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## Alpha or Wealth?

There is a steady and dramatic shift occurring in the investment world toward Exchange Traded Funds. ETFs as they are called, represent baskets of stocks which are managed only to match specific indexes, not to beat them, as is the case for actively managed mutual funds. According to a recent study by Barclays Global Investors US listed ETFs climbed to an all-time high of \$607 billion at the end of August. The study suggests that a "conservative" growth rate of 20% compounded annually, would put ETFs above \$1 trillion by mid-2011. That total would represent 10% of the US mutual fund industry. Brad Hintz, an analyst at Bernstein Research, in a Sept. 23<sup>rd</sup> research note said the growth of passive index products in general and ETFs in particular represent "a threat to traditional asset managers." He expects investors will focus even more on fees and tax efficiency with a sluggish outlook for stock and bond returns after the financial crisis. In this Brief I will demonstrate that there are even more significant advantages to the passive approach offered by ETFs than simply lower costs and taxes.

The debate between active portfolio management and passive or "random walk" investing is a long and complicated one. It is not the subject of today's Brief; we accept that there are managers out there who have provided "alpha" or market outperformance relative to the market over extended periods of time. But investors are so caught up with the possibility of outperforming the markets that they ignore an important warning, just as addicted smokers ignore the very graphic Surgeon General's warning on cigarettes. You see the warning everywhere investments are advertised, even at the end of this Brief; "past results do not guarantee future performance." The issue is less whether your fund manager will beat the market – a few will; but rather the uncertainty of *when* that market relative performance will occur relative to the real life requirements on your invested money.

American Funds, the nation's second largest fund company recently published an article promoting the benefits of active management over passive in which they showcased their New Perspective, Capital World Growth and Income, and Euro Pacific funds. The piece is well done, as are all American Funds' publications. Our purpose is not to debate (or concede) their ability to outperform markets on average over long cycles but rather to demonstrate using their brochure examples how much real life results can vary from their published performance.

The New Perspective fund was selected for this example because it has the longest track record and compares best to a single index, the MSCI EAFE index. Over the last ten years the New Perspective Fund has outperformed the EAFE index five of the ten year period under study by 8.7% on average. The fund underperformed for five of the ten years by 3.3% on average, for an average outperformance of 2.7% pre-tax. This is their 'brochure number.'

For our first 'real life' example, let's take an IRA investor who contributes \$2,000 (adjusted for inflation) a year to the New Perspective (NP) fund starting in 1999. By the end of 2008 she would have \$24,200. By contrast, if she had invested in the EAFE index, she would have \$22,000 or \$2,200 less.

Now let's examine a period of saving and spending with the impact of taxes. Suppose a grandparent sets up a college fund for his grandchild who plans to start college in eight years. In 1999 he begins investing \$2,000 (adjusted for inflation) each year into the NP fund in a taxable account starting in 1999. In years 2007 and 2008 the student takes \$5,000 and \$5,150 to help with college expenses. Under this scenario the NP fund would be worth \$10,900 in 2008 while the EAFE index would be worth \$11,700. The timing of cash flows and taxes adversely impacted this individual's *wealth* performance, while the performance reported by New Perspective does not change. The timing of when over and under-performance occurs has significant beneficial or adverse impact on real world situations; whether positive or negative is simply luck.

An example of bad luck is what happened to investors of the Legg Mason Value Trust over the last three years. Mr. Bill Miller grew famous by besting the S&P performance for 17 consecutive years. He accomplished this feat by concentrating his stock selections in companies and industries he deemed would outperform the broader market - the S&P 500. Unfortunately for him and his investors, his string was interrupted in 2006 by three years of significant underperformance of 10%, 12%, and 18%. His outsized bets on the financial sector of the US worked against him. What impact would these results have under our earlier lifelike scenarios?

In the case of our saver, an investor starting in 1999 saving 2,000 each year (increased each year for inflation) for ten years would have \$42,000 in Mr. Miller's fund at the end of 2008. Our index investor would have \$51,300. Under our save and spend example, the Legg Mason Value investor would have \$19,200 in 2008, well short of the index investor with \$24,100. That's a 20% reduction in lifestyle folks and it is avoidable.

So what's going on when a fund can outperform the market, yet in many cases fail to deliver superior results for real investors? As stated earlier, the uncertainty of the timing of a fund's market relative performance can have beneficial or detrimental impact on an individual's investment plan depending upon how his or her cash flows (saving, spending, or holding) line up with the fund's results relative to the market. Remember, the market cannot by definition under or outperform itself. It is the degree of risk that an active manager adds beyond market performance that is of utmost importance.

David Loeper is a pioneer in exposing the myths and risks of Wall Street's performance game. He has written several books and white papers (referenced below) which are packed with data to make his case that the average investor is being under and even ill-served by our industry.

