

Investment Process

The Importance of
Process in Your
Investment
Strategy



CARSON
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INVESTMENT PROCESS

As investors, we would all like to effortlessly beat the markets, buying and selling investments based on brilliant timing, instinct and a little luck. But most of us realize it's not that easy. Nonetheless, it's no surprise that so much media attention is focused on day-to-day and short-term market gyrations (the exciting stuff) and so little on the investment process – the more staid aspect of investing.

While it may seem less exciting, the investment process is the workhorse behind any sustainable investment strategy. That's because the investment process provides an orderly way to create and maintain a portfolio aligned with specific goals and objectives while seeking to manage investment risk. It's critical for investors to understand the investment process for several reasons:

1. The investment process outlines the steps required to create an investment portfolio and the sequence of actions involved from defining risk parameters to asset allocation, due diligence, investment selection, buy/sell discipline, performance evaluation and more.
2. It provides a structure for implementing a strategy tailored to your specific goals, objectives, timeframe, risk tolerance and values that seeks to manage risk over time.
3. It establishes a framework for evaluating your strategy and tracking progress toward your goals.

Relying On Discipline Vs. Instinct

One of the best examples of a consistent and disciplined approach to investing is found in the Peter Lynch story. For 13 years, from 1977 to 1990, investment manager Peter Lynch ran a highly acclaimed investment portfolio, growing assets under management from \$20 million to \$14 billion. He attributed his success to adhering to a disciplined methodology.

"Investing in what you know about and understand," was at the core of Lynch's stock-picking approach. According to Morningstar, Inc., Lynch invested only in industries he had a firm grasp on. He believed investors should:

- Do their homework and research companies thoroughly
- Set realistic expectations about each stock's potential
- Focus only on the company's fundamentals and not the market as a whole

Morningstar reports that Lynch didn't believe in predicting markets, but in buying great companies – especially companies that are undervalued and/or underappreciated, advocating a “bottom up” approach rather trying to make difficult macroeconomic calls using a “top down” approach. He also believed that investors could separate good companies from mediocre ones by sticking to the fundamentals and combing through financial statements to find profitable firms with solid business models.

The final key principle of Lynch's investment philosophy, and one that remains timeless, is that investors should only invest for the long run and discard short-term market gyrations. “Absent a lot of surprises, stocks are relatively predictable over ten-to-twenty years,” Lynch told Morningstar. “As to whether they're going to be higher or lower in two-or-three years, you might as well flip a coin to decide. The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them. Stand by your stocks as long as the fundamental story has not changed.”¹

Why Time In The Market Is More Important Than Timing The Market

While Lynch's philosophy has been well publicized, many investors still believe that investment success is dependent upon the ability to outguess the markets in an attempt to enter and exit at the most opportune times. However, contrary to what many believe, the markets don't control investment success—investors do. As multiple industry and academic studies show, investment success is largely influenced by two factors:

1. Investor behavior and emotion
2. Adherence to a disciplined process over time

While financial markets are unpredictable in the short-term, they offer the potential to generate wealth over the long-term. Investing is a long-term process that has historically paid the greatest rewards to those adhering

to a consistent and disciplined approach. An approach that also removes emotion from the investment decision-making process. In fact, according to DALBAR, a leading financial services market research firm, investment results are more dependent on investor behavior than on investment performance. The company's 2016 study of investor behaviors stated that mutual fund investors who hold on to their investments have been more successful than those who try to time the market.²

“We don't have to be smarter than the rest. We have to be more disciplined than the rest.”

– Warren Buffett

TOP DOWN VS. BOTTOM UP INVESTMENT APPROACH

Top Down Approach or “macroeconomic” approach begins with the “big picture,” analyzing the broader economy and global markets. It focuses on factors such as gross domestic product (GDP), interest rates, inflation, commodity prices, exchange rates and market trends to help identify specific regions, sectors and industries. Once sectors and industries are narrowed down, further research and analysis is employed to identify individual companies for investment within promising sectors and industries.

