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How the rich stay richer

Michael Nairne, Serious Money

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It isn't prognostication skills that make the wealthy savvy with their money. It is their tendency to focus on three critical aspects of successful investing.

I'll let you in on a little secret: Wealthy investors do not have any more insight into where the market is going than the typical Main Street investor.

Consider last year's calamitous market plunge -- very few wealthy investors saw it coming. To the contrary, according to a survey of millionaires by Northern Trust in the fall of 2007, the overwhelming majority expected positive returns from stocks in 2008, while 13% were outright bulls, anticipating returns of greater than 10%. Further, the richer the investor, the more optimistic they were. The U.S. market's 38% drop must have been a shocker.

So it isn't prognostication skills that make the wealthy savvy with their money. Instead, in my experience, it is their tendency to focus on three critical aspects of successful investing.

First, they diversify across a wider range of asset classes and investment strategies. According to the Capgemini Merrill Lynch 2008 World Wealth Report, millionaires globally invested in a varied mix that not only included the traditional asset classes of cash, fixed income and equities, but also allocations to real estate and alternative investments.

Robust asset class diversification can improve a portfolio's returns without a corresponding increase in risk. Or, as the saying goes, "diversification is the only free lunch available in investing." As a case in point, certain alternative investments such as gold, managed futures and low directional equity long/short hedge funds were superb buffers in the stormy markets of 2008. Wise investors avidly pursue the free lunch of optimal diversification at the asset class level.

Second, the wealthy take a global perspective when investing. This outlook may in part derive from their personal experience with foreign travel. It's one thing to talk about Asia's dynamism, it's another thing to see Shanghai or Mumbai first hand. Moreover, given the tremendous challenge in finding managers who can outperform today's efficient markets, many wealthy families take active steps to broaden their search for investment management talent. One wealthy family I know hires hedge-fund managers in New York, London and Hong Kong, each with their own regional mandate. The family's philosophy is simple: They want managers who are geographically focused and fully plugged into the local investment scene.

Third, wealthy investors are early adopters of new and better investment tools. For example, many affluent investors use exchange-traded funds (EFTs). Savvy investors were immediately attracted to the many advantages of ETFs: low cost, flexibility, diversification, transparency and, in many instances, tax efficiency. They recognized that ETFs allow an investor to emulate institutional investors in building an inexpensive, globally diversified asset class into their portfolios.

Better investing isn't about having a better crystal ball -- it's about taking a smarter approach and that's something anyone can do.

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