Mr. Loeper granted his permission for me to share the applicable parts of a recent presentation he delivered to Wealthcare managers to highlight the largely ignored danger of market relative performance, or 'alpha.' In his study Loeper assumes the managers of funds beat the market by an average of 2% over a period of 30 years. His data is based on Ron Suz's highly regarded Pipods Universe of manager results. For the study, he uses a simple case where a client has \$2 million to invest and wants to generate \$118,000 for 30 years without eroding his principal. Loeper runs this simulation through his Wealthcare Monte Carlo model and finds that his 2% alpha assumption (outperformance) provides a 68% chance or degree of confidence that he can meet his client's required goal. He further improves his confidence to 78% by reducing taxes by

lowering portfolio turnover to only 15% and eliminating short-term capital gains. That's a fine portfolio.

But here's the problem. In the real world, alpha, or market relative performance is not predictable. There is no way of knowing when a fund is going to outperform or by how much. This problem is known as timing risk. In his example, Loeper assumes that his portfolio will outperform the market by 2% on average (the implied promise of many actively managed funds). But to keep his model realistic he does not force a constant 2% out-performance. That feat cannot be realistically accomplished. Loeper builds his model using Suz's Pipods Universe of managers to select only those managers that beat the market by 2%, while recognizing that their relative out-performance is unpredictable.

So what happens to the 78% confidence we saw earlier when timing risk (or reality) is introduced into the model? If you captured the fact that unpredictable variability reduces confidence then you would correctly guess that confidence declines. In fact, confidence falls to 57% that our investor will be able to take \$118,000 annually from his portfolio without violating his principal.

How would a passive S&P 500 index model do in comparison? To make it fair Loeper assumes his index model will cost money to implement so he fixes a negative alpha of .49%. He further handicaps it by recognizing that there is market variability as passive index portfolios have some tracking errors to varying degrees at uncertain times. Under the same requirements as before the passive portfolio provides a confidence of 54%, three points below our 2% alpha example.

Too many investors would walk out the door happy with the promise of 2% alpha and \$118,000 to spend annually from their \$2 million unaware of the hidden dangers lurking in the uncertain future. Confidence of 57% is barely better than a coin flip. Would not the client be better served if he was made to understand that there was an almost equal chance of running out of money, even with a 2% market outperformance?

Let's say our sample client was aware of the risks and demands a higher confidence in his plan. As a practical being, he is also willing to accept a lower level of income to keep his principal at \$2 million. By reducing his income to \$60,000 annually he could expect a confidence of 86% in a passive index model (burdened as before with costs) and a confidence of 84% in the 2% alpha portfolio. Surprised by the difference? Remember, the market does not underperform itself. The smaller variance of the passive portfolio provides a slightly higher confidence when compared to the alpha managers' portfolio which has a higher relative performance variance (8% in the study).

Now, before getting too comfortable with the conclusions so far, remember that the study period covers 30 years. Do you really think it reasonable to assume an alpha or outperformance average of 2% over a near lifetime of investing?

Loeper answers this question in a practical manner by building a portfolio of ten funds (with the same criteria as before), each providing alpha of 2%. But most will agree that the odds of

picking 10 of 10 stellar funds (2% alpha) over a 30-year period are incredibly small. Take a look at what happens to confidence as the odds become more reasonable – say 4 or 5 out of 10.

Funds	Confidence	Income
10 for 10:	84%	\$52,000
9 for 10:	81%	\$47,000
8 for 10:	78%	\$40,000
7 for 10:	75%	\$34,000
6 for 10:	72%	\$31,000
5 for 10:	69%	\$30,000
4 for 10:	65%	\$23,000

Don't miss the main point! You cannot spend odds or confidence, only wealth. The wealth effect is what is important here – its impact on people's lives. The far right column shows how much (or little) income the alpha portfolios would generate if they were forced to the same level of confidence as the passive model – 86% which you will recall generated \$60,000 in annual income. The price of alpha is risk! The risk is to your lifestyle!

There are controllables in the investing process and there are uncontrollables. Market risk is uncertain as to its timing and degree. Our Wealthcare Monte Carlo simulation process allows us to help you plan for market risk. The rest of the variables are controllable. To a very large degree, you can control costs, taxes, and market relative performance risk. ETFs are very low cost, highly tax efficient and can deliver exceptional index tracking. When efficient ETF portfolios are combined with the ongoing oversight of Wealthcare to provide high confidence in an ever-changing world, we believe our clients have best-harnessed the power of the capital markets to meet their important life's goals.

For additional reading of David Loeper's work:

[Stop the 401\(k\) Rip-off!](#), [Stop the Retirement Rip-off](#), [Stop the Investing Rip-off](#) and [The Four Pillars of Retirement Plans](#)) released in 2009 by John Wiley & Sons and numerous [whitepapers](#).

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