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## How Active Management Can Destroy Wealth

There are plenty of stories of how smart or lucky investors made millions of dollars through unique investment ideas, schemes, or methodologies. There are indeed still billions, even trillions to be made by those who make large gambles and bets. Our purpose is not to suggest that the pursuit of market-beating returns does not have its place. There are indeed many investors with talents, knowledge, and acumen to do so. Rather it is our purpose to demonstrate that the performance pursuit is unnecessary and even dangerous for any investor with more important goals; such as educating children, retiring comfortably, or funding scholarships, grants, or buildings.

Active management focused on producing market-superior returns has long been the method or choice for building wealth, a choice continually reinforced by relentless advertising by a billion-dollar investment industry. However, the quiet truth is that the capital markets (stock and bond markets) provide sufficient returns without enhancement to fund most investment plans. More importantly, efforts to 'enhance' returns through active management can actually cause more damage to wealth than they contribute to it.

The controversy between active and passive management of assets has persisted for decades. Even though there is irrefutable evidence that it does not work for the majority of investors, most continue to chase it. Why is this? The answer is relatively simple; human nature, and billions of dollars of marketing focused on exploiting it.

From the Hunt brothers cornering the silver market in the late 70's to Ted Knight's character in the Caddy Shack waxing poetically about 'having the stock market by the tail,' people have always dreamed of getting rich in the stock market. If stocks can make you wealthy in the long run as Jeremy Siegel demonstrated in his 1994 book, our human nature tempts us to believe that putting all of our eggs in one excellent basket (say a Morningstar 5-star fund) will meet our goal of wealth all the sooner.

By the late 1970's stocks had been in a decade-long slump. The Hunt brothers of Texas became famous by hoarding some 59 million ounces of silver by the end of the decade. Their bet seemed a shrewd move by January of 1980, when the price of silver hit \$50.35 and ounce. The sons of H.L. Hunt, a card-playing Texas gambler, had wildly outperformed the silver market, by cornering it. However, as 'luck' would have it, that same market for reasons unforeseen by the Hunts, plummeted to \$10.20 per ounce just two months later, leaving them with a debt of \$1.5 billion. To Time Magazine author Barbara Rudolph, Bunker Hunt shrugged "a billion dollars isn't what it used to be." You might also recall that shortly after Ted Knight's 'market-by-the-tail' proclamation, his 'yacht' was sunk by Rodney Dangerfield's considerably larger yacht.

Active managers, particularly, the mutual fund industry, spend millions of dollars each year touting their performance. They market it with comfortable symbols like American flags draped over peaceful front porches, happy retired couples on sailboats, green lines pointing the way to

success, and magic numbers that represent all of your future needs. Behind the imagery is an implied promise that through their superior returns they can help you accomplish your goals. But is this a value proposition that can be confidently delivered? More importantly, is outperformance constructive to wealth building?

Many active managers and mutual funds beat their market benchmarks, some with consistency that can seem almost hypnotically consistent. But can investors have real confidence that outperformance will continue every year? How can one be sure that managers will not make outsized bets that might blow up any time, causing significant wealth-destruction? Truth is, every actively managed account and mutual fund carries this inherent risk *all the time*. An active investor cannot know when his managers or his own selections are going to outperform the market or when they are going to underperform. The bottom line is that the inclusion of active management in your investment plan introduces uncertainty, beyond that of the market. It is this extra-market uncertainty that can have significant impact on your wealth and lifestyle.

Active management includes institutional, private asset managers, hedge funds, private equity pools, and mutual funds. Of this group however, only mutual funds' performance results are readily available to the public, so our examples refer primarily to them from this point on.

Of the 25 largest mutual funds currently held in America, American Funds' Growth Fund of America ranks sixth. It is the largest actively managed stock mutual fund in the country. The Growth Fund of America (GFA) is held by millions of investors in IRA's, 401Ks, 529 College plans, trusts, foundations, and so on. As an actively managed, typical, and very broadly held fund with performance data easily accessible, it provides a good example to demonstrate how active management can destroy wealth and lifestyle. We use Beacon's Aggressive Growth model in our comparisons as it most closely mirrors the GFA in asset allocation.

