Fundamentals of Successful Investing

Seven core principles that matter most

VISTA | CAPITAL PARTNERS

About Vista

Vista Capital Partners is a fee-only investment advisor based in Portland, Oregon. We specialize in managing globally diversified portfolios which minimize costs and taxes for clients with more than $3 million to invest.

We want the benefits of our work to extend beyond investment results and the health, happiness and well-being of those we serve. Our mission is simple: to help our clients live happier and more prosperous lives.

Contributors

We are a passionate team of financial advisors. Learn more about the contributors and our team at: vistacp.com/team.

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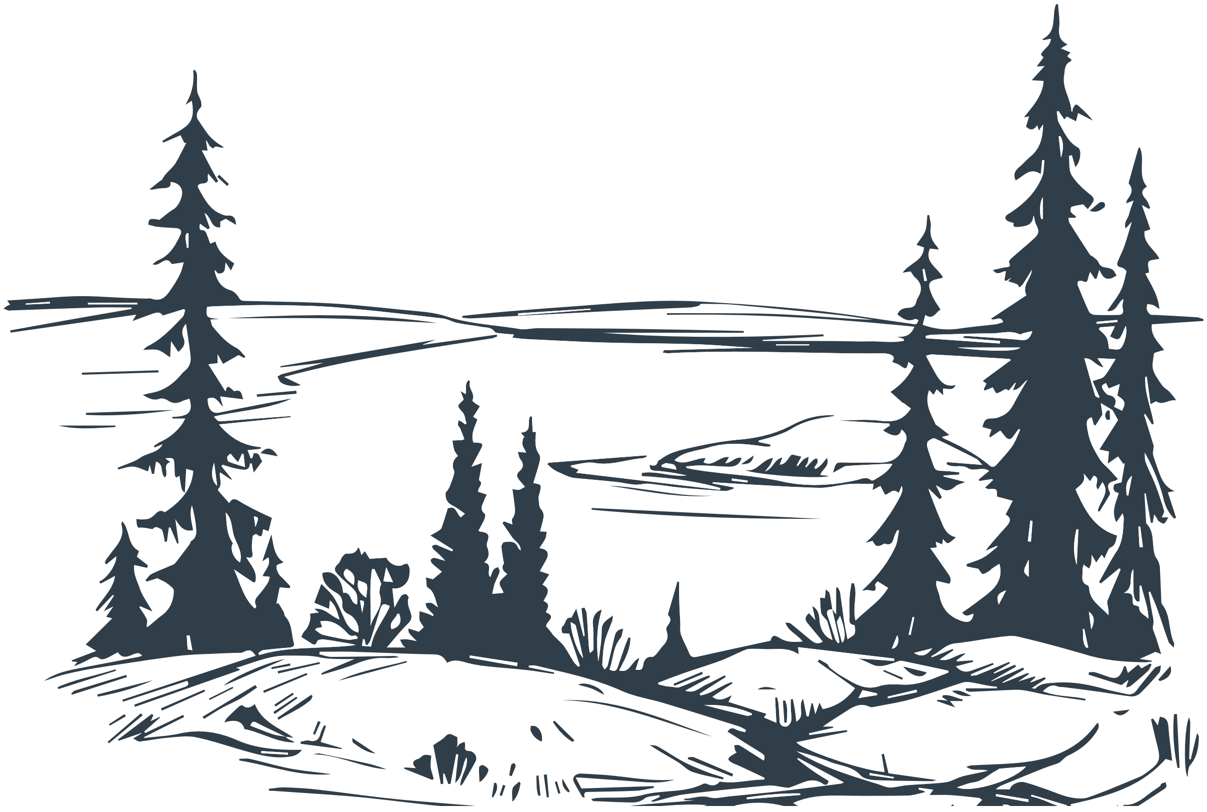
Introduction

The best chance of achieving investment success lies not in the constant struggle to outperform the market, but in formulating and adhering to an appropriate investment plan.

Adherence to a sound investment plan acts as a shield from the short-term thinking that can lead to destructive performance-chasing behavior. How investors behave in the decades to come matters more than how their portfolio behaves over the days to come.

Before feelings of optimism and/or pessimism compel investors to do something "different," they would be well-served to review their Investment Policy Statement in order to: 1) be reminded of long-term goals, 2) re-focus on the most important determinants of long-term investment success, and 3) restore their confidence in the strategy being executed in pursuit of a successful investment experience.

