

FUNDAMENTALS OF PRUDENT INVESTING

by
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George Pendergast, a managing director at Cambridge Associates, and Beth Rabbitt discuss in the following article the fundamentals of prudent investing, including asset allocation, diversification of investments, and rebalancing of investment portfolios. Since 1999, the American College of Surgeons has engaged Cambridge Associates as its investment consultant in the management of its endowment funds. Using the fundamentals presented here, surgeons can apply this investment knowledge and simple strategies to the management of their practice. How? By understanding how asset allocation drives investment returns, which will prove critical when planning for expansions, purchasing equipment, and budgeting for future expenses in your practice.

Mr. Pendergast will also be presenting this topic at this year's Clinical Congress in Chicago, IL. Because this information will lay the foundation for improving your investment knowledge, it will be offered twice, one session on Sunday (GS112) and one on Monday (GS113), at times the College hopes will be most convenient for meeting attendees.

—*Thomas R. Russell, MD, FACS,*
ACS Executive Director

When thinking about successful investing practices and asset management, many harbor the stereotypical *Wall Street Week* mentality—with a broker on speed dial and a gazillion megabytes of Internet analysis and information on hand, you can operate with the certainty that there are endless opportunities out there to buy unfollowed stocks at \$5 and sell at \$300, achieving amazing day-trading profits and a portfolio that *always* beats the market.

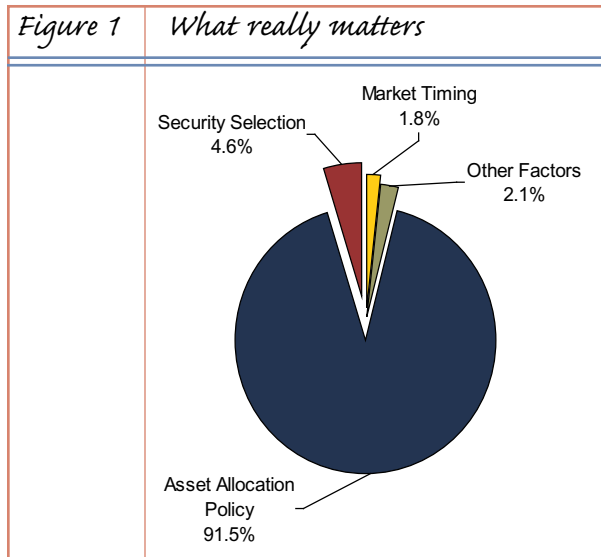
Although this notion is romantic, it is hardly practical for the rest of us. Picking individual investments is a risky and time-consuming proposition and the whole process of personal investing in this fashion can be intimidating and overwhelming. However, as will be discussed in this article, successful, prudent personal investing does not require preternatural short-term abilities, but rather long-term focus, discipline, and perspective. Using the right tools in your own portfolio can simplify the process and help ensure that you meet your goals. To use a tired Boston investing adage, “It’s a marathon, not a sprint.”

What is investing for long-term success?

Although it is tempting to focus on the short-term results of investments (for example, my portfolio is up 4% this month, down 2% the next), it is more important to think about your goals with a long-term perspective. When preparing for future retirement, we are often talking about time periods of 10 years or more, not days or months. The strategy needed to have investment gains over the long haul is very different from that of choosing an individual investment and measuring its performance on a day-to-day basis. Most stocks perform well at some point in their history. When investing for your future, what you want is more than incredibly good returns at one point in time. What is needed in this case is a consistent pattern of long-term performance.

What really matters in long-term investing? Most people point to individual stock selection and market timing as the number-one factor

Figure 1 What really matters



in success.* However, the findings of several researchers are powerful reminders that what people think does not necessarily translate to reality. (See Figure 1, this page.)

It turns out that what is most important is not the specific stocks you pick but the overall composition of your investment portfolio or asset allocation. This crucial composition accounts for 90 percent of your investment results over time.

