

The Kirk Report

one pro's view of the stock market

Q&A With Cern Basher

Thursday, May 21, 2009 at 4:30 PM

I am privileged this month to share an interview of Cern Basher, the Chief Investment Officer for [Madison Wealth Management](#) in Cincinnati, Ohio. *Wealth Manager* magazine ranked Madison among the nation's Top Wealth Management Firms and is among the nation's Fastest Growing Independent Registered Investment Advisory Firms.

I first became familiar with Cern through a recommendation of [Dick Davis](#) who highly recommended reading the free monthly [Madison Insight](#) which I have also linked to in the past. As with other Q&A sessions, I think you'll find Cern's investment insights of interest. As you know, in these Q&A sessions my goal is to provide different perspectives and you'll find this Q&A certainly in line with that goal.



We hope you enjoy the Q&A and find it helpful.

Q&A with Cern Basher

Kirk: Welcome to the Q&A Cern! I'm excited to have a CIO of a highly-respected wealth management firm to participate in this excellent [series of interviews](#).

Cern Basher: Thank you Charles. It's my pleasure.

Kirk: Please tell us a little about yourself?

Cern Basher: I was born in New Zealand, raised in Canada and college educated in the United States. So, you might say I'm a citizen of the globe!

Kirk: Tell us about your professional and educational background.

Cern Basher: I co-founded Madison Wealth Management in 2000. Before that I managed trust accounts, pension plans and a large-cap growth mutual fund for a local bank here in Cincinnati. I completed the CFA (Chartered Financial Analyst) program in 1996 and graduated from the University of Alabama with a degree in finance in 1992.

Kirk: How did you learn how to become an investor?

Cern Basher: Gradually over time. I'm still learning. I enjoyed my finance courses in college, especially one on "Speculative Markets" that was a graduate level course on options and futures markets. I then became aware of the Chartered Financial Analyst ("CFA") program. Rather than going to graduate school, I elected to begin working and study for the CFA program at the same time. The CFA program takes three years to complete, provided you pass each level consecutively. I did that and after working for the securities market regulator in Calgary, Canada and for Imperial Oil Resources (majority owned by Exxon) over two years, I completed the third level of the CFA program while working for a bank here in Cincinnati. While at the bank I managed trust accounts, pension plans and was responsible for a mutual fund that focused on large cap growth oriented investments. These varying responsibilities and client/account types were excellent preparation for setting up our advisory firm.

Kirk: How does Madison Wealth Management work with its clients?

Cern Basher: We exist to help our clients meet their lifetime financial needs. That is, we help them make sure they have enough income to last their lifetime and work with them to secure their financial legacy. A legacy might mean a smooth transition of their wealth to future generations or giving away most of their wealth over time. Each of our clients has unique goals and our advice is tailored accordingly. So, in a sense our advice is like a custom suit, hand made to fit each one of our clients individually.

For us however, our advice is not sold as a product, but as a service. Our clients pay us an ongoing fee for our advice. We do not accept any payments from others for using their products or referring our clients to other professionals. Our only income source is completely transparent and it's directly from our clients.

Our value proposition to our clients is not high returns or market beating results. After all, out performance is not a plan for achieving an income our clients' don't outlive. We are much more interested in working to earn returns that are necessary to fund our clients' lifetime goals. This leads us to focus on how much equity exposure our clients need, rather than how much they can stomach. We believe in taking only the risks you need to take. If unnecessary risks can be identified in advance, they are best mitigated in advance.

So, in short, our focus is on planning and working to determine how a portfolio can best be structured to meet each client's goals. Then we'll craft and manage a portfolio to support those needs. When someone's needs change the portfolio changes.

Kirk: I understand you're quite an athlete and successfully climbed Mt. Kilimanjaro with your father in 2007. Why did you do it?

Cern Basher: I love challenges, physical and mental. I was a long distance runner for over ten years and I competed in races all over North America and some internationally. I had some success; for example as a junior I won the Canadian Cross Country Championships and then competed in the World Cross Country Championships. But, in the end I wasn't able to achieve my goal of competing in the Olympic Games. My elite competitive running days are over, but I've refocused my exercise efforts on cycling and mountaineering. All of those sports, especially climbing mountains, are a good blend of both physical and mental challenges. In fact, at a certain level the mental challenges significantly exceed the physical. For example, you only need a certain level of fitness to climb a 19,000 foot mountain, but how you cope with fatigue, chilly nights in a cramped tent and altitude sickness is the true test of climbing high mountains. In 2007 I climbed Kilimanjaro with my father, with whom I share a passion for mountains, to raise money for and also awareness of a medical condition called 22q13 Deletion Syndrome. My son was born with this life-long condition. Not able to walk or speak, mountains are a good metaphor for the physical and mental challenges he faces. Everyday he's climbing his mountain, and we thought that we could challenge ourselves to make the 10 day climb to honor Dane. My father and I both stood on the "Roof of Africa" (as the summit of Kilimanjaro is known), but it was the journey, the preparation, the training and the fundraising effort along the way that truly made this a special experience for me. We are planning [another climb](#) in 2010. This time it will be Aconcagua in Argentina. It's 3,500 feet higher than Kilimanjaro and will be a good deal more challenging.

Kirk: Did you come away from that experience with any lessons that you can apply to investing and the market?

Cern Basher: Yes, I did. Climbing a mountain is not that different from saving and investing for one's future. In fact, any endeavor that requires time to complete and contains a measure of uncertainty is similar to investing. It requires preparation and discipline, which is simply the decision to keep doing the right things day after day whether you feel like doing it or not. Training for a big climb day after day can be hard. Saving money month after month can be difficult. Sticking with a plan in the face of a meltdown in the markets is extremely difficult. Sometimes adversity strikes and it's not just any old run of the mill adversity. While you must control what you can, you must recognize that things will occur that are completely out of your control. Perhaps a chilling snow storm high on Kilimanjaro (a mountain near the equator) or a 50% decline in the equity market strikes at an inopportune time. What you decide to do in the face of such adversity determines how successful you will be.

