The Value of Sound Investment Advice
by Eric D. Nelson, CFA

Some prospective clients come to Servō knowing that they want an advisor and are seeking the one that best fits their needs. Others struggle with this decision versus investing on their own and find it helpful to see a summary of the value they will receive for their fees. What follows is a summary of the investment value that clients can expect from Servō.

**“Pro-Growth” Allocations** +1% to +2%

Should you hold most of your portfolio in stocks, bonds or something in between? Which combination will most likely generate the returns you need without taking more risk than you can tolerate?

The most common rule-of-thumb is to hold “your age in bonds.” This means that a 40-year-old who is saving for retirement at age 66 will only hold about 50% of their wealth in stocks over the next 2 decades. A 66-year-old who lives until 90 and adopts this allocation guideline will only have an average of 25% in stocks over their retirement.

But for the average Servō client who wishes to have a secure, multi-decade retirement with rising income and leave a substantial legacy to loved ones or charities, asset allocations that are over weighted in bonds can lead to significantly lower long-term wealth accumulation because of their low returns. This is an often overlooked “cost” of investing.

A typical stock/bond allocation we use for pre-retirees (80/20 averaged across an investor’s 40s, 50s, and early 60s) has averaged +10.4% over all 25-year periods since 1926, compared to only +8.8% for an age-in-bonds 50/50 split. Results are similar for the typical stock/bond allocation we use for clients in retirement. A 65/35 stock and bond mix had a +9.7% return over all 25-year periods since 1926, compared to just +7.3% for the age-in-bond, fixed-income dominated 50% stock, 50% bond allocation. And in each case, there wasn’t a single 25-year period where the higher stock allocations underperformed the lower stock allocations.

**Avoiding Speculation** +1%

For many, the allure of stock picking or hiring superstar managers who can beat the market is considerable. But there is no evidence that these speculative approaches can consistently add value. To the contrary, they typically carry a significant cost, so we help our clients avoid these mistakes under all circumstances.

A study by Vanguard founder John Bogle found that the average large cap mutual fund has underperformed the Vanguard S&P 500 Index fund by 1.2% per year since its inception in 1976. While that may not seem like a lot, a $10,000 investment in the Vanguard index fund grew to $356,276 by 2011 versus only $226,253 in the average active mutual fund. For investors, their decision to invest actively cost them more than 30% of their wealth over their lifetime!

**Asset Class Balance** +1%

Most investors who use an index-based approach to investing stick with “total market” index funds. These portfolios hold lots of stocks but are weighted heavily in the largest and most growth-oriented companies. Nobel Prize winning research has shown that smaller and more value-oriented stocks have higher risks and are expected to produce higher long-term returns than the market. What’s more, because value and small cap stocks behave differently from the general stock market, investors could see additional diversification benefits from adding unique asset classes to their overall portfolio.

We develop asset allocations for our clients that include blue chip, large cap stocks, but also large and small value stock asset classes globally. The benefit of this philosophy can be seen when comparing a “total market” index portfolio with a small/value tilted “asset class” index portfolio in Table 1.

**Table 1: The Benefit of Asset Class Balance**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>1979 to 2014</th>
<th>2000 to 2009</th>
</tr>
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<tbody>
<tr>
<td>Total Market</td>
<td>+11.5%</td>
<td>+0.4%</td>
</tr>
<tr>
<td>Asset Class</td>
<td>+12.6%</td>
<td>+4.1%</td>
</tr>
</tbody>
</table>

The asset class index mix produced over 1% per year higher returns (+12.6%) compared to the traditional total market approach (+11.5%). More importantly, during the “lost decade” from 2000-2009, the diversified asset class index mix earned over 4% per year while the traditional index allocation was barely positive, earning just +0.4% annually.
Better Tools
The “retail” (meaning they are available to anyone who wishes to invest in them) asset class indexes listed in Table 1 produced noticeably higher-than-market returns over the last 36 years (longest available data), and we would use them in index fund or exchange-traded fund form if we felt like they did the best job of capturing the small cap and value premiums globally. But our research shows that the “institutional” (meaning they are restricted to investors who meet large minimum balance requirements) asset class mutual funds from Dimensional Fund Advisors (DFA) have done a better job in this department.