Active managers are less diversified than passive managers and therefore take greater risks, which can destroy wealth. Passive managers need only mimic the returns of the index so they very often simply hold all the stocks that indexes hold. Active managers must essentially place bets on a relatively limited number of companies that they think will outperform the economy and the broad markets. The GFA holds 283 stocks as of 4/30/2010 according to Morningstar. Our model's ETFs hold 5,607 as of 5/31/2010, according to Vanguard.

As you can see below, concentration of holdings affords GFA the ability to outperform the market in some years, but, there is also the risk of underperformance, as in years '06 and '08.

### American Funds Growth Fund of Amer A AGTHX | ★★★★★

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<b>Performance History</b>							
	2002	2003	2004	2005	2006	2007	2008
Total Return %	-22.0	32.9	12.0	14.2	10.9	11.0	-39.1
+/- Index	0.1	4.2	1.1	9.3	-4.9	5.5	-2.1

Funds use compound returns to report their results and they typically include a benchmark, (often the S&P 500) for comparison. But reporting in this manner fails to demonstrate what the fund did for real investors to build wealth for them. The reported numbers apply only to those who simply deposit a lump sum in and leave it there for years. The following two examples demonstrate how underperformance can impact the wealth of a saver and a spender, which after all is more descriptive of real investors.

**Example of an Investor Contributing \$10,000 per year  
To a fund which beats the market by 1% a Year – Until Year 11**

Year		Allocation Return in %	Out-Perform Return in %	Difference	Allocation Wealth Result	Out-Perform Wealth Result
					\$10,000	\$10,000
1	1998	24.3%	25.3%	1.0%	\$22,429	\$22,529
2	1999	25.3%	26.3%	1.0%	\$38,096	\$38,447
3	2000	-11.4%	-10.4%	1.0%	\$43,748	\$44,443
4	2001	-11.1%	-10.1%	1.0%	\$48,872	\$49,934
5	2002	-21.1%	-20.1%	1.0%	\$48,538	\$49,874
6	2003	31.6%	32.6%	1.0%	\$73,882	\$76,140
7	2004	12.0%	13.0%	1.0%	\$92,723	\$96,013
8	2005	6.2%	7.2%	1.0%	\$108,437	\$112,890
9	2006	15.5%	16.5%	1.0%	\$135,211	\$141,481
10	2007	5.8%	6.8%	1.0%	\$153,095	\$161,145
11	2008	-36.7%	-39.9%	-3.2%	\$106,911	\$106,850

In the example above you can see that it only takes an underperformance of 3.2% in the 11<sup>th</sup> year to wipe out the wealth premium the fund had amassed over the benchmark 'allocation' by outperforming it consistently by 1% for ten years. Similarly the same happens in reverse. If an investor spends \$8,000 a year his wealth premium can be wiped out by an 8% underperformance in the first year.

Year		Allocation Return in %	Out-Perform Return in %	Difference	Allocation Wealth Result	Out-Perform Wealth Result
					\$100,000	\$100,000
1	1998	18.8%	13.8%	-5.0%	\$110,756	\$105,756
2	1999	13.7%	13.7%	0.0%	\$117,921	\$112,237
3	2000	-0.9%	0.1%	1.0%	\$108,854	\$104,343
4	2001	-4.1%	-3.1%	1.0%	\$96,403	\$93,120
5	2002	-7.2%	-6.2%	1.0%	\$81,433	\$79,318
6	2003	20.0%	20.0%	0.0%	\$89,731	\$87,193
7	2004	8.9%	9.9%	1.0%	\$89,731	\$87,839
8	2005	4.9%	5.9%	1.0%	\$86,136	\$85,030
9	2006	10.3%	10.3%	0.0%	\$87,043	\$85,822
10	2007	7.3%	7.3%	0.0%	\$85,415	\$84,105
11	2008	-15.7%	-14.7%	1.0%	\$64,005	\$63,741
	Risk (SD)	11.1%	10.2%			
	Compound Return	4.54%	4.72%			

Please notice that in both examples the compound return for active management was higher than the benchmark returns, but the wealth impact was lower because of when the underperformance occurred. That is the point; you can't know when your fund or manager will underperform, which adds significant uncertainty to your plan.