Mountains also teach patience; on Kilimanjaro you can't reach the top in one day – it's a multi-day effort. It takes many thousands of steps, each one no more important than the other. Even after a thousand more steps the summit doesn't appear any closer. It can be quite demoralizing. In investing, in most cases, it takes many thousands of days to accumulate enough savings and growth on those savings to reach one's financial goals. And, certainly after a big market decline, it can be demoralizing to seemingly find yourself

back to where you started. Thus discipline and patience are two key factors for mountain climbers and investors.

Kirk: Is there any significant difference in how you manage the money of your clients versus your own?

Cern Basher: No. I use the same investment vehicles most of our clients use. And, I pay the same fee too. At Madison, we believe that it is important to be invested alongside our clients. Where we use sub-advisors (i.e. actively managed mutual funds or separately managed accounts of individual securities) we seek managers that have significant co-investments in the same funds they manage. You'd be surprised how few mutual fund managers have less than \$1 million of their own money invested alongside their shareholders. I believe that of the 8,000 or so mutual funds out there, only about 200 have managers with more than \$1 million invested in the funds they manage. For us, this narrows down the field of funds pretty quickly. We believe that fund managers should have significant skin in the game.

Kirk: I completely agree. Clearly, as you've said, every investor has different needs and different goals. However, does that mean if you have 100 clients, you will have 100 different portfolios? Or do groups of clients with similar objectives end up with identical portfolios?

Cern Basher: You are right; no two clients have exactly the same portfolio. After all, no two clients have exactly the same goals. We build portfolios to support our clients' financial goals. We don't fit our clients into pre-determined model portfolios and we don't group our clients by investment objective. Every portfolio we manage has a degree of growth, income and stability of principal (three common investment objectives). While many of the investment vehicles we use may be similar for many clients, each portfolio is customized for a particular client's needs, plans, goals and dreams. In addition, the location of a client's investment accounts often plays a large role in determining the structure of a portfolio. For example, when we advise on a client's 401k plan we are limited to the investment vehicles offered by their plan. Often the vehicles are ones that we wouldn't normally select, but in these captive plans we'll use our investment selection criteria to select the available vehicles that are the best fit within our client's overall portfolio plan.

Kirk: Do you categorize yourself as a trend follower, a contrarian, neither or a little of both?

Cern Basher: Following trends is fun, but I think by nature I lean to the contrarian camp. I tend to be skeptical when I see people chasing a trend. Of course, I recognize that some trends are very powerful and can be long lasting. I recognize my own limitations, in that I lack the ability to know for certain when a trend is going to change course. I operate under the assumption that trees don't grow to the sky and that investment returns likely revert to the mean over time. Thus, I'd rather sell or pare back a position as something is rising (in an attempt to sell high) and buy or add to a position as it is declining (in an attempt to buy low). At Madison, we don't attempt to time the market.

Kirk: How would you describe your investment philosophy?

Cern Basher: There is a lot we can discuss here, but in a nutshell, we believe that successful investing is not intellectual, but behavioral and emotional. The dominant factor in real-life investment returns is the behavior of the investor himself. Most investors take actions over time that significantly harm themselves. For example, some will concentrate too much of their portfolio in one security or sector. This is like eating or drinking too much of a good thing. Tastes great, but it will likely cause significant discomfort at some point.

We live in a culture that is focused on timing and selection. There is so much discussion on when to be in the markets and when to be out. What to buy and what not to buy. It's all very interesting and the world is full of opinions, but for most investors the key lays with their own behavior, not what they buy and when they should buy or sell it.

Our role as advisors is to help our clients make smart financial decisions in an uncertain world and to avoid making decisions emotionally.

We don't view stocks and bonds as pieces of paper to be traded. Just because they can be traded, doesn't mean that you should. Why is it that many business people who take the long-term view with their own private companies (often holding on to them for many generations) will part with their stocks at a moment's notice? Stock ownership, private or public is functionally the same thing. This inconsistency is a cultural impediment and is one that is often quite costly (to the detriment of the investor).

Kirk: Do you utilize fundamental, technical, and/or sentiment factors in your analysis? Are you partial to one strategy versus the others? If so, why?

Cern Basher: Since our investment focus is beyond day-to-day or week-to-week, we don't have much use for technical or sentiment factors (as interesting as they are). Fundamental factors are more important in our analysis. We understand, however, that there is no law that requires the financial markets to trade in line with their fundamentals. Since human actions drive the markets, most of the time the markets do not trade inline with fundamentals. Of course, the fundamentals can also be debated. For example, often the E in the P/E ratio is very difficult to determine and one can argue about whether to use historical earnings, normalized earnings, future earnings, multi-year averages, etc. Even if all the fundamentals were known with some degree of certainty, other important factors like tax rates and government regulations are always changing. So, analysis using fundamental, technical, and/or sentiment factors is often quite useless.

Kirk: Please share one of your largest mistakes in recent memory and anything you learned directly from the experience.

Cern Basher: Most of our mistakes are of the "hindsight is 20-20" variety. If we knew then what we know now, we wouldn't have made those decisions. Those types of mistakes don't worry us too much, because we realize that we are unlikely to be able to foresee the future. Fortunately these types of mistake don't hurt our clients too much, because we maintain very diversified portfolios.

Most of the big mistakes we make (that we regret) stem from not listening to our clients well enough. Failing to understand important things that our clients care about can cause us a lot of grief. We are constantly trying to become better listeners and better at asking questions that help our clients pinpoint their most important dreams and life goals. These are important skills that we are learning over time.

Kirk: In recent years have you learned anything that has made a positive impact on your approach? If so, what?

Cern Basher: We recognized many years ago that people are poor at judging their own degree of risk tolerance. We never ask a client how much equity exposure they'd like to take. Rather, we take a client through a process to help them determine how much equity exposure they need to take to meet their life-long financial goals. In essence we are trying to help our clients figure out how little equity risk they can take to meet their goals.

