

Do-It-Yourself Investing

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As a vocal advocate for improving long-term investment returns by lowering investment costs, I wholly support the idea that investors at least consider a do-it-yourself (DIY) approach to portfolio management. By making the effort themselves, investors can bypass the advisory fee and remove a significant piece of the cost structure of most investment solutions. However, one must strongly consider a decision to undertake the DIY approach, especially when considerable assets or a significant portion of one's retirement savings is at risk. While saving the annual advisory fee by DIY investing sounds enticing, doing it yourself requires a significant commitment of time and effort to do it properly and responsibly, and it only takes one bad investment decision to cause far more damage than years of paying an advisory fee might.

This shortpaper discusses the many decisions that go into managing an investment portfolio properly so that readers can make a better choice between DIY investing and hiring an expert. I'll break things down into the three stages that describe the progression of decisions a DIY investor will face: establishing your accounts, building the portfolio, and managing the portfolio. You first need to figure out *where* you'll manage your assets, then you have to figure out exactly *how* you'll invest those assets, and finally you need to have a sense of how you'll manage the portfolio *over time* and through market cycles. Not considering each of these things before deciding to DIY invest is foolish, and being foolish with your hard-earned assets is unacceptable.

Establishing Accounts

The first issue, setting up accounts, is actually quite simple. Competition in this space is considerable and many firms have developed a strong expertise in this area. Nevertheless, it is extremely important to get this decision right since it establishes the platform on which your portfolio will operate. Once you select a firm, the process of establishing accounts is straightforward and firms work hard to make sure you do it correctly. So, what are the issues an investor needs to think about? At a minimum, find an answer to these questions:

- Who offers the widest selection of investments?
- What fees will you be charged?
- Who has the cheapest fees with the most services, and what services will you even need?
- Who has the best trade execution?
- Who offers me best access to my accounts?
- Who has the best customer service?

Getting this decision right means you don't have to move your accounts later on due bad service, too many high or unforeseen charges, or poor trade execution. Don't be afraid to go with the cheapest solution, either, since a lot of this business is commoditized and price competition is fierce among even the best custodial/clearing firms.

Building the Portfolio

Next comes building the portfolio, and this is where investors quickly find themselves out of their comfort zone. The language of investing is foreign to many, and people find out just how complex things can get right away. The investment industry has been evolving at light speed for several decades, and it can be downright overwhelming. But if you are convinced you want to manage your own assets, stick with it, read as much as you can, ask lots and lots of questions, and it will begin to make sense at some point. Here are a few to start with:

- Should you invest in active strategies, passive strategies, or a mix of the two?
- Should you own individual securities, comingled funds or a mix?
- In which asset classes and sub-asset classes should you invest and which ones should you avoid?
- How much should you invest in each selected asset class to achieve the growth rate you require at the lowest level of risk?
- Within your chosen asset classes, which securities should you use for exposure?
- If using comingled strategies (open-ended mutual funds, closed-end funds, ETFs, etc.), is one structure better than another? Which individual strategies are best relative to the thousands of others?
- If using individual securities, which ones are the best relative to the thousands of others?
- How many securities will give you a well-diversified portfolio? Conversely, how many will sufficiently concentrate your portfolio?
- If using comingled strategies, how do you combine them and ensure the overlap between strategies is minimal so that your chosen allocation is what you actually have in your portfolio?
- How do you accommodate current and future risks through portfolio construction?
- How do you maximize the growth while minimizing the risk of your portfolio?
- What growth rate should you target, and how should you target it?
- How global should your allocation be, and is the answer asset class dependent?
- Do you need to consider company size (large, mid, small market capitalization companies) and style (growth and value) when investing in equities?
- How should you consider the various investment methodologies such as tactical allocation, momentum, sector rotation, top-down versus bottom-up, quantitative, technical, etc.
- Where do you put the various securities you've chosen – in your taxable account or in your retirement account(s)?
- How are various kinds of investments taxed?
- How do you consider the overall portfolio if you are structuring things differently in each account?
- How should you invest your assets – all at once or over time?
- What is the best way to reinvest dividends?
- Should you invest for income, growth, or both?

- There is a considerable amount of conflicting advice out there, how do you know which advice is good and which is bad regarding each possible investment?
- How do you navigate the conflicts of interest within the industry?
- How much is your portfolio costing you, and could you save money by substituting different securities?