An understanding of, and commitment to, the seven key principles on the pages to follow will help provide the foundation for investment success.



Risk

Investing in capital markets involves uncertainty. It requires giving up a great deal of control and can subject investors to sudden, severe, and upsetting short-term drops in the price of their investments.

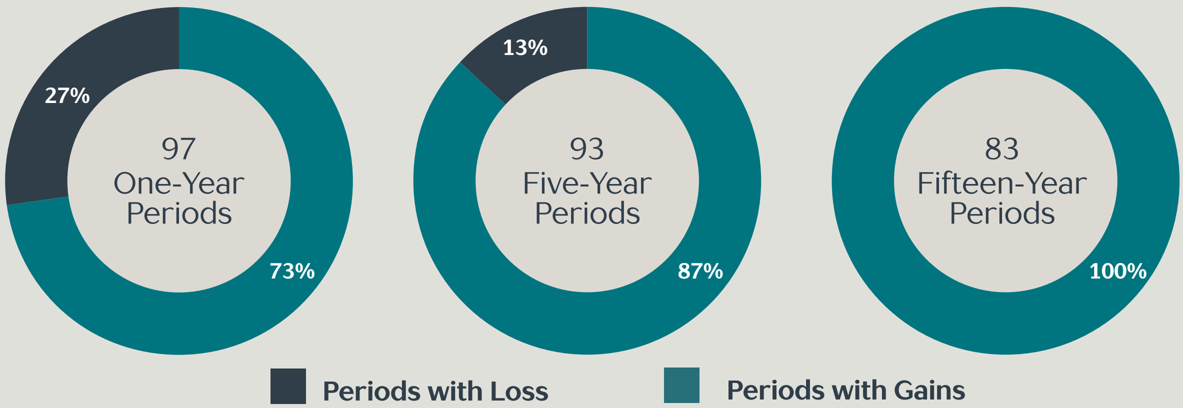
The real risk investors face, however, is not short-term fluctuations in portfolio values but the failure to meet long-term goals.

As shown below in Figure 1, stocks have posted negative returns 27% of calendar years from 1926-2022. This risk of loss has diminished over time, as only 13% of all five-year periods posted losses. Of the 83 fifteen-year periods from 1926-2022, stocks have delivered positive returns 100% of the time.

It is imperative for investors with long time horizons to remember the key difference between "risk" and "fluctuation."

Figure 1: Risk of Stock Market Loss

Calendar Years 1926-2022



Source: Dimensional Fund Advisors and Vista Capital Partners. Calendar years with gains/losses for one-year, five-year, and fifteen-year periods for the S&P 500 from 1926 to 2022.

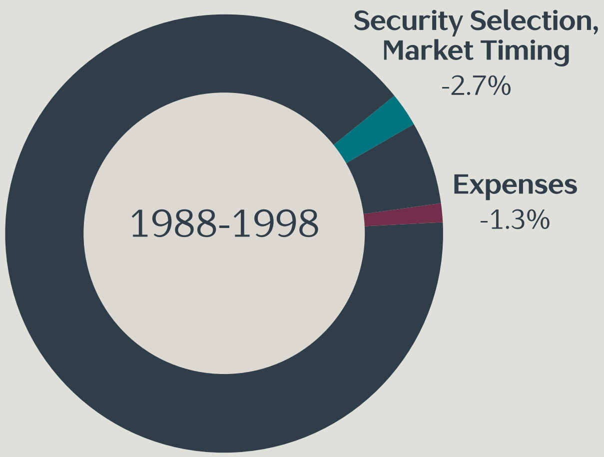
Asset Allocation

While it is tempting to focus on the results of individual investments ("stock picking") and as hard as it is to resist the urge to jump in and out of the market ("market timing"), sensible investors remain committed to their long-term asset allocation. Over long investment horizons, proper asset allocation is the most important determinant of success.

Much research has been done to address the question of whether investors can "add value" through stock picking and/or market timing. The results can be summarized by Figure 2 below.

On average, investors have earned lower returns by engaging in these activities. Adhering to a target allocation is a better approach, although occasional revisions to the asset allocation may be warranted to reflect changes in an investor's personal situation and objectives.