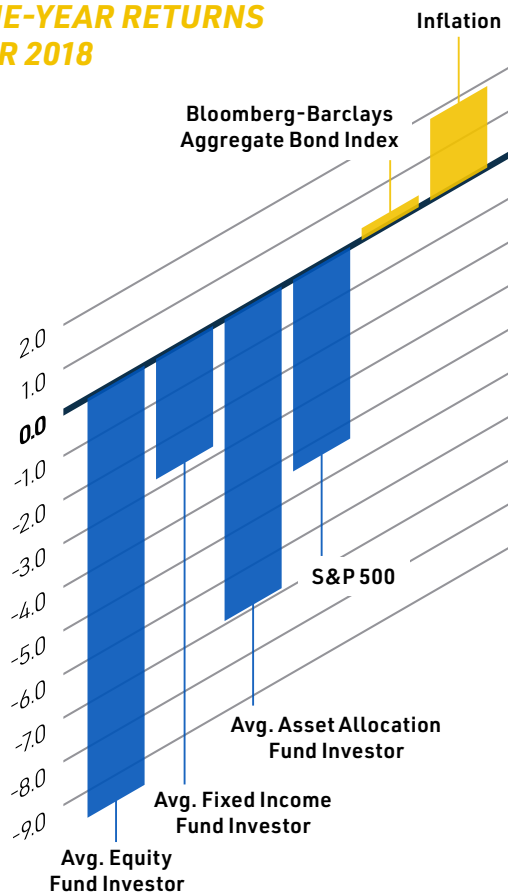
Bottom Up Approach begins with choosing specific companies for investment based on the company's individual attributes. Advocates of the bottom up approach typically seek what they believe to be well-run companies with good prospects based on specific criteria, regardless of industry or macroeconomic influences. A bottom up approach carefully analyzes factors such as business model, profit margins, balance sheet, growth potential, company management and news about the company.

"The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them."

– Peter Lynch

DALBAR utilizes a form of analysis known as the Guess Right Ratio, examining fund inflows and outflows to determine how often investors correctly anticipate the direction of the market. The Guess Right Ratio shows that investors who execute purchases or sales in response to something other than a prudent investment decision reduce the return created by the markets and portfolio managers. A great example of this is 2018 when investors "guessed right" on half of the year, but they were wrong the other half of the year. This meant they didn't beat the market because the dollar amount for "good" guesses didn't exceed the amount for bad ones. Investors can lose months of right guesses with just one month of wrong ones.

ONE-YEAR RETURNS FOR 2018

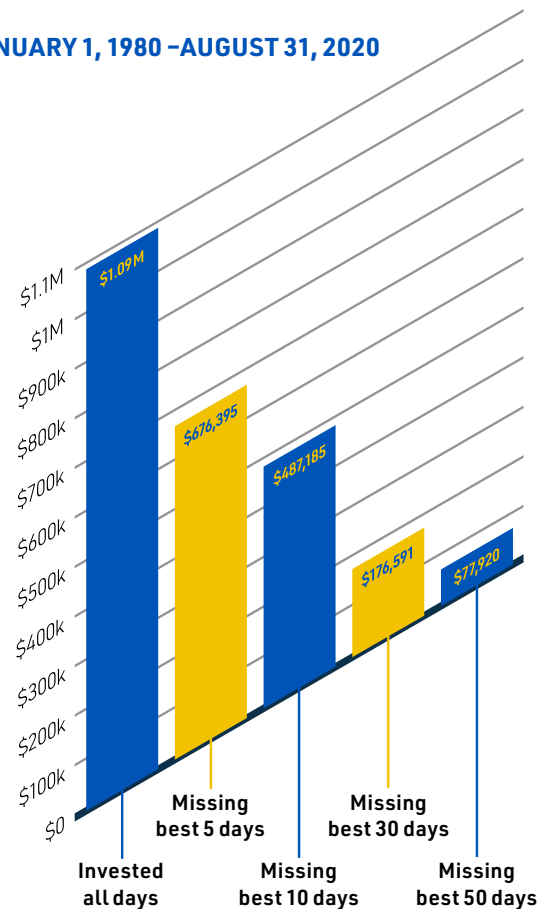


Source: DALBAR's 22nd Annual Quantitative Analysis of Investor Behavior (QAIB) 2016

According to the DALBAR report, the greatest investor losses occur after a market decline. Investors tend to sell after experiencing a paper loss and start investing only after the markets have recovered their value. The devastating result of this behavior is that investors participate in the downside of the market and are out of the market during its subsequent rise. The graph below, illustrating the performance of a hypothetical investment in the S&P 500 Index over the most recent 10-year period, drives this point home.

