EQUIUS ASSETCLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

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# This Trend is Your Friend

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*The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he already knows, without a shadow of a doubt, what is laid before him.*—Leo Tolstoy

**Have investors suddenly gotten smarter?**

"*The reports of my death are greatly exaggerated."*—Active Management (and Mark Twain)

After 25 years spent pushing this boulder uphill, the case for adopting an asset class investing strategy and the flow of investment dollars out of active strategies and into "passive" strategies have never been stronger.

In fact, so much money is now flowing into indexed and structured asset class strategies like ours that all the naysayers can do is scare investors by suggesting that too much of this good thing is actually bad. That's right, "brainless" indexing is actually distorting stock prices, they say.

Many articles and papers have been written of late that do a good job of refuting their argument, so I won't pile on at this point.* I will suggest this, however: as more and more investors concentrate more and more money into Apple, Facebook, Alphabet (Google), Amazon, and Microsoft, stock market indexes dominated by these large companies will continue to climb. When they stop, the indexes will fall.

And as the prices of these massive growth stocks fall, many of the "passive indexers" will once again become market timers. They (or their advisors) will sell their ETFs and index funds *after* prices have fallen substantially and not get back in again until *after* the indexes have recovered significantly.

Then we'll all be blessed with articles announcing "the death of indexing" and anointing a new handful of experts who happened to "call it right." Active management will be all the rage, once again.

*The king is dead. Long live the king.*

**Buy high, sell low is pervasive.**

When most people consider the tendency of investors to "buy high and sell low," they almost always think in terms of individual securities trading. But as I've pointed out in prior articles through the years, this behavior pervades our industry well beyond stock picking. In fact, it's been practically institutionalized in the 401(k) industry. Advisors recommend funds which, based on past performance, have 4 or 5-star ratings (buy high), hold them until they inevitably underperform, and then replace them (sell low) with new 4 or 5-star funds (buy high – again).

*Wash, rinse, repeat.*

The buy-high/sell-low tendency is pervasive and hard to suppress. It's a sad fact of our business: we meet very few potential clients who are willing to give up active management *before* a substantially negative event occurs. Often it takes a series of them—almost all related to short-term performance —that finally add up to a tipping point when the investor hits bottom and seeks an alternative.

This is why we're seeing such a large flow of assets out of active management today when we should have been seeing it ten or fifteen years ago. More, not fewer, investors should adopt an asset class indexing approach—and sooner, rather than later.

It's far from optimal to start working with a new client after bad stock picking and market timing decisions have destroyed wealth and reduced his investable asset base—both for the client and for us. But, unfortunately, pain is often the necessary catalyst for change. And at least we're helping clients break a behavior that fits the popular definition of insanity.

**We'll take open-minded over slow-witted, Mr. Tolstoy.**

When it comes to investing (at least), younger minds are sometimes easier for us to work with because they haven't been drawn too deeply yet into the traditional Wall Street world. Words associated with asset class investing, such as "modern," "science," "progress," "academic," and "evidence-based" seem to resonate well with them.

Except in some cases where exceptional wealth has accrued (at least temporarily) in a concentrated stock position, young investors who have not experienced the seductiveness of active management can often be convinced to avoid the false promises of the approach right out of the gate.

Equius has been moving aggressively toward building a "next generation" firm, led by T.J., Nick, Jason, and Dave. As part of this move, we've been focusing more deliberately on our clients' next generations.

For the children and grandchildren of these clients, that should be encouraging. There's arguably no better way to preserve and grow long-term wealth (particularly legacy wealth) within acceptable risk parameters than by using a highly diversified and structured asset class approach.** And there's hardly a better way to destroy it than with a highly concentrated position or portfolio.

The next logical step is to more deliberately reach out to younger people *outside* our current client base. This is not a market generally targeted by established firms like Equius, which are told constantly by industry consultants to increase minimum account sizes, work with fewer clients, and add more "wealth management" services that higher net-worth clients allegedly seek. But that is the conventional thinking. When have we ever been conventional?

Working with younger investors involves a long-term investment for Equius. But it's a strategy that stays true to our firm values and principles. Also, the strategy can be more satisfying to our team due to the impact we can have on young clients' financial futures and because our efforts are typically much less frustrating than trying to pry older investors away from traditional Wall Street firms and sales people.

**But we're still here for you, prior gen.**

Older advisors like Phil, Rick, and I know a lot of very wealthy people. Many of our personal friends are wealthy. And many of them are still dabbling in the active management world despite what they surely know about the benefits of indexing and asset class investing and the consistent failings of traditional active management.

We have racked our brains trying to explain this phenomenon. Is it simply a complacency derived from building *excess* wealth? Is it the thrill of the game? Is it ego and the need to be part of the excitement and complexity that active managers work so hard to project?

We wish we knew. But we're not losing sleep over it. All of the people we know in this regard can handle a series of bad active management experiences without a substantial change in lifestyle.

However, their spouses, heirs, and charities will almost certainly pay a price for their reluctance to simplify and modernize their investment portfolios. After all, the old Chinese proverb 富不过三代 or "Fu bu guo san dai," which translates as "wealth does not sustain beyond three generations," is an unfortunate fact of life.

We developed a formal legacy program for prospective clients a few years ago as a possible solution to this challenge. We were early, evidently, because we were not overwhelmed with interest except from current clients with whom the program has been very successful. Maybe this trend of wider acceptance of indexing will allow us some day to resurrect it.

We have an unwritten policy at Equius to avoid trying to convert active investors to asset class investors. It's unwritten because we must always allow discretion to judge whether a prospective client is open to a new approach or not. We're not trying to avoid wasting time. We're just trying to make sure that whatever time is spent, it's spent helping those who value it the most.

So we can only wait for some investors to come to us. In the meantime, and consistent with our "tortoise vs. hare" approach, we'll happily work with their kids.

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*See Mark Hulbert's recent article, "What would happen if everyone invested in index funds," *MarketWatch*, 5/8/17.

**This is why we believe very strongly that all foundations and endowments should be invested this way.

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