

# the EDUCATED INVESTOR

Summer 2004



Early developers of PC software coined the curious if descriptive acronym, “WYSIWYG” (What You See Is What You Get) to describe products that provided immediate, user-friendly views of your desired letter, report, presentation or other project. Predictably, WYSIWYG software quickly gained popularity over tools that required obscure program coding before you could view your end goal. It’s too bad all investment options weren’t WYSIWYG, with costs and incentives presented simply and clearly.

This issue of *The Educated Investor* seeks to offer a more WYSIWYG view of the market. By understanding the “coding” that goes into an investment product, it becomes easier to see why a disciplined, long-term passive investment approach based on capturing asset class returns can help you avoid hidden expenses that can eat into your portfolio’s net returns.

## 1. Smart Trading

Beware of hidden trading costs, lest they drag too heavily on your end returns.

## 2. The Myth of Hedge Funds

Hedge funds are often marketed to high-net-worth investors as sophisticated and exclusive investment vehicles. Academic scrutiny indicates that these “advantages” may be more myth than magic.

## 3. Bond Markups, Hidden and High

You may be paying more for that bond than your neighbor paid, and not even know it.

## Smart Trading

Beware of small expenses; a small leak will sink a great ship.

— Benjamin Franklin

Building a portfolio of high-quality mutual funds can be among the most cost-effective, tax efficient ways to implement a long-term, globally diversified investment approach. But it’s important to beware of total fund expenses that can hamper returns — whether those expenses are great or small, transparent or hidden. Here, we will focus on the importance of **trading costs**, and explain how a passive asset class fund manager has many ways to control such costs compared with actively managed or index fund managers (see **A Defining Moment**, page 2).

### What Are Trading Costs?

Trading costs are the expenses that a fund incurs while buying or selling stocks or bonds. The impact on returns is often difficult to detect without close academic scrutiny. Such costs do not appear within any published table of expenses, but occur when positions are purchased or sold. We will describe how one important way to minimize the impact of trading costs is with **patient trading**.

### Tackling Turnover

Just as for an individual investor, every time a fund replaces one holding with another it is known as turnover, and it incurs costs (such as commissions and “bid-ask

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### Smart Trading (cont.)

spreads”). The greater the turnover, the greater the drag on net returns. Funds both actively and passively managed face turnover costs. Active managers incur more turnover the more they seek to exchange underperforming assets for future hoped-for winners. An index fund faces turnover when its index’s holdings change.

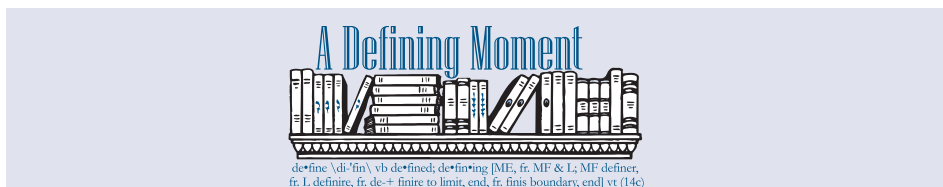
Our passive asset class approach has a similar challenge. Like a chameleon changing colors, a stock can readily move from one asset class to another, and then back. A small company grows. A successful company faces a crisis. The once-small company faces a setback, or the formerly successful company’s crisis is resolved. Throughout, their stocks can jump among small-cap, large-cap, growth and value asset classes.

What’s a fund manager to do? If the fund executes a trade every time a stock experiences minor flips and flops, turnover costs could significantly reduce expected return. A passive asset class manager using patient trading can incorporate reasonable **buy and hold ranges** that allow a stock to deviate a bit from its strict asset class definition before the movement actually triggers a trade. Buy and hold ranges minimize excessive trading while allowing the fund to remain true to its asset class definition.

#### Managing Market Impact

When you go grocery shopping, whether you buy 10 or a 100 pounds of coffee, you expect the per-pound cost to remain static or even improve as you buy bulk. Not exactly so in the stock market. When the market sees someone is anxious to trade a significant number of shares (a **block trade**), prices typically begin to adjust, usually in that trader’s *dis*favor.

If a large sale is tendered, prospective buyers might expect a lower price before they’ll bite. Similarly, when a buyer seeks to rapidly



**Passively Managed Asset Class Funds** seek to cost-effectively capture the returns of an asset class, such as large-cap value or international growth. A passive asset class fund independently sets its own rules for how it will trade holdings that fall within the targeted asset class. Such holdings may not appear in any specific index.

