SERVO

Factors In Focus

Knowing Isn't Doing

by Eric D. Nelson, CFA

> "In theory, there is no difference between theory and practice. In practice, there is."
> —Yogi Berra

Doing The Scary Thing

Someone interested in learning more about having us manage his family's retirement portfolio contacted Servo a few months ago. He was needing an ongoing income stream from his investments and had read several of our articles on how to do that efficiently and successfully.

However, this wasn't your typical investor—he had worked as the editor of a major financial publication for many years. He had read all of the articles that discussed the superiority of index over active investing, the need to diversify, to have a plan and stick with it, etc. He knew what to do; however, his portfolio was over 80% in cash and had been that way since 2007.

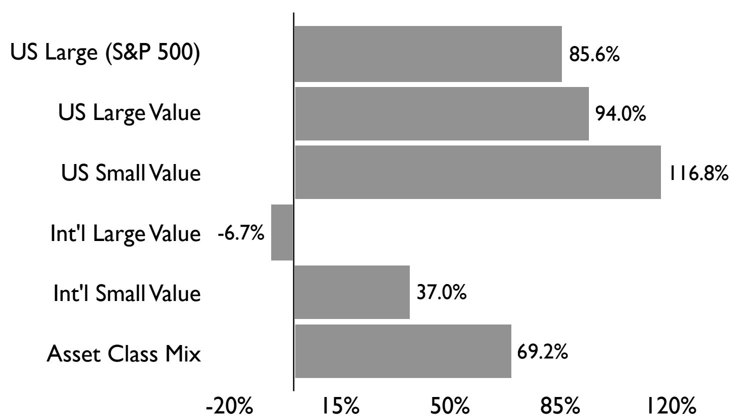
What happened? Upon initially retiring, he hired an "hourly" advisor to prepare a plan that he would then implement and manage on his own. When 2008 hit and with stocks in free-fall, it seemed like a reasonable thing to postpone putting the plan into place. The 2009 recovery caught him by surprise, and by 2010, 2011, and 2012, the market had run up so much he was concerned that it was too late to act.

The plan probably cost a few thousand dollars, and at the time that seemed like a smart investment as opposed to paying an advisor an ongoing fee to manage his portfolio. On a balance that was well into seven figures, he thought he'd be saving a lot of money.

Chart 1 looks at the return on core stock asset classes from 2008 through 2016. Including the worst year for stocks since the 1930s (2008), US asset classes are up between 85% and 116% through 2016, including a healthy premium for value and small cap stocks over the market (S&P 500). International stocks haven't performed as well (yet), but are still up from where they were.

An all-stock asset class portfolio, dutifully rebalanced, has seen more than a +69% cumulative advance (+263% since the generational low in March of 2009) over this period. The missed-out-on returns of the last eight years are more than two lifetimes of advisory fees.

Chart 1: Asset Class Total Returns (2008-2016)



US Large Cap = DFUSX, US Large Value = DFLVX, US Small Value = DFSVX, Int'l Large Value = DFIVX, Int'l Small Value = DISVX, Asset Class Mix = 21% US Large Cap, 21% US Large Value, 28% US Small Value, 18% Int'l Large Value, 12% Int'l Small Value, rebalanced annually. Source: DFA Returns Web

Doing The Hard Thing

I recently read an article on the internet written by a prominent financial commentator in which he outlined his personal investment holdings. His articles are some of the few I read consistently. He's one of the good guys. I was expecting to see a beautifully diversified portfolio of stock

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mutual funds and ETFs, including small cap and value asset classes that have rewarded investors so handsomely over the years. Instead, I was horrified. Approximately 50% of his portfolio resided in his company stock. A US Stock Market ETF and Berkshire Hathaway stock held another 30%.

The primary consideration for the significant remaining stake in the company stock was his unwillingness to pay the long-term capital gains taxes. He chose the Total Market Index ETF mainly for its tax efficiency. There were no foreign stocks, and the rest of the mix was in a few other individual stocks and a Master Limited Partnership (MLP).