HYPOTHETICAL GROWTH OF \$10,000 INVESTED IN S&P 500 INDEX

JANUARY 1, 1980 – AUGUST 31, 2020



Source: <https://www.fidelity.com/viewpoints/investing-ideas/six-tips>

And keep in mind that achieving those returns required our hypothetical investors to not only remain invested to enjoy the market's best days during the period, but also to weather the market's worst days during the same period.

Now look at what happens if the same investors missed the 20, 30 or 40 best days in the market; annualized returns for the period fell to -0.25%, -2.58% and -4.63% respectively. The reason missing the market's best days can do so much damage is because gains are not able to compound over the holding period. So an attempt to avoid the market's worst days not only leads to potentially missing the market's best days, but losing out on the power of compounded earnings over time which help fuel future investment growth.

"Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who hold on to their investments have been more successful than those who try to time the market."

– DALBAR 20th Annual Quantitative Analysis of Investor Behavior (QAIB) 2014

Understanding The Investment Process

Think about the process of building a custom home. You wouldn't begin by constructing walls or selecting paint colors. You'd start with a blueprint that reflects your vision for the final product. Developing the blueprint forces you to make certain decisions to ensure the home you build is aligned with your needs and goals, including the type of foundation (slab, crawlspace or basement), the number of floors, bedrooms and bathrooms you desire, where the front door, kitchen and windows will go, etc. Once the blueprint is completed, you have a concrete plan and footprint to build upon in executing your plan.

During the construction process you may make some adjustments, but you have an overall framework to follow in accommodating any adjustments and building out your vision. Once your home is built, it will require regular care, maintenance and updating. Later, you may want to make some changes, adding a screen porch or outdoor kitchen, or remodeling certain rooms to reflect your changing needs or current design trends. A strong foundation and solid construction will provide greater flexibility in accommodating these changes down the road.

The investment process is similar. Think of your investment portfolio as the place where your wealth will live and potentially thrive. It should reflect today's needs and goals while offering the flexibility to accommodate tomorrow's growth. Whether you develop and follow your own investment process, or work with a financial advisor or firm, certain steps are critical to pursuing the results you seek. At a high level, the investment process consists of four primary steps:

- 1 Goal Setting:** Your blueprint – a formal assessment of your needs, goals, tolerance for risk and timeframe
- 2 Portfolio Construction:** Developing the foundation and framework for your portfolio
- 3 Implementation:** Executing your plan
- 4 Portfolio Monitoring & Evaluation:** The care and maintenance of your portfolio over time

Goal Setting: The investment process begins with understanding and establishing clear financial goals. This is where you establish your investment blueprint. If you're working with a Wealth advisor, he or she can help you identify and prioritize your objectives. The more detail you provide about your current financial status, objectives, lifestyle goals, timeframe and tolerance for risk, the more effective your Wealth advisor will be in developing an investment plan and process tailored to address your needs.

Portfolio Construction: The next part of the process is the construction of the portfolio, which is divided into two primary parts: asset allocation and investment selection. Your wealth advisor will work with you to develop a framework for managing your assets. You will be provided an opportunity to review and approve all investment recommendations before your investment plan is implemented.

→ **Asset allocation** determines how your investment assets are allocated across the different investment classes defined broadly as equities, fixed income securities, cash or money market instruments, and real assets (such as real estate, commodities and other assets). Asset allocation decisions are also framed in terms of investments in domestic securities versus global or international assets.

