EQUIUS ASSETCLASS℠

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

March 2018

# Be a Financial Designated Driver

*Jeff Troutner, Equius Partners*

Tim Slattery, an advisor friend of ours, starts out a meeting with a prospective client by stating the following:

*"Our investment philosophy is 100% driven by logic, with one exception. We're asking you to take one thing on faith: capitalism will make us money over time. If you don't believe that you shouldn't hire us and you should not own stocks. Because if you don't believe capitalism will make you money over time then the stock market is just a gambling casino. It's purely a speculative venture."*

Capitalism creates wealth in many different ways. For example, you can assess all the risks and then invest your time, money, and brains into opening a local coffee shop. Or you can invest in the global public securities market and rely on others to assess the unique risks of their businesses and build wealth that is reflected in rising stock prices and, hopefully, dividends. How you "invest" in these securities markets is the critical issue.

Most investors purchase mutual funds run by money managers who buy and sell a concentrated portfolio of, say, 50 stocks. It's considered good diversification if you own many of these actively managed funds with different investment styles. Welcome to the gambling casino.

The table below shows that over the last 15 years only 42% of U.S. actively managed stock funds have *survived*. Would you consider a 58% chance that your fund either merges with another one or is liquidated (almost always to hide bad performance) a gamble on the viability of active management?

**Results After 15 years (ended June 2017)**

| Fund Category | Comparison Index | Survivorship | Style Consistency | % Outperformed by Benchmark |
|---|---|---|---|---|
| All Domestic Funds | S&P Composite 1500 | **42%** | **39%** | **85%** |
| All Large-Cap Funds | S&P 500 | 36% | 27% | 93% |
| All Small-Cap Funds | S&P SmallCap 600 | 51% | 45% | 94% |

*Source: S&P Index Versus Active (SPIVA) report, S&P Dow Jones Indices LLC, CRSP. Data as of June 30, 2017. Table is provided for illustrative purposes. Past performance is no guarantee of future results.*
*1. SPIVA Persistent Scorecard*

Over the last 15 years only 39% of actively managed funds stayed true to their investment style. If, as the empirical evidence suggests, returns are driven by style, isn't this 61% failure rate considered a gamble?

Over the last 15 years only 15% of all U.S. stocks funds managed to outperform the market. Should a 85% failure rate be considered a gamble?

Finally (not shown), only 10% of funds that were in the top 25% in performance at the end of 2013 remained in that top quartile a year later. Four years later, only .87% were still top-quartile. Is this lack of performance persistence not a gamble?[1]

This is why traditional active management should be consider an *uncompensated* risk by fiduciaries, such as advisors and trustees. Some risks are worth taking and others simply aren't. Capitalism creates the opportunity. You need to decide how to most wisely exploit that opportunity.

With so much empirical evidence supporting efficient market theory, the availability of highly diversified index and asset class funds, and a better understanding of investment risk (as well as how emotion and behavior affect decisions), investors can *invest* in capitalism rather than gamble with it. Asset class investing is the answer.

According to the Ad Council, since the "Friends Don't Let Friends Drive Drunk" advertising campaign in 1983, "more than 70% of Americans exposed to the advertising have acted to prevent someone from driving drunk. As a result of the campaign, the term 'designated driver' is part of American culture."

Maybe you should be the financial designated driver for family, friends, and colleagues by steering them away from active management. After all, after *you* rejected the low odds and uncertainty of that addiction, aren't you less stressed and more confident of your financial future?

# Place your bet, choose a path.

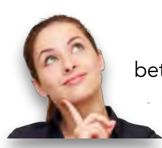
- Asset Class Investing
- Indexing
- Active Management

Pick a long-term strategy to preserve and grow your wealth.

## Asset Class Investing (Knowledge – Confidence – Discipline – Sharing)

Place your bet on capitalism and markets.

Review your history of investment mistakes and learn how to avoid them in the future.

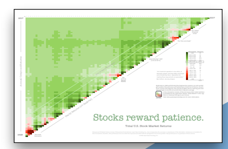


Learn the difference between compensated and uncompensated risks.

Understand markets, the failures of traditional investing, and the true source of long-term returns.

Build a "four-factor" portfolio based on Fama/French research to increase expected returns.

Reject simple "risk profile" questionnaires that lock you into your current thinking on risk and return.



Review the long-term history of asset class returns and rethink risk from that perspective.

Treat predictions from articles, the Internet, TV, friends, and family as investing "noise."

Enjoy time with family and friends that you would otherwise spend worrying about your investments.

When markets fall, rebalance to target allocation by buying stocks and selling bonds. Take planned distributions from the bond side of the portfolio.

When markets rise, rebalance to target allocation by selling stocks and buying bonds. Take planned distributions from the stock side of the portfolio.

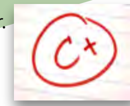
Share your less stressful and more predictable investing experience with a loved one or friend.

- Requires more learning
- Highest expected return
- Tilted to small cap, value, and profitability factors
- Should reduce stress and uncertainty

## Indexing

Ignore the Fama/French research.

Accept that your risk profile and return expectations represent the average investor.




Build a simple portfolio with total stock market and total bond market index funds.

Try to stay the course with a portfolio tilted heavily toward higher-priced large growth stocks. (See FAANGs)

Rebalance to target allocations regularly, especially when it hurts.

Achieve market performance only with a strict buy-and-hold discipline with rebalancing.

