FACTORS IN FOCUS

You've Got Me, Who's Got You?

by Eric D. Nelson, CFA

In Richard Donner's *Superman* (1978), Lois Lane had fallen from a high-rise building and was heading to her imminent death. Superman caught her in mid air, miraculously, appearing to save Lois. But as reality set in, she worried, "You've got me, who's got you?"

While financial matters aren't nearly as important as a life or death situation, anecdotally investors have been asking the same question of their financial advisors: I work with you, *but whom do you work for*? The Department of Labor (DOL) has for years been working on a higher standard of financial advice for retirement investors—a universal fiduciary-based model where all financial advisors are required to put their investors' best interests first. Traditionally, this has only been the practice of Registered Investment Advisor (RIA) firms like Servo. Brokers were allowed to give advice that was only "suitable," or that "did no harm" in laymen terms. But the DOL is pushing to hold all financial professionals to a higher level of care, Wall Streeters included.

This distinction might seem like a technicality, but consider recent news reported by the Wall Street Journal and others about brokerage firm Morgan Stanley. A short time ago they terminated their relationship with Vanguard, the largest and lowest-cost mutual fund company in the U.S. Because their performance was poor, you'd think? Hardly.

Vanguard refused to pay the six- or seven-figure annual kickback to Morgan Stanley necessary to access their army of brokers. Because Vanguard refused to "pay to play" like so many other mutual fund firms, preferring to stand on the merits of their investment results, Morgan Stanley customers will lose access to the best mutual fund company available to them. DFA, incidentally, has never made themselves available to commissioned-based brokers, choosing to work only with RIA firms who share their client-first principles and investment philosophy.

If the fiduciary standard is applied uniformly across the investment industry, we will hopefully see an end to unscrupulous annuity sales, high-fee mutual funds and other esoteric, commission-based products like non-traded REITs. But this is not the same as magically transforming all brokers and advisors into principled, evidence-based client advocates. No matter how extensive the regulation, or how many stacks of additional forms or disclosures are added to the client engagement process, investors' best interests cannot be legislated. The industry will continue to fall short in several key ways. What follows is a summary of a few widespread issues in the advisory industry and how we specifically address them to truly act in our clients' best interests.

Short-termism

Advisors that work with individuals and families are effectively responsible for helping them achieve their lifetime wealth goals—financial independence, a secure retirement, and in many cases a legacy for the ones they will someday leave behind. Measuring the actual progress towards these goals can only be done over a period of decades. Days, months and even years are largely irrelevant in the grand scheme but are still closely scrutinized. In fact, most investment approaches and products are designed to address the very short-term issues that should be of little concern to an investor's long-term goals.

Even a casual glance at the historical risk/return relationship of stocks and bonds demonstrates that it is fixed income, and not equities, that pose the greatest long-term threat to lifetime financial goals that become more expensive each year. Stocks, with historical returns of 9-10% annually, have outpaced inflation by such a wide margin (6-7%) that they offer a clear path to accomplishing the goal of modest real growth. Bonds, on the other hand, have only bested inflation by a percent or two, and even then their track record is spotty. For the 50-year period from 1941-1990, investors in bonds earned no return net of inflation. Now *that's* risk.

And yet, many professionally managed portfolios today, even at record-low interest rates, contain a significant allocation to bonds (and longer-term and lower quality holdings). Why? Because bonds have less volatility and help investors "sleep well at night." It's a long conversation and requires counter-cultural thinking to understand that short-term volatility,

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while admittedly tough to stomach (but quickly forgotten), does not have a material impact on long-term financial outcomes. Most advisors who advocate for bond-heavy portfolios prefer to take the short-cut and drown out the necessary gyrations in a portfolio so essential to generating acceptable long-term returns. Maybe we're conditioned to do things the hard way, but Servo is one of the few firms that is willing to have that conversation. Repeatedly. **It's truly in our clients' best interests**.