Taking this approach allows our clients to stick with their investment plans during a difficult market environment. I'll use an extreme example and at the same time discuss why beating a market benchmark is irrelevant. Say a new client comes to us with a portfolio that's 100% in stocks. Last year the S&P 500 was down 37%. Let's say we did a great job for her and outperformed the index by 7%. So she was down 30%. We might feel good that she outperformed by so much, but she certainly isn't feeling that great about us! Instead, in our planning work we determine that she only needed 30% equity exposure. In that case, last year her blended market benchmark was down about 9% and say we delivered a -15% return. Although we don't feel great about underperforming the benchmark by 6%, our client is very pleased that she avoided a bigger negative outcome. This is an extreme example, but it shows why its important to get the asset allocation part right.

Kirk: I think you bring up an important point here - we all need to figure out for ourselves how little risk we must take to meet our goals whatever they may be. This is not something you hear many people discuss, but it is the hallmark of successful financial planning in my view. Most people unfortunately think they need to take large risks to achieve their goals (and for the most part the media inspires such risk-taking behavior), but the truth is that behavior can wreak tremendous havoc.

Next question! They say that there are 2 types of people in Wall Street - those who don't know, and those who don't know that they don't know. How can the investor have confidence seeking advice from an industry where nobody knows?

Cern Basher: Investors can have confidence in seeking advice from people that are operating as fiduciaries and who "know they don't know." At Madison, we tell our clients that we can not and do not try to predict the future. Our job is not to predict the near-term direction of the financial markets, any stock, the economy or anything else that is unknowable. Successful outcomes for our clients do not depend on our ability to successfully predict the future. We don't make public policy and we aren't swayed by our personal views regarding political issues. Our job is to make sound investment decisions for our clients in the policy environment we are given. We don't create tax laws. Our job is

to help our clients invest as tax efficiently as possible. Thus, we lead with advice, not predictions.

Kirk: Can you explain the difference between the fiduciary duty that advisors have versus the suitability standard that stock brokers have and why it's an important distinction?

Cern Basher: A fiduciary standard simply means that your financial advisor is putting your interests first. Fiduciaries disclose any conflicts or potential conflicts of interest. Fiduciaries like Madison Wealth Management (a registered investment advisor) must adopt a Code of Ethics and fully disclose how they are compensated. Most so-called financial advisors are considered "Broker-Dealers" by the Securities and Exchange Commission (SEC). They are held to a lower standard of diligence on behalf of their clients. In fact, they are required by federal law to act in the best interest of their employer, not in the best interest of their clients. Examples of fiduciaries in other professions include physicians and lawyers. We believe that in important matters such as your health and financial well-being it only makes sense to work with advisors who must act in your best interest.

Kirk: Many of the online brokers have reported a surge of new accounts as people feel they can do better on their own than by paying others to manage (i.e. lose) their hard-earned money. Has your firm experienced any significant client turnover during this period and what thoughts do you have regarding this surge of interest into DIY investing?

Cern Basher: Yes, we have lost clients during this difficult market period. We lose clients in one of four ways; the client dies, the client chooses to transfer the account to another advisor, the client chooses to DIY or we choose to terminate the relationship. During this difficult period, some clients are opting to DIY. In our view, most of them reached their decision during an emotional time. Yes, their portfolios were down significantly and by all means with the benefit of hindsight we could have done better in avoiding losses, but our planning work indicates to us that they are still on track to meet their financial goals and they can weather this storm. We now fear that those clients who left us will take action to harm themselves in order to obtain some short-term relief from the stress of the current market situation.

So in general, our concern with the surge in people's interest in DIY investing is that they too are ill equipped to handle the emotional/behavioral challenges of investing. All the noise about what to buy and when to buy, and not to mention all the political theatre of late, is often extremely distracting. This will likely be to the detriment of DIY investors, many who seem to be swayed by the fears of the moment.

Kirk: You've said that you "*design all-weather portfolios with components that will perform differently in different market environments.*" Yet, in most major bear markets, including the most recent, the reality is that everything goes down, with precious few exceptions. How do you protect your client's assets when the old principle of uncorrelated assets seems no longer to apply?

Cern Basher: First, one must remember that diversification works over time, not all the time. When everyone is trying to sell assets during a time of crisis, all assets become

correlated. As long as one doesn't become a forced seller, the forced actions of others can be used to one's benefit.

Second, there is a trade off between protecting the value of assets over-time vs. protecting assets overnight. Short-term government securities or bank accounts are the best vehicles for protecting assets overnight. But, don't expect them to protect assets over-time as the ravages of inflation will eat away their purchasing power. In order to protect assets over-time one must give up the idea of protecting their value overnight. Short-term volatility is the price one pays for longer-term protection of purchasing power.

Third, it is important to get the right mix of stocks, bonds and cash. This is why we focus on finding out how much equity risk our clients need to take to meet their goals. If you take only the risks you need to take, then you aren't surprised or worried about market events like those we've experienced in the last year.

Kirk: It's often said that professional advisors, especially those not guided by technical indicators, are subject to the same emotions (fear, greed, etc.) as everybody else. Apparently, Wall Street is not immune from the powerful influences of human nature that affect Main Street at market tops and bottoms. How does Madison avoid the "emotions trap"?

Cern Basher: Sadly, I think this is true. After all, we are all human and strong emotions are certainly part of the human condition. At Madison, while we are not infallible, we try very hard to recognize our limitations and when we are at risk of acting emotionally. Coupled with the experience embedded in our team, we have a disciplined financial planning process (not a perfect one) and a disciplined investment process (not perfect either) that guides us.

Kirk: In your [April '09 Insight](#), you point out that in the 13 trading days between March 9 and March 26, the S&P rose +23%—"the quickest bull market in 70 years (a bull market defined by a rise of 20% or more)". You make the point that since no-one knows when such explosive rallies will occur, it's important to be invested at all times. But isn't it true that there's another half to the "fully invested at all times" theory—namely, you must SELL somewhere along the way?