Active management costs more than the passive management and cost destroys wealth. The reported cost of the GFA is .76%. The reported internal cost of our two ETF's in our Aggressive Model is .10%. An unreported cost is that which is related to the buying and selling of stock by the managers. Commissions paid and the spread between bid and ask are unreported costs by mutual funds. The higher the turnover the higher the costs. The annual turnover for GFA is 38% according to Morningstar. It is .06% for our funds (Vanguard). A study done by Wharton for the Congress revealed that trading at GFA's levels (at the 25% percentile) amount to roughly .40%. Our costs, including commissions paid on re-balancing trades would come to roughly .05-.06% for a \$400,000 investor. Additionally, investors who buy mutual funds pay an up-front sales load of 2.5% for a \$400,000 portfolio. It costs just \$18 to buy the initial two holdings for our Aggressive model, or .005%.

You may be wisely thinking that mutual costs are fully netted in their returns and you are correct. The point though is that those costs serve as a hurdle for active managers to clear even before they can achieve market-beating results. The higher their hurdle rises, the lower their odds of success. Costs are certain, performance is not. In fact, our Wealthcare analysis shows objectively and conclusively that just a 1% higher fee can have a huge impact on lifestyle forcing people to save more, take more risks, or spend considerably less on important goals such as college or retirement.

Investors all too often forget another certain cost – TAXES. If you own mutual funds in taxable accounts (or actively managed private accounts) you are giving substantial returns to Uncle Sam. Since its inception in 1973 the GFA has earned a compound annual return of 14%. Morningstar calculates the impact of taxes on the funds' reported income (dividends reinvested) at the highest federal level. State taxes are not considered, making the point even more emphatically for investors in states like NC with 8% income taxes. The GFA lifetime return is reduced by nearly two full percentage points to 12.1%. The passive approach is low in turnover and by its nature holds positions well into the long-term gains period, minimizing the impact of taxes. Further, ETF's do not generate annual gains from turnover as their counterparts, mutual funds do.

There is the argument that costs don't matter if the fund outperforms anyway. That's true in theory, but you must consider the odds of your funds doing so over the lifetime of your plan. They are miniscule. Consider these facts. From 1970 – 1974 an investor in Forbes' Top 30 Funds beat the S&P by 3.1% over that five-year period. But, during the next twenty five years the same funds underperformed the S&P 500 by 1.6% per year. Remember that even a 1% reduction in return can have a huge impact on your lifestyle.

The odds of picking outperforming funds are also dicey. A recent study by *Advisor Perspectives'* Robert Huebscher revealed that Morningstar's star rating system was not much better than a

coin-toss at predicting performance. During the latest market cycle a randomly selected 5-Star fund had only a 58% chance of beating a randomly selected 1-star fund. Alternatively, a randomly selected 1-Star fund had a 42% chance of beating a randomly selected 5-star fund.

Even if funds do a tremendous job of delivering returns, investors must consider their ability to make good decisions, without falling prey to emotions. The GCM Focus Fund was the top-performing fund for the decade ended 2009 with an average annual return of 18%. But its rock and roll ride proved too much for many investors. The average shareholder return for the same period was a decidedly worse -11%. In fact, Dalbar a perennial analyzer of investor behavior most recently reported that during the period between 1988 and 2007 the average stock fund returned 11.6%, yet the average investor earned only 4.6% in returns.

Most people and institutions invest not for the thrill of beating market averages, but for the purpose of accomplishing goals that are very important to them. It is our strongly held conviction that the returns from the capital markets, properly allocated, are sufficient to meet those requirements and that further 'return-enhancement' is unnecessary and even destructive to their purpose. Any perceived benefits of active management are vastly diminished by the odds of choosing well, poor or misleading benchmarking, high expenses, increased taxes, greater timing risk, threat of underperformance, and emotional and behavioral mistakes.

Investing for a lifetime and for life-impacting goals is serious business. Why risk striking out by swinging for homeruns when walks, singles, and a few doubles will get the job done? We stand ready to prove it to you in terms you can understand – your assets, goals, and priorities.

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