Table 2 looks at five “core” global stock and bond asset classes (with 20 years of live history) that comprise well-balanced portfolios, comparing DFA mutual fund returns to retail index results. In every example, the DFA fund exceeded the returns of their index, often by almost 1% per year. Including index fund expenses, the differences would be even greater.

Table 2 also illustrates this point with diversified portfolios. In the case of both the all-stock allocation and the stock and bond balanced allocations, the DFA fund-based portfolios produced annualized returns that were almost 1% per year more than the gross-of-fee traditional index versions.

We build client portfolios using what we believe to be the most well designed, expertly managed asset class strategies available to investors. Over time, the advantage of using better asset class “tools” for a given asset allocation can add upwards of 1% per year to a portfolio’s bottom line.

Table 2: Retail vs. Institutional-Class Indexes (1995-2014)

<table>
<thead>
<tr>
<th>Asset Class/Portfolio Mix</th>
<th>DFA fund</th>
<th>Retail Index</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Large Value stocks</td>
<td>+11.3%</td>
<td>+10.5%</td>
<td>+0.8%</td>
</tr>
<tr>
<td>US Small Value stocks</td>
<td>+12.9%</td>
<td>+11.0%</td>
<td>+1.9%</td>
</tr>
<tr>
<td>Int’l Large Value stocks</td>
<td>+6.7%</td>
<td>+5.9%</td>
<td>+0.8%</td>
</tr>
<tr>
<td>Int’l Small Value stocks</td>
<td>+7.6%</td>
<td>+7.0%</td>
<td>+0.6%</td>
</tr>
<tr>
<td>Short-Term bonds</td>
<td>+5.6%</td>
<td>+4.9%</td>
<td>+0.7%</td>
</tr>
<tr>
<td>All-Stock Asset Class Mix</td>
<td>+10.5%</td>
<td>+9.6%</td>
<td>+0.9%</td>
</tr>
<tr>
<td>Balanced Asset Class Mix</td>
<td>+9.2%</td>
<td>+8.3%</td>
<td>+0.9%</td>
</tr>
</tbody>
</table>

Disciplined Behavior
On their own, even the smartest investors are often unable to stick with their plans over time. Many investors become greedy after several years of above-average stock gains and fearful in the throes of a bear market, causing them to buy and sell at precisely the wrong time. Morningstar has documented a “gap” of about 2.5% annually between the returns on mutual funds and the results that actual investors earn after controlling for this fear/greed-induced behavior.

Tactical changes within asset classes can also lead to significantly lower long-term portfolio returns. A recent study from Vanguard covering the 10-year period ending in 2013 simulated an investor who continually chased the best performing funds in each of the nine US “style boxes” over the previous three years as an investment strategy 3. When compared to the returns of the buy-and-hold investor, the performance chaser underperformed by 2.8% per year and in no single style box did the buy-and-hold investor perform worse.

We spend a considerable amount of time up front and on an ongoing basis educating our clients about why we’ve made specific investment decisions and encouraging them to stick with their plan unless something dramatic has changed in their lives. The Morningstar and Vanguard research, as well as many other studies conclude that the discipline we promote in adhering to our plans adds significant value above and beyond the average investor experience.

Unconventional Value
No investment decision alone appears all that noteworthy, but when we consider the collective decisions we make to help our clients achieve their long-term financial goals and aspirations, the cumulative value is considerable.

By shunning typical asset allocations that are dominated by low-returning bonds and high-fee “alternatives,” avoiding traditional approaches to picking stocks and timing the market, promoting and adhering to more balanced asset allocations, and using the best available asset class investment strategies, we believe our clients are positioned as well as they can be to achieve what matters most to them. By staying patient and disciplined in all market conditions, we believe our clients are capable of truly accomplishing their most cherished financial goals. Ultimately, that is the value of sound investment advice.

Source of data: DFA Returns 2.0

Past performance is not a guarantee of future results. Indexes and index portfolios are not available for investment, and do not include the costs or market impact that comes with managing actual investments. This information is provided solely for educational purposes and is not a promise or solicitation.