Cern Basher: Our premise is that no one can consistently predict the future. So for us, trying to time the markets in any way is futile. We know our limitations: our clients' interests are not well-served by us attempting to call the highs and lows. As I mentioned earlier, we build portfolios to support our client's needs. Note: I should point out here, that for most of our clients we are allocating their portfolios among various asset classes, sub-classes and sub-advisors. In all but a few cases we don't select individual securities. My comments here pertain to the actions we take at the portfolio level, not at the security level. Most of the time our sub-advisors are responsible for making the individual buy/sell decisions at the security level where the timing of buying and selling is an important endeavor.

So in our view, investors should sell for the following reasons. First, if money is needed to meet a spending need. Hopefully, the investors have prepared for this in advance and have

built up a cash reserve to meet their spending needs. We don't ever want our clients to be forced sellers. Second, rebalancing activities often necessitate the need to sell. At Madison, we conditionally rebalance back to pre-determined asset class, sub-class and sub-advisor allocations. Third, if a client's goals change, this will often necessitate a change to the portfolio's asset allocation, causing further changes to the asset class, sub-class and sub-advisor allocations.

Kirk: You also recently addressed the “buy and hold” debate. We all know that buy and holders seem to be very much on the defensive after watching the value of their holdings sink below levels of 10-12 years ago despite a big jump in earnings over that time. You have defended “buy and hold” by saying “no one can time the market”, citing the Dalbar study which shows how notoriously bad investors are at timing the market, buying high and selling low.

Let's say you have confidence in a technical source that is reasonably good at identifying “oversold” and “overbought” markets—realizing, of course, that such markets are likely to become even more overbought or more oversold. Would you agree that a simple strategy based on buying in markets or in an individual stock widely considered “oversold” and selling when “overbought” is likely to yield better results than just holding and riding up and down?

Cern Basher: While I am skeptical of such strategies (they seem to work for a while and then stop working) I am all for sticking with a disciplined approach. I think folks tend to get themselves into trouble by bouncing around from one good trading idea or strategy to another.

The investor behavior penalty observed in the Dalbar study is staggering. The Dalbar study looks at mutual fund investors' actual returns over twenty year periods. In the most recent study, from 1989 thru 2008, they found that investors' actual returns underperformed the same mutual funds they invested in by 6.5% per year! That's right, 6.5% per year for twenty years. The only way to achieve such poor results is to buy at the wrong time (too high) and sell at the wrong time (too low). That is an absolutely unbelievable price to pay for poor behavior. If we as advisors help our clients capture all but 1% (our fee), then we've added tremendous value.

Kirk: How has your investment approach evolved and changed over the years?

Cern Basher: First of all, for me personally, what I do has changed a lot. As an analogy, I've evolved from looking at grains of sand, to building sand castles, and now to surveying broad landscapes. I started out in this business as a research analyst looking at specific companies. Then I moved to building and managing portfolios of individual securities. Now I focus more on building portfolios containing a variety of sub-advisors to meet our clients' specific needs. It's not that focusing on specific companies and building portfolios is unimportant work, but the biggest impact we can make for our clients is helping them stick with a plan that's designed for them. As the Dalbar study showed, there is plenty of opportunity for advisors to add value by simply keeping clients from making big mistakes. Which securities and which funds you own are secondary.

Second, at Madison our approach has also incrementally evolved and been refined over time. This is a continuous process. As additional investment products have become available, we've incorporated some of them into our clients' portfolios.

Kirk: In previous Q&A sessions (like with [Mebane Faber](#)), there are strategies that have proven to be quite effective in limiting downside exposure and help to preserve capital during the inevitable bear markets. Is it your view that these market-timing strategies are inherently flawed and unsound or is it just a better business practice for you and your firm not to be involved in market-timing approaches because it doesn't match your firm's no-market-timing philosophy?

Cern Basher: Largely the later. That said, I am skeptical of market timing strategies. I would have a lot of questions. How does one ensure that the claims made by the proponents are truly accurate? If a market timing strategy works for a particular individual over time, are there any limits on the number of people that could replicate it without destroying it? How does one account for survivorship bias? What are the limits to a particular market timing strategy in terms of capital that can be applied to it? But, admittedly I have not done the necessary work to be able to take a stand and say that "market-timing strategies are inherently flawed and unsound." So we simply stand aside and let others focus on this.

Kirk: Admittedly, if large numbers of disenchanted investors did abandon the buy and hold philosophy, wouldn't that be a severe blow to the investment advisory business?

Cern Basher: I suppose so, but we have faith that enough people will not abandon sound investment principles. At Madison Wealth Management, we advocate portfolios should serve our clients, not the other way around. This doesn't mean blindly following a "buy-and-hold" strategy. Instead it means following a strategy that is designed to deliver the results our clients are looking for, with the greatest probability for success and within the set boundaries. And it doesn't mean that the strategy should never change, but the changes should not be dictated by what may happen in the financial markets today or tomorrow. Changes to our client's investment strategies should be driven by their changing needs, plans, goals and dreams.

Kirk: Do you think your going through recent markets of historic severity and volatility has made you a stronger and wiser firm? Why or why not?

Cern Basher: Absolutely. We all continue to learn a great deal. While we don't have all the answers, we know more of the questions to ask and we've become better advisors (still not perfect).

Kirk: I assume most of your clients come to you with existing portfolios. Do they always require immediate changes? If a client starts with a clean slate, do you automatically invest all the funds at the time the account is opened or do you sometimes wait or dollar cost average if the market is widely perceived as "extended"?

Cern Basher: Some clients come to us with existing portfolios that were managed by other advisors. In many of these situations, it's not the portfolio that was the problem.

Perhaps the advisor didn't establish a relationship with the client, consider her whole financial picture, proactively work with her other advisors, or communicate on the level she desired. There are many reasons why clients may choose to work with us, and what we recommend for them on the portfolio side may be a minor reason.

