SERVO

FACTORS IN FOCUS

Where We Stand

by Eric D. Nelson, CFA

Many people have had the unfortunate experience of sitting down with or speaking to a financial advisor only to discover that their primary objective was sales related. They weren't so much concerned with *your* long-term financial well-being, but instead how *they* could "convert" you to a customer (as opposed to a client) and begin transferring your wealth to their firm's coffers through commissions and hidden fees. I talk with clients about their past experiences all the time and hear the horror stories.

It's no surprise that the financial advisor industry has a poor reputation and many people have sworn off receiving professional help and advice altogether or are willing to trust their hard earned wealth to a giant mutual fund complex or an on-line "robo advisor" who utilizes a simplistic risk-tolerance questionnaire to guide your lifetime savings.

My goal was always to create a different kind of advisory firm, one that stood on durable, evidence-based and client-focused principles and was unwavering in the application and adherence of our beliefs. But above all, one that took a sincere personal interest in our clients' long-term financial success. Servo is not about being all things to all people, but instead about being the best we can to those individuals and families who take the time to understand our unique philosophy and process and trust that we have a sensible approach and your best interests at heart.

We *Reject* Traditional Investing

You're not likely to hear this from most holders of the Chartered Financial Analyst (CFA) designation, but despite its continued popularity, traditional stock picking and market timing doesn't work. We're not able to do it reliably well and neither are most other investors and advisors.

A look at the long-term returns of stock and bond mutual funds that are "actively managed" finds that all of the time and effort that professional investors spend on trying to identify winning stocks while discarding the losers is a waste of time. A study by Dimensional Fund Advisors looked at all US-centric stock mutual funds from 1984 to 2015 and found that their average returns were +9.3% per year. But simply buying the entire stock market through the Russell 3000 Index did +10.7% per year. That's a significant difference. What's worse, the small handful of funds that do outperform periodically are not able to maintain that advantage for any meaningful length of time.

In recent years, adherents to traditional investment approaches have begun to concede that they can't add value in normal markets. Instead, they claim, they can avoid significant declines when the market goes down. The evidence points to a different reality. Standard & Poor's examined actively-managed fund results in the 2000-2002 and 2008 downturns and concluded "the belief that bear markets favor active management is a myth."

Starting off on the right foot by rejecting traditional investing not only affords us a meaningful advantage over most investors, but it also allows us to focus on the elements of the investing process that truly matter.

We Think *Long-Term Investors* Should Own *Long-Term Portfolios*

Whether you realize it or not, you're probably a long-term investor. Even in retirement, your wealth may need to support you for several decades and some of it might be passed on to family members or charities/organizations after your retirement. This means you need to plan and invest for the long-term.

And yet, many investors who should be focusing on long-term outcomes make decidedly *short-term* decisions. They hold excessive amounts in low-returning bonds because of their lower *short-term* risk. They include large allocations of "alternative" assets like real estate, commodities, managed futures, and long/short funds that are designed to dampen *short-term* portfolio volatility.

But think about it—in 20 years, will you really care how volatile your portfolio was this year or next? Or will your primary concern be how much wealth you've been able to accumulate and how much cash flow you've been able to generate? I'm betting it's the latter.

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If so, then your portfolio should consist mostly of the ideal long-term investment: **stocks**.

Time Periods (1928-2016)	% S&P 500 Outperformed T-bills	Average Annual Outperformance
One Year	69%	+8.1%
Five Years	79%	+6.6%
10 Years	85%	+6.5%
20 Years	**100%**	**+6.8%**

We know stocks fluctuate a lot in the *short run*. But in the *long run*, they've consistently produced higher returns than safer alternatives. As a long-term investor, you have the time to allow your wealth to benefit from the positive long-term results of stocks. We always encourage our clients to hold as much of their portfolio in stocks as they are comfortable owning after an extensive review of market history.

We Believe an *Asset Class Approach* Is Essential To Your Success

Admittedly, many investors have woken up to the realities of traditional investing as a record amount of money is flowing into index mutual funds that simply try to track market returns. But there's an issue with where most of this money is headed—"Total" Stock (and bond) Index Funds. These indexes buy a broad basket of all the stocks and bonds in a particular market. On the surface this is a reasonable approach. The issue, however, is that a Total Market Stock Index is heavily weighted towards the largest and most growth-oriented stocks. When you buy an S&P 500 Index Fund, you're expecting to own a bunch of high-priced, mega-cap companies. Most total market investors expect to get more. They're not.

The recent "Lost Decade" from 2000-2009 illustrates the risk of plowing your entire stock portfolio into large stocks.

Asset Class Index	2000-2009 Annualized Return	Growth of $1
S&P 500 Index	-1.0%	$0.91
Russell 3000 Index	-0.2%	$0.98
DFA US Large Value Index	**+4.1%**	**$1.50**
DFA US Small Value Index	**+12.5%**	**$3.24**
MSCI EAFE Index	+1.6%	$1.17
DFA Int'l Large Value Index	**+6.6%**	**$1.89**
DFA Int'l Small Value Index	**+12.7%**	**$3.30**

The S&P 500 Index lost -1.0% annually and the "Total Market" Russell 3000 Index didn't fare much better, losing -0.2% per year. The MSCI EAFE Index of developed international stocks, many of which are multi-national companies with significant operations in the US, didn't provide much benefit either, gaining just +1.6% per year. US and international large and small *value* stocks, on the other hand, which receive almost no representation in Total Market Index Funds, had noticeably better results.

We believe that owning these asset classes is essential for investors to achieve their long-term goals. For this reason, the portfolios we manage are well diversified across large *and* small, growth *and* value stocks globally.

We Know That an Ongoing Partnership *With Us* Can Be Profitable *For You*

Skeptical of the value that a financial advisor can provide, some people hire financial planners on a one-time basis or choose to self direct their investments. By reducing or eliminating the fees they pay to an advisor, the thinking goes, they will have more wealth. For most investors, we don't believe this is the case. Instead, we know that an ongoing partnership with *us* can be more profitable for *you*.

Summarizing what we've just said, we think that our advice to avoid traditional active management and all forms of market timing will benefit you over time. We believe that adopting a more growth-oriented, tax-efficient portfolio will add meaningfully to your bottom line. We also believe that holding a portfolio that is more deliberately diversified across smaller and more value-oriented stocks globally, and one that is implemented using institutional-based "asset class" funds (such as those from Dimensional Fund Advisors) as opposed to "retail" index funds and exchange-traded funds (ETFs) will help you achieve a superior result.

But most important of all, we believe the *consistent application* of these policies and procedures, which requires ongoing advice and counsel, can help you avoid making ill-advised decisions at the wrong moments, which frequently costs investors several percent of their wealth on an annual basis over time. And we believe that our coherent and practical approach will afford you more confidence and peace of mind, and give you the added freedom to pursue more rewarding (non-financial) aspects of your life. We believe that all of this can add up to a benefit that is significantly greater than our costs.

These are the principles I founded Servo on and that, five-and-a-half years later, I still believe in and stand for. I'm sincerely grateful for the confidence and trust you place in Servo and your willingness to stand alongside me as we travel down the road to your financial success together.

Source of data: DFA Returns Web

Past performance is not a guarantee of future results. Diversification does not eliminate the risk of loss. Index returns include the reinvestment of dividends but not expenses or additional advisory fees. This article is for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, product, or service. Servo is an investment advisor registered in the states of Oklahoma and Texas with clients nationwide. Unauthorized copying, reproducing, duplicating, or transmitting of this material is prohibited. For past *Factors In Focus* newsletters, please visit Servo's website at servowealth.com. **Edited by Kathy Walker.**

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