**Index Funds** (also passively managed by definition) seek to cost-effectively capture the returns of a particular sponsor’s index, such as the S&P 500 (sponsored by Standard & Poor’s). By only holding positions within the index it is tracking, the fund faces impact costs as it must quickly react when a sponsor changes holdings within its index.

**Actively Managed Funds** seek to outperform the market by trying to predict the next winning stock or by timing trades based on where they think the market is headed next. Unlike a passive approach, active funds typically seeking to outperform their index, frequently engage in more trading and thus face greater cost hurdles.

purchase a large block, prospective sellers usually demand higher prices to meet the request. The difference — the market impact cost — is a classic case of supply and demand.

The harder it is to trade a large number of a stock’s shares (for example, stocks with smaller market capitalization or less liquidity) — compounded by the more urgent the need to trade quickly — the greater the market impact cost is likely to be.

There are several reasons a trader might seek such urgent trades. Active managers might want to rapidly trade a stock that they believe is about to rise or fall. Index managers may be required to execute rapid block trades to continue tracking their index. (And, when an index composition changes, all funds tracking it must simultaneously execute large trades.) An owner of a concentrated small-cap stock position may simply be seeking greater liquidity.

Patient trading enables fund managers to take the *opposite* side against a rushed trader, only accepting trades when the price is in

their favor. Passive asset class funds focused on long-term fund construction are often in just such a position, and thus can often take advantage of an active or index fund’s urgent trade requests.

Fund managers also can better avoid market impact costs if they wish to sell a large block of shares, but are willing to sell in a disciplined, gradual manner. For example, if a fund plans to sell 150,000 shares of a particular stock, it can sell 10,000 shares the first day, 10,000 the next day and so on. Again, a passive asset class manager often has greater flexibility to sell more patiently — and cost-effectively — while remaining adherent to the fund’s objective of capturing the returns of a particular asset class.

#### Running a Tight Ship

A passive asset class investment approach includes many proactive steps to ensure that trading costs — and their significant drain on expected net returns — are well managed. By selecting managers who carefully tend to leaks large and small, you can expect your investment ship to reach its intended destination.

## The Myth of Hedge Funds

Hedge funds represent a small and specialized investment niche, but they seem to be growing in popularity. What are hedge funds, and why do we agree with a recent *Economist* column that concluded, for the prudent investor's portfolio, they can be considered "mad, bad, and dangerous"?<sup>1</sup>

Can hedge funds deliver superior returns? It is difficult for the average investor to assess, because hedge funds are not required to report their performance. This means a hedge fund manager can skip reporting

after a period of underperformance, or specifically report returns after a period of outperformance and then back fill data for previous years, creating an instant history that can be misleading.

Fortunately, there has been academic scrutiny to shed light on the matter. Stephen Brown, William Goetzmann and Roger Ibbotson published their 1989-1995 study of hedge fund performance in the January 1999 *Journal of Business*. They concluded that there was little evidence of consistently outstanding performance, and that most of the funds underperformed the S&P 500 Index.

A more recent study by AQR Capital Management covered the five-year period ending January 31, 2001.<sup>2</sup> They also found that the average hedge fund lagged behind the S&P 500 Index, even though taking on significantly greater risk by investing in highly illiquid securities.

And the above data are for the hedge funds that survived. The *Journal of Business* study also observed that only 25 of the 108 funds they analyzed survived their study period. Still another study, published in the December 2002 *Journal of Asset Management* and covering 1990-2001, concluded that half of hedge funds studied survived less than six years.

### So, What Is a Hedge Fund Anyway?

The SEC has described the term, hedge fund, as a "catch-all classification," with no commonly accepted universal definition, making a precise definition a challenge.<sup>3</sup> Hedge funds differ from typical mutual funds in several ways:

- ▲ Hedge funds have been largely marketed to high-net-worth investors offering what one reporter described as "an irresistible velvet rope, the allure of investing where most everyone else hasn't been invited to invest."<sup>4</sup> But exclusivity may be eroding, as the industry has been rolling out "funds of hedge funds," with lower minimums and no eligibility limits.
- ▲ Unlike the typical broadly diversified mutual fund, they often have large, highly concentrated positions in just a few securities.
- ▲ They have broad latitude to make large bets, either long or short, on almost any type of asset.
- ▲ Management generally has a significant stake in the fund as well as strong financial incentives that make it tempting for them to take those large bets. A typical arrangement is 20 percent of profits in addition to a 1-2 percent operating fee. This means investors take all of the downside risk, while sacrificing a good percentage of any upside gain.
- ▲ Management has been subject to less regulatory oversight than are mutual fund managers. There are currently no SEC regulations requiring hedge funds to report their performance. An October 10, 2003 *Wall Street Journal* editorial observed that the SEC seemed to believe, "hedge fund investors are big enough to look out for themselves." However, in July 2004, the SEC voted to publish for comment a proposed new rule that would require hedge funds to be regulated like registered investment advisors and mutual funds.