Regarding whether we invest all the funds at the time an account is opened: First, we don't attempt to time the market. We don't claim to know if the market is extended. Second, we defer to our client's wishes on this. If they want us to invest a large cash position over time, that is perfectly fine with us. Third, typically a portfolio in transition may have been fully invested one week ago, so generally we would look to reinvest the portfolio relatively quickly. We would only reinvest the funds once our financial planning work was completed and we begin this only after someone becomes a client. Therefore, there could be a period of time during the transition where we have access to the client's accounts, but haven't yet agreed on an investment strategy. And fourth, if a portfolio consisted of a large cash balance that wasn't previously invested and it was left entirely up to us to invest, we would still proceed with some caution. Murphy's Law tells us that as soon as a portfolio is fully invested, the market will drop 20%! It's never a good idea to begin a new client relationship with a 20% drop out of the gate.

Kirk: How often do you rebalance to your target allocations? Any rules of thumb to share?

Cern Basher: The most important thing in rebalancing is to actually do it. And, it often makes the most sense when it feels least "right." At Madison, when money is added or withdrawn from a portfolio, we take the opportunity to do some rebalancing. Otherwise, we look often and rebalance when it makes sense. Whether something "makes sense" is hard to define, but we have to consider the tax impact, the trading cost, and the frequency we've been rebalancing. In more normal market conditions we don't want to rebalance too often as we don't want to "cut a move off at the knees" before our clients' portfolios benefit from it. That said, we'd rather be faulted for leaving the party too soon than over staying our welcome.

Kirk: Can you recommend any good software tools to help determine appropriate asset allocation ranges?

Cern Basher: There are many good software tools available today, but we use a tool that is only available to advisors, so I don't have any specific recommendations for your readers. The important thing to remember when using software tools is that they are simply tools. It takes some skill and experience to operate them. A lathe in my hands isn't much good. It's also important to remember that the results the tools produce are directional in nature and are not to be etched in stone. There are simply far too many variables to model to get perfect results and clients' personal circumstances frequently change. That said, the tools can be used to test various asset allocation scenarios so that you can arrive at a range that is acceptable.

Make sure you use a software tool that factors in some element of variability of investment returns. This is known as Monte Carlo analysis. They aren't perfect as the real world doesn't fit under a bell curve. However, it is even more dangerous to assume a straight line

return, how ever conservative it may be. Adding some random variability to a return pattern at least helps to simulate some of the uncertainties that are likely to be encountered in the real world. Just because someone might have a 90% probability of meeting all their goals doesn't mean that you can forget about the 10% that result in negative outcomes. While the probability of success might be high, it's the consequences of the bad outcomes that need to be examined.

Kirk: You emphasize that diversification is not a short term but strictly a long term strategy. Has the recent “no place to hide” bear market caused you to raise your estimate of about how many years it will take, on average, for a long term strategy like diversification to work?

Cern Basher: No, but I can tell you it will take the diversified investor several years less than it will take the non-diversified investor to recover the losses. We've always understood that diversification doesn't always work – meaning that sometimes everything in a portfolio heads in the same direction (usually down). There will be times when events occur that have the potential to reduce the price of almost every investment. We've just experienced such a time. Fortunately such events don't occur very often, but perhaps more often than we'd like. While diversification doesn't protect against losses, it certainly helps to lessen the likelihood that something will destroy a portfolio. In our view, a diversified investor should be excited when markets go down, because they really represent opportunities to buy things on sale. Capital losses are not permanent for truly diversified investors. For an investor who is not diversified, capital losses maybe permanent, especially if a few of their large positions go bankrupt.

Kirk: Is there any time when your portfolios will include short positions?

Cern Basher: No

Kirk: You have previously noted the dramatic increase in life expectancy from an average of about 25 for most of human history to 47 in the US in 1900 to 78 in the US today. As you point out, a 65 year old retiree in good health today might look forward to another 25 to 30 years. In fact you reveal that your firm runs financial scenarios using a life expectancy of age 100. Doesn't the challenge of additional decades of spending needs after retirement conflict with the traditional belief that one should reduce equity exposure as retirement approaches—i.e. where will the growth kicker come from to deal with additional years of expenses and to protect against inflation?

Cern Basher: Great question! Yes, the old rules of thumb of 100 or 110 minus your age equals your equity allocation really doesn't apply. Our work has shown that someone's required allocation to equities has nothing to do with their age. It's dependent on their financial resources, how long they will need to draw income from their portfolio and, most importantly, their level of spending in retirement. Now, this doesn't mean that everyone should maintain a high equity allocation as they grow older - just that one's age is not a variable.

Kirk: You are careful to define risk, not as the possible loss after purchase of a stock but the loss of purchasing power over time. Are you in the “sooner” or “later” camp when it

comes to prospects for inflation and what are you doing now to protect your clients against that eventuality?

Cern Basher: Sooner and later. We are always worried about the potential long-term loss of purchasing power. While most people worry about the decline in their portfolios and focus on how much money they've lost, we are more concerned with positioning them so that they can live the life they want to live 30 years from now. We are building portfolios to provide income for periods of multi-decades. So, we don't judge whether we've been successful in that goal by how a portfolio has held up during a market decline like this. This also points out the dangers of trying to time the market – if you miss a big upswing like we've had since early March, how do you ever regain the opportunity to protect the purchasing power of your money if you are not invested in the instruments that can offer it? With that lens, today's market movements can be put in the proper perspective.

Inflation fighters include equities, commodities, real estate and some fixed income instruments that have built in inflation adjustments.

Kirk: If a client asked you for a good place to put cash with no downside risk and maximum amount of safety income, what would you recommend?

Cern Basher: A boring, but safe FDIC insured bank account up to the coverage limits. Those two goals (no downside risk and maximum amount of safety income) are conflicting. Whenever I hear two conflicting goals, I focus on the one with the least risk. If you focus on the one with the highest risk, chances are that something bad will happen. Remember the folks who purchased auction rate notes? They purchased an instrument with a long-term maturity but paid short-term rates. Without realizing it they gave up liquidity for a little extra yield. This was fine until that wanted the money and realized they couldn't get it (without selling at the discount and realizing a loss). The loss of principal is much more painful than the enjoyment of the extra yield.