These are exactly the questions you will confront if you are taking a serious approach to DIY investing. Of course, you could ignore most of them and still build yourself a portfolio (answering these questions is by no means *mandatory*), and many DIY investors take exactly that approach. But I would argue that their portfolios suffer from being either too risky or not risky enough, loaded with unnecessary asset classes and overlapping strategies, and they are almost always far too expensive. In short, the chance that such portfolios will do the best job of meeting their investing goals is practically zero. Unfortunately, many “professionally” constructed portfolios suffer the same flaws, but that is because the industry is full of “advisors” who are only minimally more knowledgeable about investing than their clients! This shortpaper, however, is focused on DIY investing, so if you want to know more about selecting competent money managers, please read my shortpaper, [Evaluating Investment Firms](#).

Maintaining the Portfolio

Once you have built your portfolio, you then need to properly maintain your portfolio over time and through evolving market and economic cycles. Most DIY investors make one of two mistakes. Either they build their portfolio and then forget about it for years to the point that they have no idea what they are invested in or why, or they tinker with it far too much and never allow it to do what it was designed to do in the first place. The second mistake is probably most prevalent, and why individual investors have suffered abysmal performance historically. It is natural for us to “overmanage” our portfolios, trying to capture the hottest trend or avoid the next blowup, and there is a growing body of research explaining why we can’t seem to avoid buying high and selling low. As evidence of the average investor’s abysmal performance, the research firm Dalbar, Inc. reports that for the previous twenty years through 2010, the average equity investor achieved annual returns of 3.83% versus annual returns of 9.14% for the S&P 500 over the same period. Looking at investors’ allocations across asset classes, Dalbar found that portfolios actually *lagged bond returns and even inflation* over the last twenty years (6.89% annual returns for bonds, 2.57% for inflation, and 2.56% for investors). So keep that in mind as you press forward with the DIY approach. But, behavioral issues aside, here is what you will need to consider when thinking about portfolio maintenance:

- Will you take the time to monitor the portfolio on a regular basis to ensure you are at or near your target allocation?
- When and how should you rebalance your portfolio?
- How will you measure performance and what will you compare yourself to so you know if you are getting all you can from the capital markets?
- How do you incorporate cash flows in and out of the portfolio when calculating relative performance?

- How do you stay abreast of all the news that could affect your portfolio?
- What will you do when the markets get significantly turbulent?
- How will you know when you need to change something in the portfolio to account for some major shift in the global economy or capital markets, and what constitutes a “major shift”?
- What will you use to forecast relative market performance?
- How will you keep abreast of the evolving investment industry so you can take advantage of any advances or sidestep potential industry problems?
- How will you make withdrawals/take distributions when you eventually need to?
- What tax minimization strategies will you use?

As in building a portfolio, most DIY investors forego much of the above and by doing so they reduce their chances of maximizing risk-adjusted growth and achieving their overall investment goals. Probably the biggest shortcoming in this stage for DIY investors is their reluctance to properly measure their portfolio’s performance. For some reason, many investors are perfectly happy as long as their portfolio returns are positive, and they completely ignore the issue of relative performance. Why is a 10% return acceptable when your appropriate benchmark returned 20% in the same period? DIY investors are either avoiding a painful truth, or they simply don’t know how to measure performance the right way (I find the latter explanation is most often the correct one). By the way, I have a shortpaper that covers the topic of [performance measurement](#), too, for those interested.

Clearly there are many questions that confront any do-it-yourself investor. However, if you have the time and interest to properly sort through all investment issues then it may be worth it to save the cost of working with someone who already has answers to the above questions. You’ll find the key to making the correct decision about going it alone in honestly answering two questions: 1) how much effort are you willing to put into managing your own portfolio, and 2) how much value do you assign to hiring someone to do the job for you? Understand, too, that these questions are interconnected. That is, the less you want to or can manage your own portfolio, the more you should logically value the convenience and expertise of another. And, if that manager you hire can objectively offer a reasonable chance at boosting your portfolio’s performance by more than his fee, the cost of that advisor in essence goes away and the choice to save yourself the time and effort of a DIY approach becomes incredibly easy. Be careful about a promise of strong returns, however. It’s amazing how many people in this industry have magic beans to sell you.