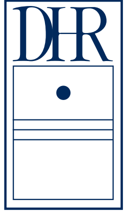
Perspective

July 2014 *By Davis Riemer*



DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

'Tis summer – a time for light reading, like: *"Twas brillig, and the slithy toves did gyre and gimble in the wabe; All mimsy were the borogroves, and the mome raths outgrabe."* (Lewis Carroll, "Jabberwocky") I trust my own text will be somewhat more intelligible.

This summer issue of the *Perspective* is seasonally adjusted, with a less intense focus. Subjects include: a matter recently in the news – High Frequency Trading; "Mr. Market's" Wanderings – the path of stock prices; "Alpha and Beta" – whether we're smart or lucky; Hard Choices - some difficult choices confronting many investors; and last, Advisor's Alpha - some comments on assessing value in an Advisory relationship. In addition and just for fun, we have inserted a separate sheet with some humor on each side. We hope you enjoy it.

High Frequency Trading (HFT)

At least to my eye, there has been so much ink and talk about this in recent months, that I have little new to add, and will offer only a few basic points.

First: Michael Lewis, who exposed HFT in his recent book "Flash Boys," stated flatly on CBS' '60 Minutes' that "the market is rigged." I disagree. Lewis has made a somewhat sensational remark. As an investment professional, I think otherwise. I also think that individual investors, or even small institutional investors, who tend to use particular trading styles have no chance to prevent themselves from being victimized by HFT.

On the other hand: Investors who day-trade (a practice which differs fundamentally from HFT) can avoid harm almost entirely by altering their trading style, which they probably ought to do anyway. Given the paucity of evidence that supports claims of success for day-trading (not HFT), people who practice it ought to pay more attention to statistics, reason and logic, rather than marketing pitches and behavioral biases.

Second: A long term investor experiences either no measurable negative impact from HFT or such a small one that it vanishes in the distance over time. Nonetheless, as a public policy matter, HFT demands attention from the SEC, from market participants and from us all. People who invest as you do, in broadly diversified,

slowly traded, long term hold positions in passively managed mutual funds, have very little about which to be concerned personally. The danger to us all comes from a tendency to lose confidence in the market. We need good regulation to address this.

Third: Private capital seeking outsized profits will always outstrip the government funds to control it. Many millions of dollars have been invested in this trading style, because it produces staggering profits. Early in my business career, I remember hearing "better fast nickels than slow quarters." Well, this HFT trick produces only pennies per trade, but at such a rate that the recipient quickly gets rich. Lewis estimates billions. There is nothing inherently wrong with quick wealth, but this technique presents serous ethical issues. It may be deemed similar to insider trading, and might even be prosecuted as such. The nation, through its regulators, must figure out how to identify, catch, regulate or criminalize it. This type of action will support public confidence in the marketplace.

Alpha and Beta

Both DHR clients and regular readers of this publication often hear about research that demonstrates that investors should not rely on "stock-picking" (selection of individual issues) as a method of generating performance above the market. That demonstration does not result from the presumed lack of knowledge on the part of unsophisticated individual investors. It applies also to the very intelligent, highly trained and well equipped professionals who manage funds. The debate over this issue began in earnest in the 1970's and has continued full-throated since. A major difference separates the two sides. The "should not rely on" side points to statistical studies and financial theory to support its findings. The "of course you can" side points to superior individual past performance. The reliance on past performance has some weakness, in that its persistence is very low. The population of managers in the top quartile of performance is unstable. More importantly, the number of outperformers in the total population of managers cannot be differentiated from the number that would result from pure chance. Two recent studies add to the "should not" side of the debate. This past month, Morningstar published *"Shrinking Alpha,"* and the National Bureau of Economic Research published *"Scale and Skill."* Neither organization has a bias in the matter, but both add additional statistical weight to the skepticism about the ability of selection or timing to increase performance in a reliable way.

Two technical market terms - "Alpha" and "Beta" - appear in this debate. Very briefly: Beta describes the risk and return of the particular investment market. As an example of a pure "beta" fund, consider the Vanguard S&P500 fund. Except for its very low costs, the performance of it almost exactly matches the performance of the S&P500 itself. So, it has a beta of "1." In this example, "alpha" denotes the degree to which the performance, risk adjusted, of an investment exceeds the performance of that sector. So, if the S&P500 rises 10%, but an investor in that sector generates 15%, we say that investor has "alpha." We hear and read all the time of portfolio managers' "alpha." But is it really skill, or is it just chance? Because variation from average always occurs in large populations, so outperformance always occurs in investor populations. However, its cause – whether it results from skill or chance - cannot be proven either way. Therefore, those who claim to have alpha will always be able to

continue their claim, until, as in musical chairs, they have nowhere to go. Now, as continuing research continues to pull away more and more chairs, where do alpha seekers go? If they make their money relying on their claim to "alpha," they certainly will need a hat with some rabbits in it (who have some more chairs). Ah, the mixed metaphors!