Figure 2: Asset Allocation Explains Performance



Source: "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance." Ibbotson and Kaplan, Financial Analysts Journal, 2000. Performance of Total Fund Return Explained by Investment Activity of 94 US Balance Mutual Funds, 1988-1998.

Diversification

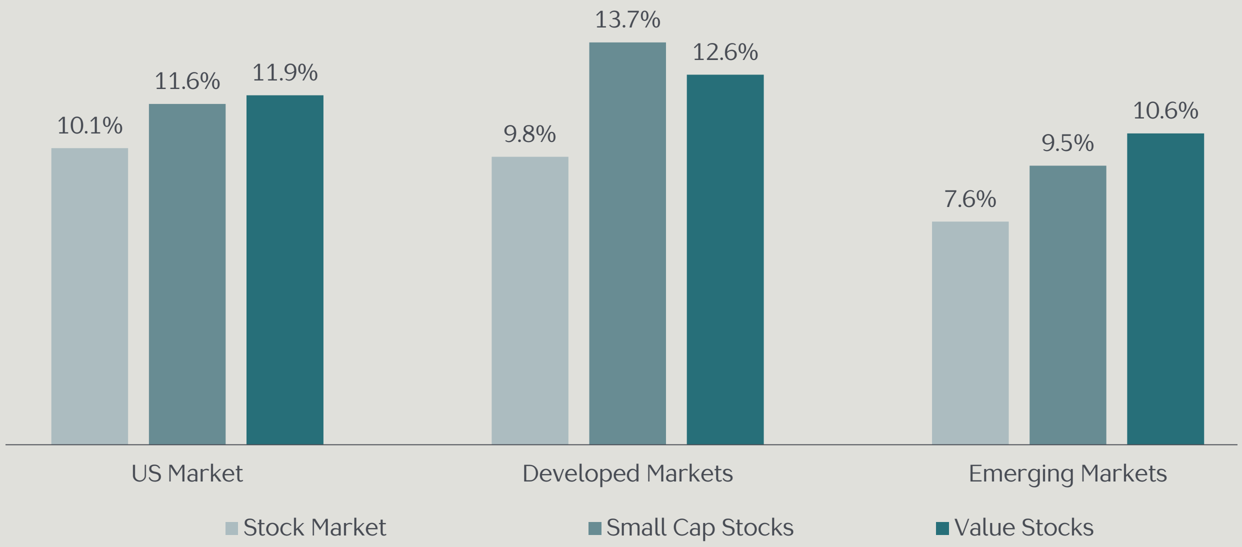
Portfolios should be diversified broadly across the core asset classes—stocks, bonds, real estate and cash—to minimize portfolio fluctuation. The work of Nobel Prize-winning economists has shown that combining such asset classes in a portfolio has historically resulted in higher returns with less risk, as compared to non-diversified portfolios.

Each of these core asset classes plays an important role in a portfolio, although their inevitable periods of disappointing performance may cause investors to wonder why they own (fill in name of asset class here) in the first place.

U.S. stocks, including small and large companies exhibiting both "value" and "growth" characteristics, are expected to provide portfolio growth. As shown in Figure 3 below, small company and lower-priced value stocks have historically rewarded investors with higher long-term returns. This has been true in U.S. markets, as well as international and emerging markets. As a result, a healthy weighting of small cap and value stocks can tilt a portfolio toward these significant long-term sources of return.

Figure 3: Higher Expected Returns

Small Cap and Value Stocks Have Delivered



Source: Dimensional Fund Advisors. U.S. (1927-2022) Market: S&P500, Small: Fama/French US Small Cap Index Value: Fama/French US Large Value Research Index; Developed (1975-2022)Market: Fama/French International Index, Small: Dimensional International Small Cap Index, Value: Fama/French International Value Index; Emerging (1990-2022) Market: Fama/French Emerging Markets Index, Small: Fama/French Emerging Markets Small Cap Index, Value: Fama/French Emerging Market Value Index

International stocks, in both developed and emerging markets, can also contribute to portfolio growth. They also provide some level of diversification since they often behave differently than U.S. stocks. Diversified international stock exposure means also favoring small company and value stocks.

Real estate, via publicly traded real estate investment trusts (REITs), can provide income and long-term inflation protection. Well-diversified portfolios include REITs in both U.S. and international markets.