- Simple, lower costs
- Lower expected return
- Less diversified by asset class
- Weighted to large growth stocks

## Active Management

Places your bet on stock-picking and market-timing gurus.

Take 10 minutes to pick a portfolio of 5-star funds based on past performance that is unlikely to persist.

*What will the Fed do?*

One fund manager believes interest rates will rise. Another one believes they'll fall. Have a scotch. Make it a double.

Oops, one of your fund managers messed up. Roll the dice, pick a new one.

*Will interest rates rise?*

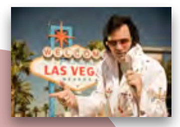
Another fund manager lost his mojo and closed his fund. Pick a new horse on the active management merry-go-round.

*Inflation ticked up. Should I buy gold?*

You got out of the market. Good job, you just flatlined your portfolio!

*If he/she wins the election, should I sell or buy?*

Bitcoin is on fire. Buy now or miss your chance! Or consider a vacation to Vegas instead.




Take a detour into complex and illiquid "alternatives" despite egregious fees and lack of transparency.

*Oil prices are falling. Should I sell my oil stocks?*

You've redistributed your wealth generously. Now get back into stocks after they've risen 200%.

All your funds own large positions in the FAANG stocks. Tech decline just chewed up your profits.

*How high can tech go?*

*Why is investing so stressful??*

Congratulations! You transferred a substantial amount of your wealth to old-school advisors who most likely didn't earn it.

- Usually complex and opaque
- Lowest expected return
- Much less diversification
- Much higher costs
- Expect more changes and greater stress and uncertainty

**WARNING:** Active management can be detrimental to your financial health. It underperforms a simple index fund 80% of the time.* Everyone's known this for over 40 years. So if you have a lot less wealth for retirement, your children, or your charities, you have only yourself to blame.

**SPIVA report (S&P Index Versus Active) and other sources.*

*The curve of the active management path represents the emotional ups and downs most investors experience with the approach. Greater uncertainty, fear, stress, lack of clarity, complexity, high costs, constant changes, poor relative performance, and other negative attributes are among the reasons long-term investors are increasingly turning to indexing and asset class investing and away from active management. The path to success with indexing and asset class investing is hardly ever as smooth as portrayed here. Asset class investing requires a new—some would say radical— way of thinking about risk and return, and the inevitability of market cycles will always create doubt and uncertainty. Confidence builds over time and should lead to uncommon discipline and self-control. This is the unique challenge of indexing, which is often undertaken by "do-it-yourselfers" with inadequate knowledge and no professional assistance with the confidence and discipline challenge. Market timing (usually of the buy high/sell low variety) is too often the result. Preventing these costly "detours" is Equius' greatest opportunity (and our greatest value) with clients.*

# Now and Then

Dave Goetsch, Executive Producer of The Big Bang Theory, reflects on his investment experience in the recent market downturn and contrasts his new perspective with memories of the 2008-2009 financial crisis.

Seeing all the recent headlines about the sudden downturn in the stock market has transported me back to February of 2009, when I was close to despair. It's striking how different I feel now.

In February 2009, the stock market was down around 50% from its high, and everyone seemed to feel like the sky was falling. I was familiar with this state of panic because my relationship to the financial markets was that I didn't trust them.

They were always going up and down in ways no one could predict, and I couldn't trust those folks who said that they could anticipate what was going to happen. So when the market went down, I went down with it—sinking into a depression, knowing there was nothing I could do.

*I haven't changed because the stock market rebounded. I changed because I learned that there was a different way to think about investing.*

What a difference nine years make. I haven't changed because the stock market rebounded. I changed because I learned that there was a different way to think about investing. I was right not to trust those people who thought they could predict what was going to happen in the markets, but I was wrong in thinking that there was nothing to do. I've learned that I can have a great investment experience if I just accept a few simple truths.

I have to understand the uncertainty of the market. The stock market, as measured by the S&P 500 Index, has returned about 10% per year over the last 90 years,* but there are very few individual years in which it has ever actually returned that amount. In fact, how many of those 90 years do you think the S&P 500 was up more than 20% or down more than 20% for that year? The answer is 40. Astounding, right? I wish somebody had explained that to me decades ago. Then I would have known to look at stock market returns in terms of decades—not years, months, days, or hours. I would understand that so many of those articles and cable news pieces are just noise, designed to keep an audience obsessed and unsettled.

In order to be a long-term investor, you have to have a long time horizon. This can be hard to remember when you're being assaulted by noise, but if you can stay strong, the results are stunning. By results, I don't mean the investment returns, which hopefully are good. The return I'm talking about is how I feel every day. I worry less—not just about the future, but also about the present. Of course, I know that there are no guarantees when it comes to investing, but I feel like I'm going to be okay. I have a plan.

There's no way I could've done this without a financial advisor. I needed someone who could not just talk me through what my asset allocation should be, but also help me work through how I felt about investing and what exactly I could do to change my perspective.

I was a mess nine years ago. Now, my outlook is totally different. The markets haven't changed; they still go up and down. The difference is, I don't anymore.

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*I'm not sure I should admit to being a huge fan of The Big Bang Theory, but there you go. I met Dave at a CEO Forum sponsored by Dimensional a couple of years ago and was struck by how this incredibly talented artist has so passionately embraced asset class investing. He has inspired me to try to inject more humor into what is clearly a serious business of building and preserving our clients' wealth. This month's "centerfold" is an attempt I hope you will appreciate.*

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