The bottom line is that, although it is tempting to think that investment success is mostly about being great at picking individual stocks—a myth many day-traders take to the extreme—in the long run, it is the allocation of your assets that really drives performance. The impact of market timing and individual stock selection pales in comparison to the impact of getting your asset allocation right. Once you have put the time into creating an asset allocation policy that is right for you, given your timeline and objectives, what is really required is staying focused and being disciplined in implementing your investment plan.

*Brinson GP, Singer BD, Beebower, GL. Determinants of Portfolio Performance II: An Update. *Financial Analysts Journal*. May/June 1991.

Creating an appropriate personal asset allocation policy

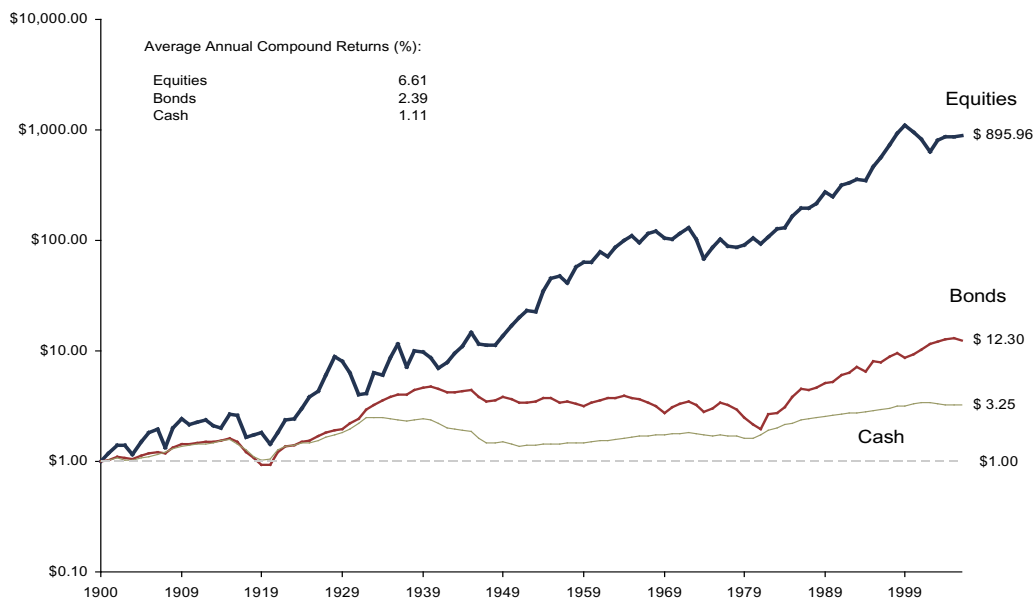
All investments share two common characteristics: return, or how much an asset increases in value over time, and risk, or how volatile the value of the asset can be on a short-term basis (in the investment world, risk is often measured in standard deviation). Generally these two characteristics have a positive relationship—as expected return increases, so does risk.

Creating a personal asset allocation therefore starts with one simple decision: How much return do you want and how much risk are you willing to accept to get it? This fundamental

tradeoff should form the basis for any investment decision you make.

The choices people make usually are dependent on their investment horizon (when they plan to retire or will need to tap into their funds) and their own affinity for risk. A highly risk-averse investor—for example, a surgeon who plans to retire in a few years—will most likely decide to choose an allocation with lower return in exchange for the security of knowing that the chance of losing a portion of his or her assets is slim. Conversely, recent medical school graduates with 40 years before retirement can invest more aggressively because they have a longer time to both see the returns on their investment as well as recoup any losses in down periods.

Figure 2



Bureau of Labor Statistics, Citigroup Global Markets, Common-Stock Indexes (Cowles Commission), Federal Reserve, Global Financial Data, Merrill Lynch & Company, Standard & Poor's, and Thomson Datastream. Cumulative wealth indices are shown on a logarithmic scale.