Bonds provide income, but their primary appeal comes from the stability and preservation of capital they often provide. In exchange for expecting lower long-term returns relative to stocks, bonds can provide safety and stability during downturns in the stock market. For precisely these reasons, only the highest quality bonds should be favored. High quality bonds include U.S. and international government bonds, Treasury inflation-protected bonds (known as "TIPS") and, when appropriate, tax-free municipal bonds.

Cash reserves should be relatively free from risk and instantly liquid. Cash consists of money market funds, U.S. Treasury bills, and other similar instruments with less than one year to maturity.

Disciplined Rebalancing

Over time, performance differences in the various asset classes will cause them to drift from their allocation targets. Adhering to the target allocation, even when it seems uncomfortable to do so, is critical to long-term success.

A disciplined rebalancing strategy restores the portfolio's target allocation once a minimum or maximum threshold has been exceeded. This disciplined process serves to keep risk at the appropriate level and promotes the investment ideal of "buying low and selling high."

An example of disciplined rebalancing is shown in Figure 4. Asset classes are allowed to fluctuate within a 20% range from the target in order to minimize trading costs and defer taxable gains but rebalanced back to the target weight once the 20% threshold has been exceeded.

In this example, international stocks exceed their target by 20% (having grown from 18% to 22%), so would be prudently pared back to target. The proceeds would then be reinvested in asset classes relatively underweight to their target (in this case, bonds).

This is a fairly simple process and makes intuitive sense—after all, it adheres to the "buy low, sell high" discipline. But, in practice, rebalancing is rarely easy to do since emotions at the time may compel the opposite behavior.

Figure 4: Disciplined Rebalancing

Managing Risk and Expected Return

Asset Allocation	Target	Current
U.S. Stocks	36%	36%
International Stocks	18%	**22%**
REITs	6%	6%
Bonds	37%	**33%**
Cash	3%	3%
Total	**100%**	**100%**

Sell High

Buy Low

Vista Capital Partners. This asset allocation is for illustration purposes only and not intended to be a specific recommendation.

Index and Asset Class Funds

Sensible investors favor asset class, or index, funds when building their portfolios. An index fund is a basket (portfolio) of stocks which owns most, if not all, stocks in a market or sector. In the management of these funds, no attempt is made to pick “attractive” over “unattractive” securities or to time the market, as is typical of conventional “active” portfolio management. Rather, by owning most (if not all) of the stocks in a particular market or sector, index and asset class funds can reliably deliver the returns of a given market.

In the race for performance, asset class and index funds enjoy a huge advantage over actively managed mutual funds due to their lower cost structure. Investment costs vary in form (i.e., management fees, transaction costs, market impact, and taxes) but are always a direct subtraction from returns. Index funds minimize these costs and, on average, have delivered superior long-term performance compared to actively managed funds.

Minimizing Taxes

The impact of taxes should be minimized to ensure the lion’s share of a portfolio’s return ends up in an investor’s pocket. The use of index funds, tax-loss harvesting strategies, and tax-free municipal bonds (when appropriate), can help reduce the drag caused by taxes.

An “asset location” strategy can help maximize a portfolio’s after-tax return. Asset location, as shown in Figure 5, refers to holding the least tax-efficient investments, such as income producing real estate and taxable bonds, in tax-deferred accounts. Investments with the highest expected returns can be favored in tax free accounts, such as Roth IRAs, whenever possible.

Figure 5: Asset Location

Total Portfolio

Taxable Accounts	Tax-Deferred Accounts	Tax-Free Accounts
Stocks	Real Estate Investment Trusts (REITS)	Stocks
Municipal Bonds	Taxable Bonds	

Evaluation and Review

In evaluating investment performance, it is important to maintain focus on the long term. A portfolio's performance should be compared against relevant benchmarks, such as the Wilshire 5000 Index for U.S. stocks, MSCI All-Country ex-US Index for international stocks, and the Barclays U.S. Aggregate Bond Index for bonds. In addition, a focus on performance relative to real life goals (retirement plans, income needs, keeping pace with inflation, etc.) helps reduce the temptation to make long-term decisions based on short-term results.

Frequent and candid communication between an investor and an advisor is critical to investment success. Annual face-to-face meetings help ensure the portfolio remains well-matched to an investor's personal goals and unique circumstances. In between these meetings, communication via phone and email allows investor concerns and life changes to be discussed, as well as contributions or withdrawals to be planned for in advance. Communication is a vital ingredient in the success of any long-term relationship.

Important Disclosure Information

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