At Madison, we have a relationship with a local bank in Cincinnati where clients of our firm can open an FDIC insured checking account and receive a yield on their cash greater than 2% (but less than 3%). We don't derive any benefit to our firm (e.g. we don't earn any fees from the bank for bringing our clients to them), but our clients get to enjoy an attractive return on their cash holdings in this very low rate environment. A small, but in some cases meaningful, value add.

Kirk: In evaluating new clients' portfolios, what are some common mistakes you tend to find?

Cern Basher: We see a lot of great looking portfolios and numerous mistakes! I'll highlight just seven of them here:

1) Portfolio full of products: Some portfolios are full of products that were sold to them by brokers (who made a lot of money in commissions). Some of the products needlessly lock up the investor's money and subject it to back-end charges. The problem is that the investor's situation can change over time and the investor might need access to some money.

2) Asset collectors: Some investors are collectors. Having 50 different funds doesn't mean that you are diversified. Most of these portfolios weren't designed to support someone's overall financial plan or goals.

3) Too much risk: Some portfolios contain security concentrations or sector concentrations that are just not necessary. For example, holding on to a large position because of a reluctance to reduce risk simply to avoid paying capital gains taxes is a big mistake. You just have to ask those folks around the country who held large positions in local bank stocks to see the impact of this.

4) Asset location: Some investors put the tax inefficient investment vehicles in the wrong accounts. Income producing investments that are subject to one's marginal tax rate should be placed in tax-sheltered accounts, if possible.

5) Over investing in one's company: Many investors have a lot of stock and options in the company they work for. Not only is a large portion of their portfolio subject to the ups and downs of their employer, but so is their income. Chances are they lose their job at the same time their employer's stock is down 50%.

6) A focus on income not total return: Some investors, especially those who are already relying on their portfolios for income often just focus on generating maximum income. They tend to forget about the other component of total return, and that's capital appreciation or depreciation. Also, in going after high income, many investors unknowingly subject themselves to leverage, further magnifying the potential downside.

7) A lack of rebalancing: Some investors never rebalance. Some don't have an asset allocation target, so it's impossible for them to know what to rebalance to. So over time, their equity (i.e. risk) exposure grows and grows. This works nicely in a rising market, but during a market decline they have no cushion.

Not every portfolio we see has a flaw. Many portfolios are well constructed and would serve the client well. Many clients hire us not because we are going to rip up and rebuild their portfolio, but because we offer the kind of advisor/client relationship they are looking for. Other things like trust, communication, planning, reporting, etc. all matter and in many cases are far more important than the portfolio.

Kirk: You quote Shelby Davis as saying, "*People make the bulk of their money investing during a bear market. They just don't know it at the time.*" Do you significantly increase your commitment to the equity portion of your portfolios during bear markets? In essence, what do you do differently in a bear market than a bull?

Cern Basher: Nothing different. We just try to maintain the courage of our convictions and discipline to do the things we know will help our clients. If we knew a bear market would be no worse than a 20% decline, then we would recommend adding to one's equity allocation after such a decline. But, since we don't know whether a 20% decline will turn into a 40% decline, a 60% decline or an 80% decline, we don't ever suggest to our clients that they should increase their equity exposure just because the market is down.

Kirk: With the Dow down some 6,000 points from its October 2007 high and up less than 1,500 points from its low, you would still expect to find plenty of “bargains” around. Is it easy or difficult for you to find long term values in today’s market?

Cern Basher: What lens can I use? When looked at thru a long-term lens, it’s easy. When using a lens of where things were a couple of months ago, it’s harder.

Kirk: Looking ahead, do you see any investment themes or trends that you believe offer exciting opportunities over the coming years?

Cern Basher: No, I’m not bold enough to say anything specific (that hasn’t already been said by many others). But we do have faith in the future. We believe that our children will live better than we do. We believe that the pace of all the scientific, medical and technological progress will continue. And, we believe that this will create untold investment opportunities in the future that don’t exist today. There will be many “Googles” and “Microsofts” in our future. It will be an exciting time to be an investor.

Kirk: You note that, historically, 10 year periods of very low return have been followed by 10 year periods of considerably higher returns. With that in mind, are you now investing more than usual in larger US company stocks?

Cern Basher: No. This observation leads us to not shy away from investing in stocks of all types. This year we’ve increased our allocation to sub-advisors focused on global opportunities. We had two main reasons for doing this. First, the investment opportunities more than ever are now global and we wanted our clients to benefit from higher economic growth outside the U.S. This doesn’t mean that the actual allocation to international equities has increased, as the sub-advisors might have increased their exposure to the U.S. within their global mandate. So the second reason was that we wanted a portion of the domestic/international balance within our client’s portfolio to be determined by sub-advisors who are constantly weighing the benefits one investment at a time. Their job is to find the best investments in the world wherever they may be.

Kirk: You stress the importance of taking a global view. On what parts of the globe, in particular, are your portfolios focused?

Cern Basher: On every continent but Antarctica. Too many penguins there and all the markets are frozen! This doesn’t mean owning everything on every continent, but it does mean looking everywhere for opportunities. It’s well known that most investors have a home country bias. That is, they concentrate their portfolios in stocks of their home country. Canadian investors own too many Canadian stocks, U.S. investors own too many U.S. stocks, etc. There are some very good reasons for this. Foreign stocks can be expensive to trade, hard to obtain good information on and foreign investors might not be offered the same protections as domestic investors. Also, since U.S. based investors spend U.S. dollars, not Chinese Yuan, it makes sense to own U.S. dollar investments. That’s all true, but the world is changing right under our noses. Many of our biggest companies now have more foreign sourced revenue than domestic sourced revenue and some foreign based companies have the U.S. as their largest single market. If you limit yourself to just U.S. based companies you are effectively reducing your investment opportunity set, somewhat

arbitrarily based on where a company's headquarters happens to be. That doesn't make any sense to us.