Tools of the trade: Equities, bonds, and cash

Given that inflation averages approximately 3 percent a year, you need to seek a return of greater than that to merely preserve your personal wealth. When it comes down to it, most amateur

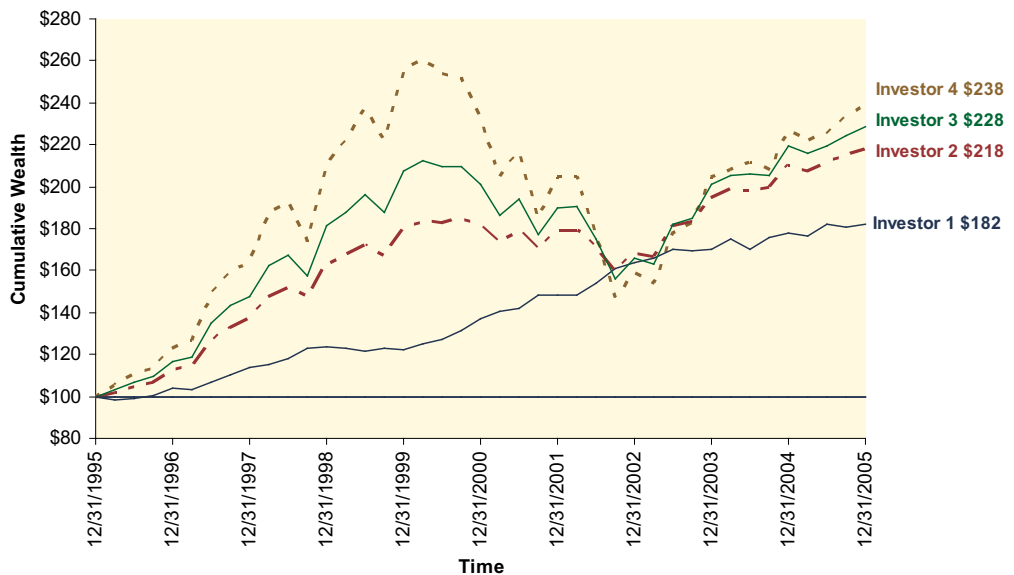
market watchers have three choices for investing assets: stocks, bonds, and cash. Stocks (or “equities”) offer the highest potential for return. However, they are generally the most volatile. Bonds offer a safer bet, but in most markets, you can expect a significantly lower return. Cash and

Table

	Investor 1	Investor 2	Investor 3	Investor 4
Percent invested in U.S. stocks	0%	50%	70%	100%
Percent invested in U.S. bond	100	50	30	0
Expected real return after inflation	1	3.4	4.3	5.8
Expected risk (standard deviation)	7	9.9	12.3	16.5

These data use the S&P 500 Index as the basis for a U.S. equity investment and the Lehman Brothers Aggregate Bond Index as the basis of a U.S. bond investment.

Figure 3



its equivalents, such as money markets, are a safe bet for short-term use, but you can incur a higher opportunity cost (or loss of benefits from investing those funds elsewhere) for holding on to too much of it.

Figure 2 on page 23 shows the cumulative real gain of a dollar invested in the three asset classes since 1900. As you will see, stocks clearly beat bonds and cash in the long run, providing the highest return over time.

However, what also is clear is the fact that stocks are more volatile, and the variability of the peaks and valleys in the return line in Figure 2 shows this fact. If you invested 100 percent of your assets in stocks at the wrong time, you could risk losing a significant portion of your assets in one year alone. In order to hedge against this downside risk, you need to use an asset allocation that is appropriately diversified. Diversification is a powerful tool for reducing overall risk and increasing the probability of achieving a consistent pattern of returns.

The case for diversification

Despite the fact that it is a cliché, the old saying that you should not put all of your eggs in one basket is particularly true when it comes to personal investing. The more diversified you are, the better return you can get for any given amount of risk.

The Table on page 24 shows the risk and return profiles of four investors with four different personal asset allocations. Investor 1 is highly conservative, investing all his assets in a U.S. bond fund. Investor 4, on the opposite end, is highly aggressive, putting all her cash into the U.S. stock market fund. Investors 2 and 3 take a more moderate approach, investing their assets in a mixture of U.S. stocks and bonds.

If each of these investors invested \$100 dollars in their respective allocations, rebalancing their portfolios back to their targets over a 10-year period, where would they be now? Figure 3 (page 24) simulates the returns of the four portfolios.

