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20 Rules of Prudent Investing

November 2009

Overview: Some of the most complex problems investors face can be solved with simple solutions. The following rules may help investors build and adhere to a well-designed investment plan—giving them the best chance of achieving their financial goals.

Constructing an Investment Plan

1. **Do not take more risk than ability, willingness or need dictates.** Plans fail because investors take excessive risks. The risks unexpectedly show up and the plan is abandoned. When developing a plan, investors should consider their investment horizon, stability of income, ability to tolerate losses and the required rate of return.
2. **Never invest in any security without fully understanding the nature of all of the risks.** If investors cannot explain the risks to their friends, they should not invest. Fortunes have been lost because people did not understand the nature of the risks they were taking.
3. **A well-designed investment plan has many elements.** It should be integrated into a well-designed estate, tax and risk management (insurance of all kinds) plan.
4. **Do not treat the highly improbable as impossible, nor the highly likely as certain.** Investors assume that if their horizon is long enough, there is little or no risk. The result is they take too much risk. Taking too much risk causes investors with long horizons to become short-term investors. Stocks are risky no matter the horizon.
5. **The consequences of decisions should dominate the probability of outcomes.** Investors should ask themselves if they can live with the outcome, regardless of how small of a chance there is of the outcome occurring.
6. **Avoid working with commission-based advisors.** Commissions create the potential for biased advice.
7. **Only work with advisors who will provide a fiduciary standard of care.** That is the only way to ensure that the advice provided is in the investors' best interest. There is no reason not to insist on a fiduciary standard.
8. **Separate the services of financial advisors, money managers, custodians and trustees.** This minimizes the risk of fraud.
9. **A strategy is either right or wrong *before* the outcome.** In general, lucky fools do not have any idea that they are lucky. Even well-designed plans can fail because risk (that was deemed acceptable) shows up.
10. **The only thing worse than having to pay taxes is not having to pay them.** The “too-many-eggs-in-one-basket” problem often results from holding a large amount of stock with a low cost basis. Large fortunes have been lost because of the refusal to pay taxes to convert to a more diversified approach.

11. **The more complex the investment, the faster investors should run.** Complex products are designed to be sold, not bought. Investors can be sure the complexity is designed to favor the issuer, not the investor. Investment firms do not simply give away higher returns.
12. **Securities with high yields have high risks, even if they are not apparent.** Investors should never confuse yield with expected return. Just as Snow White could not see the poison inside the apple, investment risks may be hidden, but you can be sure they are there.
13. **The safest port in a sea of uncertainty is diversification.** Portfolios should include allocations to the asset classes of large-cap and small-cap stocks, value and growth stocks, real estate, international developed markets, emerging markets, and the appropriate amount of bonds.
14. **Equity investing is a positive sum game. Expenses make outperforming the market a negative sum game.** Prudent investors do not play negative sum games unless they can identify a distinct advantage, sufficient to overcome the costs of playing. Use only low-cost, tax-efficient and passively managed investments.
15. **Take risk with equities and not bonds.** The role of bonds is to provide the anchor to the portfolio, reducing overall portfolio risk to the appropriate level.

Staying the Course

16. **Diversification is always working. Sometimes investors like the results, sometimes they don't.** Diversification reduces risk without reducing expected returns. Once investors diversify beyond popular indexes (such as the S&P 500 Index), they will be faced with periods when popular benchmark indexes outperform their portfolio. The noise of the media will test their ability to adhere to their strategy.
17. **The strategy to get rich is entirely different than the strategy to stay rich.** One gets rich through inheritance or by taking risk. One stays rich by minimizing risk, diversifying and not spending too much.
18. **The four most dangerous investment words are “This time, it’s different.”** Getting caught up in the mania of the “new thing” is why the surest way to create a small fortune after starting out with a large one.
19. **The market can remain irrational longer than you can remain solvent.** Bubbles occur. However, investors should never attempt to short them because, while bubbles eventually burst, they can grow larger and last longer than investor resources.
20. **Good advice does not have to be expensive, but bad advice always costs dearly no matter how little is paid for it.** Smart people do not simply choose services based on cost (the cheapest doctor or CPA). Costs matter; but it is the value added relative to the cost of the advice that ultimately matters.

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