Complexification

I see a fair amount of portfolios managed by rival firms in the course of offering investment plan reviews to referrals from our existing clients. The statements are emailed because no one wants to waste the printing of 30+ pages of holdings and transaction data necessary to summarize their financial picture. And that's a real problem. Not only do investors not know what they own, their "plans" have been infected with such superfluous complexity that it's all but assured they will never be able to understand their own portfolios.

Even some advisors who, on the surface, would appear to have similar investment philosophies as Servo, cannot help but fall into the trap of needless portfolio complexity. They use dozens of mutual funds spread across several different fund families for the faux appearance of diversification, along with a healthy dose of "sophisticated" alternative assets like commodities, managed futures, long/short funds, and non-traditional lending schemes. I'll admit, this is brilliant marketing, as very quickly an investor feels overwhelmed by the vast array of holdings deemed "necessary" and euphoric over the irrelevant backtested returns that are used to sell based on past performance instead of educating about past risk/return relationships.

None of this, of course, is essential. Core asset classes (stocks and bonds) have proven to be more than sufficient to achieve long-term financial goals, and we can document with a high degree of confidence the relationship between various types of stocks and bonds.

Knowing this, Servo chooses a different path. We take the time necessary to explain and educate our clients about basic asset class relationships and the complete randomness and unpredictability in their short-term patterns. Our plans are simple—spread across only a half-dozen mutual funds, targeting only the core asset classes (globally) that we have the most confidence in and the longest history of quality risk and return data. We don't use this information to sell you on unbelievably high simulated returns, but instead to help you set realistic expectations about what to expect in the future from your portfolio and how bumpy the ride will be. We rebalance periodically and avoid making wholesale portfolio changes based on valuations and forecasts or perceptions of short-term risk. It's a different approach, for sure, but **it's truly in our clients' best interests.**

It Takes a Thanalyst

If "simple" is so effective, then why doesn't everyone practice it? Because there is a question that almost every advisor is afraid to hear and has an even harder time answering: "if it's so easy, then what do I need you for?" Our answer, like our approach, is simple. *You're human*.

You see, knowing what to do with your investments and doing those things consistently well are not the same. This isn't a knock on you or an insult. It's part of how we are all wired. Our emotions get in the way when our life savings, important lifetime goals and highly erratic investment markets are involved, and bad/costly decisions usually follow.

When investment portfolios are trending higher, we get greedy. We are not satisfied by the decent returns on our diversified portfolios. We seek out and shift to those holdings that have performed best recently and carry with them an intelligent-sounding narrative for why the streak will continue. When the eventual setback occurs, we extrapolate bad recent results forward and assume that a significant decline is inevitable and a recovery will be long in the making. All along the way, our brains are trying to find signals in meaningless short-term returns, drawing us to new strategies with a great story and a compelling backtested history like a moth to a flame. Investors and advisors are constantly tweaking their portfolios to fight yesterday's battles and focusing far too much on noise and not enough on long-term and well-documented signals.

To combat these tendencies and to keep investors confident and disciplined when things don't appear to be working, it requires an advisor to act as much like a therapist as an analyst. Underneath the surface, there's usually an underlying cause for the fear or feelings of portfolio inadequacy.

Unlike most advisors, we take the time to understand our clients and the motivations behind their money. Not just their long-term goals, but also their previous (often sub-par) investment experiences, how they've responded to previous challenges and their worst financial fears. In doing so, we're in a much better position to coach our clients through difficult personal and economic periods and empower them to stick to their financial plans. Our two decades of industry experience and our healthy skepticism of investment companies, not to mention all backtested data, helps us to avoid getting burned by the latest hot strategy. Compared to the typical investor who loses several percent per year in returns over time from ill-advised behavior, this outcome is not only exceptional, but the process necessary to deliver this result **is truly in our clients' best interests**.

We can't pretend to answer this question for all firms in our industry. But if you ask us "who's got you?" we can answer simply and confidently: ***you do***.

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