By the early 2000s, I had broken free of the full commission sales side of the financial industry. I joined the country’s largest discount brokerage firm (where Servo clients still retain their accounts to this day). They were evolving and had become eager to start giving their clients advice as opposed to just providing a platform to inexpensively buy and sell investments.

**Independence Was Not a Panacea**

I learned, however, that commission-free advice wasn’t always good advice. We were able to direct the firm’s clients in a number of different directions: to an internal “private client” program predicated on actively managed funds and quarterly tactical portfolio tweaks, an “advisory network” of external investment advisors who picked individual stocks trying to beat the market, or worst of all, to their active trader platform. I was already well versed in the long odds that any of these would be successful, especially the active trader avenue that was merely Vegas-style gambling done through the stock market. I decided that I would do my best to forego all of these and focus on educating people about the merits of long-term investing, broad diversification, and index funds. It would be an uphill climb because merely bringing in new clients to the firm and guiding them toward index funds from Vanguard or Schwab wouldn’t provide me the same bonuses as these “managed solutions” that were highly encouraged and for which we were compensated the most. But I would be able to live with myself so the struggle seemed worth it.

**Not All Index Funds Are Created Equal**

After a year or two of this the issues became too big to ignore. My basic index approach was good enough, and at least I had helped many people get off the merry-go-round of active management and market timing. But “good enough” wasn’t my goal nor was it what I thought clients deserved. I had more to offer. I understood that indexing principles had continued to evolve. By the early 1990s it was widely known, thanks to the academic research of Eugene Fama and Ken French, that a portfolio’s orientation to smaller and more value-oriented stocks was as important as its mix between a stock index (the S&P 500) and lower-risk, short-term bonds. These essential asset classes were noticeably absent from my portfolios because Vanguard, Schwab and similar exchange-traded funds (ETFs) didn’t offer indexes in these asset classes, or when they did they were so watered down and ineffectual as to be almost useless.

It wasn’t just about the higher expected returns of these asset classes, either. For the five years ending in 2004 the S&P 500 Index had a negative return of -2.4% per year. Smaller and more value-oriented stocks globally provided significant diversification benefits and strong positive returns, assuming you could target these asset classes using the institutional-class mutual funds from Dimensional Fund Advisors (DFA), who drew inspiration and insight directly from Fama and French. But I couldn’t. They were only available to a handful of Registered Investment Advisory firms (RIAs) who had been approved by DFA to use their funds.

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**Table 1: Mutual Fund Annualized Returns (2000-2004)**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>DFA</th>
<th>Vanguard</th>
<th>Schwab*</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Large Value</td>
<td>9.1%</td>
<td>2.4%</td>
<td>-2.0%</td>
</tr>
<tr>
<td>US Small Value</td>
<td>19.4%</td>
<td>15.1%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Int’l Large Value</td>
<td>8.4%</td>
<td>3.2%</td>
<td>-2.8%</td>
</tr>
<tr>
<td>Int’l Small Value</td>
<td>17.0%</td>
<td>6.1%</td>
<td>No Fund</td>
</tr>
</tbody>
</table>

* Schwab did not offer value-oriented index funds, so “market” index funds were substituted


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by Eric D. Nelson, CFA
One Step Forward, One Step Back

Thankfully, I had a fiercely independent and progressive manager who not only understood my frustration, he believed in my philosophy. He took the dramatic step of approaching a local independent RIA firm with access to DFA funds. They had recently become a member of the advisor network with limited success; my manager suggested they sell their overly cumbersome and seldom-needed wealth management routine and simply provide a suite of DFA fund model portfolios that I could use with clients. They could charge the advisory fees, acting as my conduit to DFA, and I would be responsible for giving my clients more practical saving and retirement planning advice while also offering them true state-of-the-art investment management. I was fine with the arrangement so long as I could design the model portfolios. They agreed and I was off and running, flush with independence and investment portfolios that reflected my philosophy, beliefs and the advice I felt investors deserved to hear.

For two years it worked great. I found many individuals and families who were attracted to my approach after experiencing less-than-stellar “advice” from Wall Street brokers and do-it-yourself outlets. Teachers, professionals, small business owners, attorneys, accountants, physicians, even a newly minted member of the Forbes 400 list—all of them found value in my retirement/legacy planning and asset class investing approach. During my free time I was even able to attain the Chartered Financial Analyst (CFA) designation that I felt was a necessary addition to my education if I was to provide the very best financial advice and investment management.

But as soon as things got going, I had the rug pulled out from under me. My firm decided to change the way we interacted with clients. Any individual or family who had aligned themselves with an independent advisor (even if just to get access to DFA funds) was to become the sole responsibility of the advisor. I was no longer to have any ongoing contact or access to DFA funds) was to become the sole responsibility of others. I knew going in that despite being independent, having access to DFA funds and their general familiarity with the Fama/French research, this firm and I differed in many ways philosophically. I was principled, consistent and focused; they went in a lot of different directions. They were a “fence sitter,” managing money using a variety of different approaches without the conviction of any one in particular. Some active management, some tactical market timing, mixing in some index funds and a few DFA asset class funds for perceived “diversity.” I didn’t feel this approach wasn’t more sophisticated; it was just complicated. Ongoing education and guidance under this framework, an essential part of successful investing, was nearly impossible. I thought that once I explained to them my process more specifically, they would come around. I couldn’t have been more wrong. I learned that if you don’t start with the same philosophy you have nowhere to go but down.

This was 2008 and the market had been extremely volatile and stress levels were high. My message to clients in the midst of the chaos was simple: if you had a sufficiently long-term horizon and were exclusively in stocks you had time to ride out the storm; if you were more conservative or taking income from your portfolio, your temporary stock losses had been aided by the positive returns from a high quality, short-term global bond fund. More specifically, balanced portfolios had sufficient reserves in the DFA Five-Year Global Bond Fund that could be drawn upon until stocks resumed their inevitable up trend. There was just one problem—this was my advice and my approach. Their approach was far different. Their actively managed bond strategies, directed at the riskiest parts of the bond market, were imploding right along with stocks. I couldn’t sing the praises of balanced asset class investing in the firm’s town hall meetings and my newsletter when most of the audience and readers had been encouraged to proceed because the mixed messages would confuse more than console.

The situation for me had become unmanageable. Despite joining the firm just nine months earlier, I felt it best to cut ties before I became too ingrained. But where would I go? I didn’t want to make the same mistake again. I knew I had to find a firm that shared my beliefs and philosophy completely, one that I could complement instead of have to contend with. Once I came to this realization I knew there was only one place for me to go. I picked up the phone and called someone I had admired for a long time and learned so much from despite the fact that we had never spoken before:

“Hello, Jeff, this is Eric Nelson. I’ve been following you for years. Your Asset Class newsletter changed my career. Any chance you have an opening for a financial advisor?”

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