A recent addition to the debate, of course with its own label, can tell us where some of them go: "Smart Beta." Ironically for those of us who have followed the research career of Eugene Fama and accordingly have used investment funds created by Dimensional Fund Advisors (DFA), the new destination of alpha seekers is interesting, indeed. "Smart beta" consists in large part of small cap and value oriented bias in portfolios. Its proponents are turning to knowledge and understanding that has been available and in use for decades, but now claim it to be "new" and "smart." Even so, they acknowledge that "Smart beta" is inherent "in the market" and in portfolio structure, not in foreknowledge of future price movements. It appears that the investment world is moving in our direction.

Where is Mr. Market Going?

Mr. Market has been taking a long stroll – up the mountain. Starting in March of 2009 - up, up, up, all the way. That is a long time and a lot of price movement. Fun, eh? You bet! We all liked the recovery from the bottom. We also liked 2013, with a 30% percent gain in domestic stock prices. This year, even after a steep early drop, as of the end of June the S&P was up 7.14%.

World news reports serious political problems. Neither world nor domestic news reports tell of significant economic improvements, although they do report gradual improvement. One wonders: Why don't investors behave as if they had concerns about these facts? Is there a possibility of complacency here? Perhaps the more positive stories really are a better forecast. The Efficient Market Theory tells us that all available information is always in the prices, so nothing is held back, and "nothing is revealed." What should one conclude?

It is not unreasonable in this environment to expect a downturn. We should recognize this environment - we have seen it before. Whether prices go up or down from this point forward, we have been here before. At those "before" times, we did not know what was to come. Now, we do know what did come. It is quite unlikely that we will soon again go through price troughs as deep as those we traversed in 2000/01/02 and 2008/09. And, we know that we made it through. What was required of us was focus, discipline and patience.

A number of recent financial media stories have discussed the performance of broadly diversified portfolios during such experiences, comparing them to the more common portfolios of large cap domestic stocks. Needless to say in this publication, the diversified portfolios have displayed better performance, both on the way down and up. The perceived threats might be new – ISIS, approaching elections, market price valuation measures and more. But the fact of threats is not new and we always have the same options for our actions. We can leave the market (timing), reduce our position temporarily (timing), or modify our posture by changing positions (still timing). All these respond to an *expected* (forecasted) decline in market prices.

We can also "do nothing," which is actually not doing "nothing." It represents a conscious choice, made after analysis, based on probabilities over the time remaining to the investment horizon – of when we need the money. In fact, it is often more difficult, in emotional terms, than "doing something," when "something" means an action to sell or change. To remain calm and still in the face of expected turmoil requires an overcoming of oneself, a mastery of behavioral tendencies. Walt Kelly, one of my favorite cartoonists (lost to the younger generations, I fear) created the character Pogo, who spoke the great line: "We have met the enemy, and he is us!" In seeking success in the process of long-term investing, what is the greatest risk? What poses the greatest obstacle to success? *The investor.* As we have recommended before, on many occasions, let's just walk with Mr. Market and continue on our journey to the destination, noting but neither fearing nor chasing changes in our path.

Hard Choices

DHR's clientele spans every decade of life from the twenties into the nineties. The meaning of "retirement" and "retirement income" changes markedly over that span of time. Increasing age changes – not to say sharpens – the focus. This article is concerned mostly with "the boomers." That includes yours truly; the finance industry calls us, in concert with those somewhat younger, the "matureds." It addresses particularly those who feel they experience the same challenges, when thinking about financing their retirement. Boomers grew to maturity in a long economic boom and period of increasing prosperity. They not only believed in the American Dream, but they also saw it fulfilled. Education, hard work and dedication would win out and allow one's own dreams to be fulfilled, so, as boomers turned the corner to 65, there had been no real reason to think something might go wrong. Why should they not base plans for their futures on their entire life experience? Why assume that it would not continue?

Then, suddenly, the game changed. The "Great Recession" threw all the variables of the plan into disarray. How long would one have to work? For how much money? How much could one save? How much could investments earn? When should one retire and, importantly, how long would one live? What would medical care cost? How much income would be needed? Would one's days end in a county facility or on a curb? These questions did not appear for the first time in this generation, but the entire context, as well as the rules by which we considered all these things, changed. Now, we must ask: *What should one do?*

When doing retirement planning, the answer to "what should we do?" is usually simple to state, but often hard to live out.

Know your true life goals – they are almost never financial;

Know your expenses – in detail;

State your financial objectives clearly, in dollar terms;

Realistically determine your savings ability and your plan to execute;

Invest intelligently, for the long term;

Separate the variables that lie outside your control;

Understand and manage those variables that lie within your control;

Cultivate patience.

We seek to help clients fulfill their goals and realize their dreams. Those accomplishments require striking the right balance between gratification today and tomorrow, accepting and avoiding risk, pleasing self and others, reason and emotion. Although money measures some of the balance, and DHR works with money, it is not the money that we seek to materialize.

Advisor's Alpha

Among all the companies with whom I have worked in my near-forty years in this industry, two stand out for delivering the best and most sophisticated information, that which is high quality and unbiased, without "marketing" or sales emphasis. They are Dimensional Fund Advisors and The Vanguard Funds Group. DHR acknowledges their significant contribution to our expertise and technical capabilities. Their education, to our success, is *sine qua non*.

