means to invest. The relation between risk and return, the importance of diversification and the function of capital are three fundamental concepts that bring structure and discipline to our investment plans. Investors invest in the people, ideas and infrastructure of the capital markets and are rewarded for doing so. In times of financial duress, there is a greater need for capital and hence the cost of capital increases. So does the expected return. Most investment professionals spend tremendous energy trying to find securities that are **mispriced** and bet that that they are smarter than other market participants. A rational investor knows that long as they stay invested (keep the parking lot full) they can be assured of being well rewarded for the risk that they have taken. They can *be the house* and position themselves to take advantage of the healthy returns offered by the capital markets over time.

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Firm Background and Philosophy

Rockwood Wealth Management is a wealth management firm based in New Hope, Pennsylvania and Annapolis, Maryland. A commitment to a client-centric practice and unwavering integrity in all of our endeavors ensures that our clients' best interests are always our best interests. We specialize in working with high-net worth clients, helping them to streamline their financial affairs while offering high-level expertise for asset management, tax & financial planning, risk management, private banking and estate planning.

Rockwood offers a disciplined and process driven approach to helping our clients accomplish what is most important to them. We provide a meaningful, consistent relationship with an advisor who knows you, your values, your family and what is truly important to you in life.

Fee-Only Independence means that we remain unbiased in our advisor-client relationship as we accept no referral fees or commissions in any aspect of our practice. Fee-Only is more than a description of compensation; it dictates that our interests are naturally aligned with our clients. The result is unbiased financial advice rendered by our advisors who are committed to acting as a fiduciary in a client-centered relationship. Rockwood Wealth Management works hard to preserve our station as an independent firm, void of conflicts of interest, and dedicated to the loyal pursuit of satisfying our clients.

About the Advisors at Rockwood

Brian D. Booth

Brian D. Booth is the Managing Member of Rockwood Wealth Management. He has twenty years of experience in personal wealth management where he focused exclusively in the areas of asset management, financial and estate planning, private banking, trust and fiduciary matters.

Brian has a Masters of International Business from the Edinburgh Business School, UK and received his Bachelor of Arts from Rutgers University. He has been a CERTIFIED FINANCIAL PLANNER™ (CFP®) practitioner since 1994 and became Certified Trust & Financial Advisor (CTFA) in 1996. He is member of National Association of Personal Financial Advisors (NAPFA), the Philadelphia Estate Planning Council, the Bucks County Estate Planning Council and the Institute of Certified Financial Planners. He is also President Emeritus of the Princeton Committee on Foreign Relations and a member of the Union League of Philadelphia.

John R. Augenblick

John R. Augenblick is committed to the development and growth of Fee-Only comprehensive financial planning as an active member of the National Association of Personal Financial Advisors. With expertise well respected in the community, he writes a finance column for the Bucks County Herald independent newspaper and serves on the board of directors of Team Capital Bank. John works with his local community by volunteering his time as a member of the Finance Committee for the New-Hope Solebury School District.

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John graduated from the United States Naval Academy with distinction, earning a degree in Systems Engineering. While teaching engineering at the United States Naval Academy, John earned his MBA at Johns Hopkins University where he focused his studies on portfolio development, investment analysis, and corporate management. John is a CERTIFIED FINANCIAL PLANNER™ practitioner and has earned a Certificate in Financial Planning from Florida State University.

Thaddeus (Ted) N. Toal, Jr.

Ted is a senior partner of Rockwood Wealth Management and runs the Annapolis, MD office. Dissatisfied with the level of client care in the broker-dealer/commission model, Ted became a fierce client advocate and adopted a Fee-Only business model as he launched an independent firm, Toal & Associates. Today he is an active member of the National Association of Personal Financial Advisors and the Institute of Certified Financial Planners.

Ted, a CERTIFIED FINANCIAL PLANNER™ practitioner, graduated from Towson University with a Bachelor of Science degree and received his Certificate in Financial Planning from Florida State University's Center for Professional Development.

www.RockwoodWealth.com
267.983.6400