→ **Investment selection** is the step where the stocks that make up the equity component, the bonds that make up the fixed income component and the real assets that make up the real asset component are selected for your portfolio.

Implementation: Once asset allocation and investment selection decisions are made, they must be executed through the purchase and sale of assets or securities, resulting in your investment portfolio.

Portfolio Monitoring and Performance Evaluation:

The final part of the investment process is performance monitoring and portfolio evaluation. Over time, it's essential to monitor both your own financial situation as well as the management of your portfolio. Any changes in your objectives, risk tolerance, income, net worth or liquidity needs – or changes that take place in your life, like marriage or divorce, the birth of a child or death of a spouse will require your investment plan to be updated accordingly.

When evaluating portfolio performance, it's critical to measure performance within the context of your investment strategy. For example, it's not practical to expect returns on par with the market if a portion of your portfolio is protected through a capital preservation strategy that seeks to provide risk-adjusted returns.

“Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves.”

– Peter Lynch

Digging Deeper

While the investment process is straightforward – set goals, construct and implement the portfolio, and evaluate performance over time – much like in building a home, the devil is in the details. Think about the sheer number of decisions that go into designing and constructing the kitchen alone. How big will it be? Will it need to accommodate seating for four or fourteen? Will you need a pantry? Do you prefer a gas or electric range? A single or double oven? What type of finishes will you choose for cabinets, counter tops, a backsplash and flooring?

The investment process is similar in that multiple decision points are encountered and significant due diligence is required to implement an investment strategy designed to pursue specific goals and objectives. The process involves constant monitoring of the economy and capital markets while continually researching and analyzing investment opportunities, institutional money managers and the performance of your investment portfolio.

Investment managers and money management firms utilize a variety of techniques and styles in the portfolio construction and management process based on their individual investment philosophies, objectives, experience and beliefs about the financial markets. These may include:

Active portfolio management: In an actively managed investment portfolio, the investment manager is paid to select individual investments, like stocks or bonds to construct a portfolio.

Passive investment management: A passive management style, typically found in index funds or certain Exchange Traded Funds (ETFs), simply tracks an index (like the S&P 500) or a basket of companies.

Technical analysis: Technical analysis is the study of how prices of securities behave over time.. The goal is to use this information to drive profits while minimizing losses. The emphasis in technical analysis is to take advantage of opportunities to profit from trading, not to buy and hold securities over an indefinite time period like a buy and hold strategy. Therefore, technical analysis dictates a more active trading style that can result in significant trading costs over time.

Fundamental analysis: Unlike technical analysis, where the focus is on tracking price action and patterns in an effort to predict the next move up or down, fundamental analysis focuses on the qualitative aspects of the companies selected for investment. Considerations in conducting fundamental analysis of a company may include:

- Industry and sector
- Profit margins
- Balance sheet
- Business model
- Growth potential
- Company management
- Impending legislation or political issues that may affect the company
- News or scandals related to the company or its management

Concentration vs. diversification: Diversification is the process of spreading investment assets across multiple investments and/or investment classes in an effort to reduce the risk associated with any one investment or asset class. A concentrated investment strategy, on the other hand, typically invests in a single investment

idea (such as value stocks) and/or a smaller basket of investments the portfolio manager believes are poised to produce better results than a fully diversified portfolio. Warren Buffett, the legendary leader of Berkshire Hathaway, has long been an advocate of concentrated equity portfolios, believing that they offer the opportunity for better risk-adjusted returns.³

"Price is what you pay for something, value is what you get."

– Warren Buffett

Like Warren Buffet, John Maynard Keynes, the influential British economist, was a staunch supporter of concentration. "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes," Keynes said.⁴ However, it's important for investors to understand that no single strategy can eliminate investment risk, and that all investments and investment strategies are subject to loss.