I am sure this columnist knows about and has possibly even written on the importance of portfolio diversification, and certainly not having an excessive amount of your wealth tied up in the company you work for, tax issues or not. But doing the hard thing—recognizing the taxes, diversifying to avoid potential and unnecessary risks, including adding asset classes (like non-US large and small value stocks) that haven't performed particularly well lately—is something different altogether.

We Combine Knowing and Doing

These stories are not outliers. They are broadly consistent with the experiences of other investors that contact Servo. Many are very savvy and well read. Some even have the type of knowledge you cannot teach—experience. They've made bad investment decisions in the past and they recognize the need not to repeat them. But, in almost every case, knowing what to do still doesn't translate into doing it consistently well.

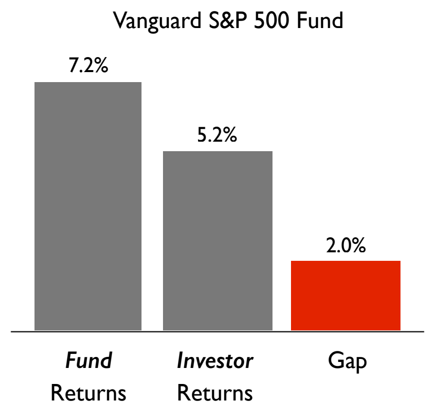
Our process starts by knowing what to do. Based on each of our client's unique financial goals, we design highly structured asset allocations, globally diversified and spread sensibly across "core" large/small and growth/value stock asset classes. We include high quality, short-term global bonds when the portfolio needs added liquidity or enhanced stability. We minimize taxes and position portfolios in a way that will benefit not just our current clients, but future generations as well through estate-sensitive implementation. There's an art to this, and it takes time and experience to know how to pull it all together.

It takes something much greater to implement and stick with a plan during difficult times and in the face of a constant barrage of new investment strategies, approaches, theories and recent star performers. Doing what needs to be done is where we can add the most to your bottom line.

The Value of Doing

Consider the $300 billion of assets that reside in the Vanguard S&P 500 Fund. For many investors, this fund is a "one-stop-shop." And yet the record shows that even shareholders in this fund have been their own worst enemy.

Chart 2: Knowing vs. Doing "Gap" (15yrs ended Feb 2017)



Investors in the Vanguard S&P 500 Fund cost themselves **10X** the fund expense ratio in "behavioral costs" due to buying and selling at the wrong time!

Over the last 15 years, while the fund itself returned +7.2% per year, investors in the fund managed only +5.2% per year. Most Vanguard S&P 500 Fund shareholders knew what to do—buy a low-cost index fund and sit on it—yet they simply could not do it. They likely sold shares after the 2002 bear market, and bought more in 2006 and 2007 after a multi-year surge, only to lose almost 50% in 2008 and sell closer to the bottom.

Whatever the reasons, investors lost about 2% a year showing that there is a significant difference in financial outcomes between knowing and doing. Remember this statistic the next time you see a commercial from Schwab or Fidelity touting a 0.01% cut in index fund expense ratios.

Doing Takes Trust

Why the diatribe on doing, you might be wondering? Two reasons. First, there will come a time when we will ask you to do something that doesn't feel natural. It's part of the process we agreed on but it will still feel foreign to you. Maybe it's a sizable stock market downturn that we'll need to avoid bailing out on or maybe it's a significant run up in one of our asset classes that we'll need to rebalance. But when the time comes, for you, there will be a difference between knowing and doing. Remember the previous examples and the countless billions of dollars that Vanguard index investors have cost themselves by not doing what they should. Commit today not to follow in their footsteps, but instead to trust us, trust your plan and trust our advice.

Second, when you make introductions to us, we will spend all the time necessary to help them know and understand better what they need to do. And our offer will be to help them do those things with more consistency, courage and confidence than they'd be able to achieve on their own or with another advisor. We will try to help them do, just as we do for you.

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your own personal financial situation.