What I'm not advocating here is putting your entire equity portfolio in international stocks. There are lots of other factors to consider. Nevertheless, we find ourselves cheering for global growth rather than rallying against it. Our clients are positioned to benefit as the global economic pie expands.

Kirk: If anything, portfolio design is becoming tougher in a world flooded with choices. Most have too many mutual funds, ETFs, stocks, options, alternative assets, and strategies to consider. How do you suggest investors confront and overcome this obstacle?

Cern Basher: The shameless answer is: Hire a professional! For the individual investor this can be daunting. For the professional investor this choice is absolutely great. We have the tools to sift through the investment products and the skills to craft a portfolio.

The less shameful answer is to say that it can be done fairly simply. All this product choice is like a fully stocked grocery store. My local grocery store has hundreds of thousands of products in there. I don't feel overwhelmed when I go there because I carry a list with me of what to buy. I can safely ignore the 99.95% of what I don't buy. For investors to do this, it means following a pre-determined investment philosophy (going after "high returns" is not an investment philosophy!) and using consistent criteria to select among the options that fit your philosophy.

Kirk: I've long been partial to utilize index funds, ETFs, and stocks as primary investment vehicles. From my understanding of your firm, you primarily utilize mutual funds for your clients. Is this true and, if so, can you provide explanation to your firm's bias in this respect?

Cern Basher: We can and do use passive vehicles like index funds and ETFs. But yes, we generally have a bias for actively managed funds. It's not a strong bias, but there are two main reasons.

First, index funds aren't the passive vehicles they are made out to be. Some are rebalanced annually, resulting in large turnover. Others are changed by committee, often resulting in poor choices. The biggest issue we have with index fund investing is that index compositions are impacted by investors. For most indexes the market cap of a company determines its weight within the index. This can result in distortions when investors are overly enthusiastic or fearful about a single company or sector (i.e. the technology sector bubble). We generally prefer to let our sub-advisors determine the appropriate weight of investments in a portfolio rather than rules.

Second, while we clearly understand that the average equity fund underperforms the market, we aren't confining ourselves to all equity mutual funds. We narrow the field down using our sub-advisor selection criteria. We filter out all the mutual funds that are products designed to be sold to investors. What's left are a small number of funds that have good long-term track records, reasonable expenses, and sub-advisors whose incentives are aligned with shareholders. All of this doesn't guarantee that the funds we select will be as

good in the future as they were in the past, but it does improve the odds versus the entire universe of available mutual funds.

We believe that the truly great long-term investors can capture the investor behavior penalty that's highlighted in the previously mentioned Dalbar study. And, if we can help our clients stay invested during the tough times, then they can enjoy some of the excess returns versus other investors. And with good selection, this gives us an opportunity to earn back the fee we charge our clients for all of our services. While it's not an expectation, we feel pleased if we can do this over time.

Kirk: After you do your due diligence, isn't it rare that you drop a manager, especially in light of the Cambridge Associates study which, as you point out, showed that equity managers that were fired outperformed their replacements?

Cern Basher: Yes, in a 2003 analysis of their clients, Cambridge Associates, an investment consulting firm to foundations, endowments, and other large institutions, found that 92 institutions in the period from 1996 to 2001 indicated that the decision to switch asset managers, often on the basis of short-term criteria, usually resulted in the destruction of value. Their analysis found that the fired equity managers outperformed the hired equity managers in 58% of the switches in the next year and in 60% of the switches over the next three years. That's a pretty poor record!

So yes, we try to be aware of this fact and we never fire a manager just because of poor short-term investment results. In fact, we expect that all of our managers, or sub-advisors as we refer to them, will deliver poor short-term results over multi-year time periods. It is simply unrealistic to expect anyone to be different from a benchmark and to consistently outperform that benchmark quarter in and quarter out. In fact, a study by Davis Advisors found that 98% of top-performing large cap investment managers' (whose 10-year returns ranked in the top quartile from Jan 1, 1998 to Dec 31, 2007) rankings fell to the bottom half of their peers for at least one three year period. A full 75% of them ranked at the bottom quartile of their peers for at least one three year period and 43% of them ranked in the bottom decile for at least one three year period. Firing these managers during their difficult periods would have been a big mistake.

Kirk: If even the most successful portfolio managers go through periods of under performing their peers how do you determine whether such weakness is likely to be temporary or a sign of more serious problems?

Cern Basher: It's not easy, but looking at their recent past performance results certainly won't tell you. First and foremost, you have to gain an understanding of how they produced their results and test whether the factors that allowed them to produce their long-term track record are still in place. Are the management team and research team still in place? Are they still motivated? Are they staying true to their investment strategy? Are their incentives properly structured? What distractions do they have? Even after obtaining answers to those questions, it is still not a guarantee that successful sub-advisors will find a way to continue being successful. This is why we also diversify the portfolio by sub-advisor.

Kirk: In his op-ed piece in the NY Times on 10/17/08, Warren Buffett said, “*Bad news is an investor’s best friend.....This market will likely move higher, perhaps substantially so, well before either the economy or sentiment turns up.....If you wait for the robins, spring will be over....*” Do you think this applies to long term investors now waiting on the sidelines for the market to go back down to where it was a few months ago?

Cern Basher: Yes, but not because I think one way or the other that we’ve seen the bottom of this market cycle. I can’t predict which way the market will go in the near term, so in my mind, to tie one’s investment strategy on something you can’t predict makes a difficult task that much more challenging. I would counsel that investors should invest when they have the money, not based on where they think the markets are going. This is hard to do, because we all bring our own views to the table. But, most likely, our views turn out to be largely unfounded, so it’s best to invest independently of what your brain is telling you about the possible direction of the market. This doesn’t mean that you should leave yourself exposed. You still have to determine how much of your savings should be invested in equities before you willy nilly go investing.