Despite the fact that Investor 4 does end up in a marginally wealthier position at the end of the 10-year period, this investor experienced a

much higher level of risk and endured a roller-coaster ride in the market. Depending on when she needed to retire, the probability of being able to predict her financial position would be low. Conversely, through diversification, Investors 2 and 3 experienced a much smoother ride with less risk and more certainty and enjoy returns in the end that are fairly comparable to the more aggressive position.

Obviously, this scenario simplifies the story a bit. As an investor today, you have many options beyond just investing in U.S. stocks and bonds. Mutual funds offer an opportunity to access a more diverse group of investments through a pool of funds than you would on your own. Global investments also offer a way to diversify into different markets. Finally, investing in specific sectors such as real estate or energy can also tap into new opportunities for return and tend to be less correlated with one another, which is another way of diversifying your risk.

What now?

Meeting with a financial advisor can be a great way to start the process of creating a diversified asset allocation that fits your time horizon and objectives. Many mutual fund companies will offer free assessments online or in person. Once you have figured out an allocation that works for you, stick with it. Consistent rebalancing back to your targets on a regular basis (such as annually) will lower your risk and help you meet your goals. Rebalancing requires diligent discipline, primarily because it often means selling your most successful investments and adding to your underperforming ones. It is the opposite of “momentum” or “market-timing” investing, which, in the long run, is a good thing. By staying focused, you will have a greater potential of achieving your investment objectives prudently. Ω

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Finance update

by Gay L. Vincent, CPA, ACS Comptroller, Chicago, IL

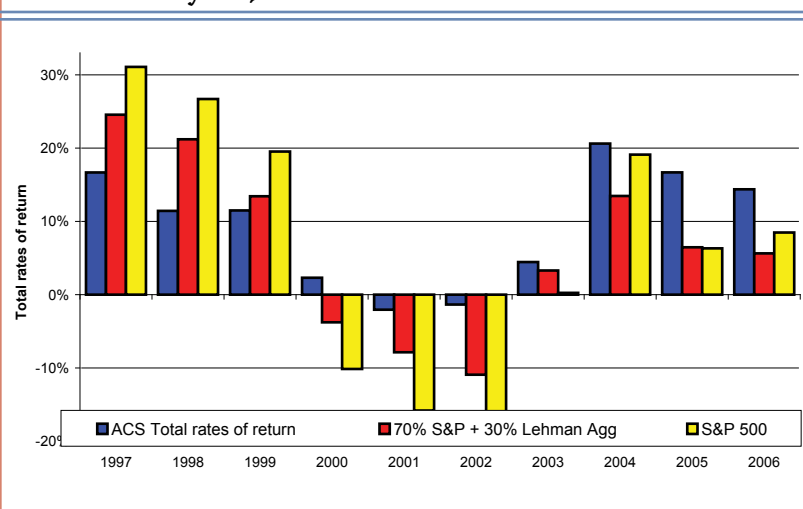
The American College of Surgeons Endowment Fund consists of funds designated by the ACS Board of Regents, affiliate organization funds, and donor-restricted funds. As of June 30, 2005, the donor-restricted and affiliate organization funds composed less than 10 percent of the total fund.

The College's endowment funds are managed by the Investment Subcommittee of the Board of Regents' Finance Committee. In 1999, the Board hired Cambridge Associates to provide consulting services to the endowment fund. The investment returns for the endowment fund have been above the total fund's benchmark as reflected in the chart on this page.

The benchmark is based on the endowment fund's allocation between equity (70% using the S&P 500 Index) and fixed income (30% using the Lehman Brothers Aggregate Bond Index). This generalized benchmark has been used for the total investment fund. Individual benchmarks are used to measure and compare performance for each individual money manager (for example, NAREIT Equity Index, MSCI EAFE Index, MSCI Emerging Markets Index, and so on). The endowment fund employs a simple strategy of asset allocation, diversification, and rebalancing.

The Board of Regents adopted the concept of a spending rate for the endowment fund that allows up to 5 percent of the fund to be used by the College to cover new programs and initiatives and to help cover the costs of programs that are supported by membership dues. The endowment

Investment rates of return as of June 30
(2006 YTD as of May 31)



fund's returns have helped the College maintain its existing dues structure, provided funds for new programs and initiatives, and provided continual funding for annual scholarship awards of more than \$1.5 million.