Yes, a few hedge fund managers succeed and are able to offer outperforming returns. However, we encourage investors to ask the following questions when deciding whether an investment's potential rewards are worth its risks:

- ▲ Does the approach succeed more frequently than can be expected from random luck?
- ▲ Is there persistence in performance?

Academic analysis suggests that, for hedge funds, the answer to both of these questions is, "No." Taking the uncompensated risks into account — and realizing that these risks have not resulted in risk-adjusted return premiums — we conclude that hedge funds more closely resemble speculative products than prudent investment vehicles, and that they warrant no position in investors' well-structured, globally diversified portfolios.

<sup>1</sup> *The Economist (London)*, September 20, 2003.

<sup>2</sup> *The Wall Street Journal*, February 22, 2001.

<sup>3</sup> [www.sec.gov/news/testimony/052203tswhd.htm](http://www.sec.gov/news/testimony/052203tswhd.htm).

<sup>4</sup> *Forbes*, May 24, 2004.

## Bond Markups: Hidden and High

Constructing and maintaining a high-quality custom bond portfolio can be an excellent way to seek maximum returns from your fixed income assets while adhering to the mission of fixed income investing (a combination of risk reduction and/or income source). The trick is receiving an accurate measure of a bond's true cost.

When you see transaction fees on a bond's trade confirmation, you might logically assume those fees were the bond's only cost. In reality, bond markups (or markdowns) prior to your purchase (or sale) are common and legal.<sup>1</sup> Reasonable markups/markdowns are considered fair compensation for a bond dealer's risk of holding securities as interest rates fluctuate. But what is considered "reasonable"? We see two challenges that characterize bond investing:

1. Unlike in the stock market, it is nearly impossible for investors to independently determine bond markup amounts or compare prices among different brokers.
2. There currently are few legal limits on markups.

### How Much Markup?

The equity industry is highly transparent these days, with countless Web sites yielding clear disclosure of a stock's latest price. In contrast, determining bond market pricing is neither free nor easy. To do so requires costly subscription to a financial information service such as Bloomberg's. Even if investors had such access, they would still need the expertise of a bond analyst to monitor and compare the pricing hidden within relatively arcane listings.

### Who's Guarding the Goods?

Another important characteristic of the bond market is that there are no clear guidelines on when a markup becomes excessive, nor regulations requiring brokers to disclose their markups to the public. The MSRB (bond markets' primary regulatory agency) mandates that "each broker, dealer and municipal securities dealer . . . shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions."<sup>2</sup>

In an April 2002 ruling, SEC administrative law Judge Lillian A. McEwen dismissed fraud charges brought against a former Los Angeles broker. McEwen concluded that, "Markups and markdowns on municipal securities ranging from 1.87% to 5.64% were not excessive and did not violate the securities fraud laws."<sup>3</sup>

Perhaps the market is evolving. More recently, the NASD (which oversees the MSRB) settled cases with eight firms regarding potential bond market overcharges. The firms neither admitted nor denied the allegations but paid a modest collective fine of \$610,000. NASD Vice Chairman Mary Schapiro commented, "Unlike a traditional markup case involving unfair profits to the dealer, these cases involve dealers who failed to take reasonable steps to obtain fair prices for their customers."<sup>4</sup>

We hope to see this sort of trend continue. For many high-net-worth investors, individual bonds can be an important part of a portfolio. However, excessive markups can reduce or eliminate the advantages of bond investing. Through our advisor services, you gain access to and expertise in interpreting bond markup pricing. Because we serve you in a fee-only capacity, we are prohibited from assessing markups of our own; further, our access to current bond pricing and multiple bond markets helps ensure that the bonds used in your portfolio are had at a fair and reasonable price.

<sup>1</sup> Comments throughout refer to both markups and markdowns. A markup (or markdown) is the difference between the price dealers transact among other dealers and the price the customer pays.

<sup>2</sup> MSRB Rule G-18, [www.msrb.org](http://www.msrb.org)

<sup>3</sup> *The Bond Buyer*, May 1, 2002.

<sup>4</sup> *TheStreet.com*, June 29, 2004.

### Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...**  
**A TRUSTED ADVISOR RELATIONSHIP**