Buy/sell discipline: Nowhere does emotion play a bigger role than in portfolio buy and sell decisions. That's why it's often difficult for investors to sell a once-prized holding that is underperforming or no longer provides any benefit to the portfolio. However, emotional decision-making is eliminated when a strong buy/sell discipline is in place and adhered to by a professional portfolio manager who is able to maintain an objective approach. Through a combination of rigorous research and qualitative screening methods, portfolio managers develop a set of stringent buy/sell criteria to apply to each holding as they monitor it over time. If the holding no longer meets specified criteria, it's sold to make room for new holdings that better meet the investment parameters.

The Value Of A Repeatable Process

Similar to a manager's buy/sell discipline, your investment manager's overall investment process should be clearly laid out, consistent and repeatable. When choosing a financial advisor or firm to assist in managing your assets, it's important that they are able to articulate their investment process in a manner that's easy to understand and makes sense to you. As Albert Einstein once said, "If you can't explain it simply, you don't know it well enough."

Our wealth advisors are passionate about ensuring you understand how and why your individual investment strategy can help you pursue your goals.

We rely upon a repeatable, research-driven process that focuses on identifying high-quality, well-managed companies and leveraging secular market trends, in constructing personalized allocations aligned with your individual needs, goals and risk parameters.

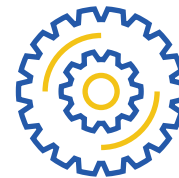
Each of our process-driven, time-tested strategies are managed by our Investment Committee, comprised of a dedicated team of portfolio managers as well as fundamental and technical analysts and strategists. This experienced team seeks to employ a repeatable, research-driven process that:

- Focuses on selecting high-quality, well-run companies determined through disciplined investment selection and due diligence.
- Is rigorously evaluated by our analysts and Investment Committee prior to implementing a new investment idea.
- Applies a sequence of screens that eliminate investments deemed to be outside of a portfolio's risk profile or the established investment themes.

- Develops investment strategies based upon ultimate end-goal themes:



Irreplaceable Capital
Protects Existing Wealth



Yield
Draws an Income



Growth
Grows Your Wealth



Specialty
Tailored Investment Goals

By leveraging our disciplined investment process, you receive transparency of information, seamless proactive service and the trust and accountability you require to help meet your financial objectives.

The Critical Role of Communication in the Investment Process

While process is essential to the ongoing implementation and execution of an investment strategy customized to your needs and goals, communication is equally critical. Investment results, prospectuses, annual reports and faceless call centers are hard pressed to answer the questions: "Am I still on track?" or "How will current market trends impact my overall strategy?" However, your dedicated Wealth advisor can provide answers to these questions and more.

You can expect your wealth advisor to meet with you at regular intervals, based on your needs and preferences, and to work with the Investment Committee to manage and continually evaluate your portfolio to help ensure you remain on track toward your goals. And because your Wealth advisor takes the time to get to know you and serves as your personal advocate and guide, you can rely on your Wealth advisor to proactively recommend adjustments to your financial strategy as market conditions or circumstances in your life change. You will receive trade notifications whenever activity takes place in your portfolio.

Between scheduled meetings, your wealth advisor will keep you informed through a series of proactive communications, including our weekly market commentary, newsletters, free guides, infographics and blogs. You will receive invitations to attend our monthly Investment Committee meetings, as well as access to our quarterly market outlook videos and more.

Many people leave their financial advisor confused about what's happening with their money.

Our advisors are just as good at explaining investments as they are at making them. Our clients fully understand what's happening with their money at every stage of their financial journey.

How we make the complex simple:

- Straightforward fees
- Effective game plan
- Advice in common language

Our goal is to make your life easier. We exist to serve as your guide for life's big tradeoff decisions and by working with us, we want you to be confident you made the right decisions.

Find Your Freedom.®

Past performance is not indicative of future results. Before investing in any investment product, contact your Wealth advisor or investment company to obtain a fund prospectus. The prospectus contains more complete information including all charges and expenses.

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

¹Morningstar; Investing Classroom, Great Investors: Peter Lynch.

²DALBAR 22nd Annual Quantitative Analysis of Investor Behavior (QAIB) 2016

³Warren Buffet; March 1994 letter to Berkshire Hathaway shareholders

⁴www.maynardkeynes.org

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