This year, for the first time, the College will sponsor continuing medical education programs at the Clinical Congress designed to provide surgeons with investment knowledge and simple strategies they can apply to the management of their practice. (See page 28 for more information on these programs.) Understanding how asset allocation drives investment returns will prove critical when planning for expansions, purchasing equipment, and budgeting for future expenses in the surgeon's medical practice. The programs will incorporate the endowment fund's simple strategy of asset allocation, diversification, and rebalancing. □

SAM holds organizational meeting

Working to advise the College's new mutual fund




Pictured are members of the SAM Board of Directors. First row (left to right): Thomas R. Russell, MD, FACS, Chief Executive Officer and Director; John Cameron, MD, FACS, Chair of the Board; and Charles D. Mabry, MD, FACS, Director.

Second row: Josef E. Fischer, MD, FACS, Director; Ms. Savi Pai, Chief Operating Officer; J. David Richardson, MD, FACS, Director. Not pictured: Richard J. Finley, MD, FACS, Director.

The Surgeons Asset Management, LLC (SAM) Board of Directors held its organizational meeting on June 8 in Chicago, IL. SAM was constituted to manage and advise the Surgeons Diversified Investment Fund (SDIF), a new mutual fund sponsored by the American College of Surgeons.

SDIF is available to U.S. citizen members of the College and their families and their employees; and to affiliated retirement plans, physician prac-

tice plans, and U.S. medical societies and associations that include members of the College in their organization. SDIF seeks to provide investors with long-term capital appreciation and income by investing in a variety of ETFs (exchange traded funds) among several asset classes.

SDIF is intended to provide an opportunity for its shareholders to invest their assets and benefit from asset allocation, diversification, and rebalancing. 

Improve your financial health

Sessions of special interest at the 2006 Clinical Congress

Luncheon Event:

Fundamentals of Prudent Investing

Sunday, October 8, 2006 / 12:30–2:30 pm

Session also offered on

Monday, October 9, 2006 / 9:30–10:30 am

George Pendergast, a managing director of Cambridge Associates, will discuss the fundamentals of investing, including asset allocation, diversification, and rebalancing. Surgeons need to plan early in their careers in order to build a solid financial future for their medical practices and themselves. The task sounds daunting; however, with a little fundamental knowledge and by following a few simple strategies, any surgeon can gain considerable investment savvy. This luncheon session will be beneficial for both members of the College and their spouses.

Because this session will lay the foundation for improving your investment knowledge, it will be offered again on Monday, October 9, from 9:30 to 10:30 am. (Monday's session is not a luncheon.)

Panel Discussion:

Equity Investments vs. Fixed Income Investments

Tuesday, October 10, 2006 / 1:30–3:00 pm

Introduction:

John L. Cameron, MD, FACS, Baltimore, MD,
Treasurer, American College of Surgeons

The panel will include four nationally recognized money managers from leading investment management firms who will discuss investment options, risk tolerances, and the advantages and disadvantages of equity versus fixed income. This session is sponsored by the Finance Liaison Committee of the Board of Regents as a continuing

effort to assist members in need of new ideas and innovative resources to enhance their ability to manage money now and in the future.

Surgeons' Roundtable:

An Open Discussion of Investment Experiences

Tuesday, October 10, 2006 / 4:00–5:00 pm

College leaders will share investment experiences, mistakes, and lessons learned. The goal of this session is to increase participants' investment savvy so they can become smarter money managers. This high tea event will be held at the Hilton Chicago. Participants include Charles D. Mabry, MD, FACS, Pine Bluff, AR; Thomas R. Russell, MD, FACS, Executive Director, American College of Surgeons, Chicago, IL; Josef E. Fischer, MD, FACS, Boston, MA; and John L. Cameron, MD, FACS, Baltimore, MD.

To register for these Sessions of Special Interest, use the Social Program Registration form, which is available online at www.facs.org/clincon2006/social/socialregform.pdf.