A little more than a decade ago, Vanguard began to formalize the meaning of a term that had previously been used only somewhat casually in the industry – the "Advisor's Alpha." At first, Vanguard applied it in a conceptual manner, referring to various areas of knowledge, advice and counsel in a professional relationship, and emphasizing three characteristics – diversification, balance and discipline. As they assessed in deeper detail the needs of the clients served by the practices of the advisors who used their funds, Vanguard's thinking evolved and their focus shifted more to the emerging ideas of "wealth management." This led them to consider what they call "enduring principles" in a professional relationship which lasts over the decades of clients' financial lives. Wealth management practitioners build long-term relationships, base their work on a long-term focus, emphasize rationality and discipline, use financial planning to pursue client objectives and consider a great variety of risks attendant to their clients' success. An advisor's ability to incorporate these characteristics in a relationship with a client creates "alpha" – the value delivered to the client, over and above the returns on the portfolio.

That is all well and good. However, today's highly calculated financial world measures success in dollars and "percents" - even in hundredths of a percent (e.g. 0.01%). In that context, how does one calculate the value of enduring advice - that "alpha" that an advisor might claim? Clients ask: "What are your fees and what do you do to earn them?" What calculus can an advisor use to answer in terms that are consistent with the question? How can advisors compare long-term benefits, realized un-evenly over years, to fees billed every calendar quarter?

In an interesting and substantial white paper, the Vanguard Investment Strategy Group has offered an approach to that dialog. They have identified seven separate categories of activity which form a major part of an advisor's role in a wealth management relationship. Based on our own work, DHR would add a few more. For each of the seven, the Vanguard team has attempted to measure the value added by the advisor in portfolio return percentage points. Its arithmetic precision, however, is based on assumptions.

Naturally, a fundamental question will be: "Compared to what?" In the following chart, Vanguard has made this comparison between a hypothetical portfolio (the advisor's) and an "average portfolio." Their text: "…comparing the projected

returns of a portfolio that is managed using well known and accepted best practices for wealth management with those of portfolios that are not." They varied their example of the "average portfolio" in the various categories measured. They used independent data for aggregated endowment portfolios, expense ratios of all mutual funds, performance results of hundreds of retail IRA accounts and other base line examples. You will notice two zeros in the "Value Added" column; each represents acknowledgment that client situations are unique and no number can accurately capture this item.

I do not claim that this calculus presents exact truth. However, I do believe it offers insight and ways to think about this very important subject. I look forward to refinements, both from the profession and from DHR.

Here is Vanguard's table of conclusions.

Advisor's Alpha Strategy	Value Added (*) in Basis Points of Portfolio Return
Broad diversification and suitable allocation	0
Cost effective implementation	45
Re-balancing	35
Behavioral coaching	150
Asset location in portfolio accounts	0-75
Spending strategy (withdrawal order)	0-70
Application of total return strategy	0
Potential Value Added	230 - 325 BPts (About 3% annual return)

Note: (*) - Relative to "average" client experience

Without any attempt to quantify and without detail, I mention here several areas of DHR's involvement with clients that we believe produce value.

1. Where helpful, annual prior-to-the-end-of-the-year tax-management consultations with client and tax preparer;

2. When needed, joint work with legal counsel to maximize the economic benefits of the estate planning;

3. Periodically, a consultation with client and broker for property / casualty and liability insurance coverage, to improve mutual understanding and appropriateness of the terms of coverage;

4. Analysis and recommendations for the wisdom of purchasing Long Term Care insurance and life and disability insurance coverage.

To close this section, I again refer to the planning tool DHR has used for almost a year – Money Guide Pro. Our understanding of its capabilities and sophistication is increasing by the month. We look forward to using it with all of you.

The solstice has passed. Summer has full sway. We wish you all the best of it.

Happy Trading...

1 Ah, the price is going up, let's watch the market

2 The trend is holding - I'll buy at the next consolidation

3 Damn! I missed the consolidation, but if I wait any longer, I won't profit from the trend. LET'S BUY!

4 Good thing I didn't wait!

5 I'll use this correction increase my position...

6 Brilliant! At this price, let's double it!

7 Ouch. As soon as it goes back up, I'm selling out!

8 I don't believe it! It's down to 8 1/4! It's hit its absolute bottom!

9 OK, let's wait for it to recover - otherwise this will have to be a really loooooong-term investment.

10 What are the SEC doing about this?!?!!?!?!??!

11 Enough! I'm selling out! And staying out.

12 Good thing I sold everything!

13 It's going to tank again anyway.

14 Told you so.

15 You what???

16 What the hell???

17 More crazies who are going to get taken to the cleaners!

18 This is it! I knew this was going to happen all along!

19 Drat! I'll buy in again. It's cheaper than last time anyhow.

Life.*

*Available for a limited time only. Limit one (1) per person. Subject to change without notice. Provided "as is" and without any warranties. Nontransferable and is the sole responsibility of the recipient. May incur damages arising from use or misuse. Additional parts sold separately. Your mileage may vary. Subject to all applicable fees and taxes. Terms and conditions apply. Other restrictions apply.

No refunds and batteries are not included!