As a side note, at Madison we believe that markets don’t always have to be right or even function properly all the time to be able to use them to your advantage. Remember we are dealing with auction markets, where the price of everything is set by the last buyer and the last seller. Sometimes buyers don’t show up (and prices fall) and sometimes sellers don’t show up (and prices rise). The vast majority of equity owners don’t do anything. We counsel our clients to not worry too much about what other people are buying and selling their investments for. After all, if you don’t need to sell any of your investments for a long time, then why worry about what others are selling them for? If other people are “losing their cool” why let them make you lose yours?

Kirk: Author Jason Zweig says that the factors that determine long term investment success are the exact opposite of the ones that tend to create short term success. Does that mean, in your opinion, that successful short term traders are apt to be poor long term investors?

Cern Basher: In many ways they are two very different skill sets. I suppose if you are wired in a way that makes you a good short term trader that those skills could work to your disadvantage for longer time periods. That said, I don’t assume it has to be the case. I don’t believe that all short term traders are doomed to be poor long term investors.

Kirk: Is the setting of unrealistic goals by your clients a frequent problem?

Cern Basher: No, it’s only a problem for people who aren’t yet our clients! Seriously, our planning process helps our clients identify any goals that are unrealistic and we help them prioritize which goals are the most important. We’ve never had anyone tell us that they are willing to take as much investment risk as possible to achieve all their goals.

Kirk: “Know thyself” is a widely perceived key to investment success. Would you say that most Madison clients have a good understanding of their emotional selves, i.e. a true understanding of their likely reaction in very bad and very good markets? How much of a hindrance or a help is this in the performance of your job?

Cern Basher: In my view, this is the most difficult aspect of investing. Even if you understand how you will react in very bad and very good markets, it's another thing to not be swayed by it. And, even if you don't allow your emotions to sway your decisions today, you might not be able to stay on track tomorrow under a different set of circumstances. As advisors, this certainly adds another element to our jobs. Sometimes it helps and sometimes it makes it more difficult. For example, if someone reacts to a rising market by feeling more greedy, they might be motivated to save more (which is an important action people can take to reach their goals independent of what the market does). On the other hand, if one reacts to a falling market by doing something to their detriment, this can be very frustrating for us. However, at the end of the day, we can only offer advice.

Kirk: Do you ever wonder how affluent clients who know so little about investing money have been able to accumulate so much of it?

Cern Basher: Accumulating money can come from earning lots of it or from investing wisely. Some folks end up with \$10 million by starting with \$20 million and making lots of mistakes. Others end up with \$10 million by starting with almost nothing. Of those that start with nothing, some of them achieve it by working harder than others while others are able to drink Cherry Cokes all day and use the misfortunes of investors to their advantage. The formula for monetary wealth goes something like this: ending wealth = beginning wealth +/- brain power +/- skill +/- effort +/- emotional stability +/- behavioral maturity +/- luck (squared). Luck is a big part of the equation.

Kirk: Do you believe individual investors have an equal chance to profit from the market as much as the professionals? Why or why not?

Cern Basher: Yes. It used to be that professional investors had an informational advantage. Today that may not be the case (although professional investors can get access to information and people that the average individual investor can not). In our view successful investing is more about emotional and behavioral actions than intellectual abilities. That is not to say that brains and information don't matter, but it only gets you so far.

Kirk: Many of my members are short term traders, most part-time, some full-time. But at some point in their lives, they will stop earning income from their trading and instead rely on their investment portfolio for support. What advice can a long term oriented investment counselor like yourself give short-term oriented readers that may be helpful in achieving their retirement security?

Cern Basher: Build a food cache. Since most food won't keep very long, you must build up a personal cache of money so that you can buy food and other items at some future point. Unless they plan on trading until the day they die, it is important to build a personal money cache. At some point in their life, they will likely want to switch from earning an income from working (i.e. trading) to earning an income from their savings and investments. How much they need to save is dependent on how much they will need from their portfolios after their "trading days" are over and how much investment risk (if any) they are willing to take. I'd imagine that traders have to build an income reserve or cache for those periods when their income from trading doesn't cover their expenses. The same

thinking applies to the time at the end of their trading careers when they will need to draw an income stream from their own resources to supplement any other retirement income streams.

Kirk: There are those in this business who find the job of making more money for people who already have it - unrewarding. They find work outside the office (hobbies, sports, volunteering, etc.) far more fulfilling. Where do you come down?

Cern Basher: I try to find a balance in all that I do. Sometimes it is hard to find that balance, but I'm always thinking about finding it. I enjoy doing a lot of different things. Some of those things help me be a better advisor (i.e. reading and learning) and others recharge me (i.e. family and exercise activities).

I love this type of work. This is really important stuff. Our clients are putting us in charge of a lifetime of their savings. We are impacting lives. I really enjoy seeing folks achieve their goals. I find it very rewarding to help people, regardless how wealthy they may be, make smart financial decisions. I enjoy working to ensure our clients have the financial resources they need in place for their lifetimes. Maybe they don't need the extra millions, but over time a lot of good can come from growing and preserving wealth. Whether it's spent, which creates income for others, or given away, it's all good.

Kirk: If you weren't in this business what would you like to be doing? Do you have any consuming hobbies?

Cern Basher: I can't imagine doing anything else. Like Warren Buffet, I'm glad that I don't have to roam the land and kill something in order to eat.

Kirk: Finally, if you had one piece of advice to share with all traders and individual investors what would it be?

Cern Basher: Know the edge of your competence. If you find that you are going beyond it, seek help. When seeking help, don't seek validation, but someone who can point out the risks you are taking. Don't compound risk by taking on risk where it's not needed.

Kirk: Thank you Cern.

** Madison Wealth Management is an SEC registered investment advisor with offices in Cincinnati, Ohio and in the Washington DC area. Madison works with their clients wherever they may live in the United States. Madison can be found online at www.madisonadvisors.com and you can subscribe to their monthly Madison Insight [here](#).*

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