

# Asset Managers (Brokers) Seven Dirty Little Secrets

*Is your money being passively managed?*



**ESP FINANCIAL SERVICES, LLC**

2010

Authored by: Rod S. Hormell

## ASSET MANAGERS (BROKERS) SEVEN DIRTY LITTLE SECRETS

Is your money being passively managed?

If it looks like a duck, swims like a duck and quacks like a duck then it probably is a **DUCK**.

We've all heard this little common-sense gem, yet when it comes to investing, many people have a hard time telling the ducks from the swans. Nowhere is this case of mistaken identity more pronounced than when it comes to recognizing what most so-called "active" investment advisors (brokers) are doing with their client's money. Most investment advisors (brokers) claim to be "active" managers but are really just the same old buy-and-hold sheep in fancy clothing.

What do I mean by this? Well in a moment you'll find out why so many common strategies that profess to be active management solutions are basically just different twists on the same old worn out ~ and thanks to the recent bear market ~ now thoroughly discredited investment philosophy.

### Seven Things Investors Need to Know

If You Want to Avoid Repeating Mistakes of the Past

Think about this for a moment. Have you ever heard a firm or an advisor actually come right out and say that they offer investors a buy-and-hold portfolio management style? Of course you haven't, and that's because no one in their right mind would pay an advisor to essentially do nothing for them but buy and-hold stocks and mutual funds. But these managers have a few marketing tricks up their sleeves. You see, while no firm or advisor actually calls their strategy buy and hold, often they employ strategies that, while not technically buy and hold, are basically just pretend versions of this self-serving management philosophy.

Let's take a little closer look at some of the more common buy-and-hold pretenders out there. By shining the light of reason on each of the following strategies, you'll be able to see why each is essentially just a buy-and-hold imposter. Remember the duck test? Well, by the end of this report, you'll be able to spot these buy-and-hold ducks well before you ever get close to the toxic investment ponds they spawn in.

#### Passive Strategy #1

A 'Diversified Portfolio' or the Modern Portfolio Theory

You've got to **diversify** your assets. We have all heard it sometime in our investing lives! It's one of the cornerstones of today's modern portfolio theory. I think the premise that, "You should never put all your eggs in one basket," is in fact a good one. And while I agree with this premise, there is a big problem with most of today's so-called "diversified" portfolio models.

First off, most of these models are not truly diversified. I recently spoke with one couple who said their advisor had put them into a diversified portfolio of blue chip stocks so that they could ride out the latest market storm. But how can you have a diversified portfolio when all you own is blue chip

stocks during the worst bear market since the 1930s? Oh, and by the way, that couple's account was down over 40% from its 2008 high!

You see, most so-called diversified equity portfolios are anything but diversified. Sure, these stock-heavy portfolios might perform well when lifted by the rising tide of a strong bull market, but what about during bear markets and/or protracted periods where the market is mired in a tight trading range?

Being “diversified,” i.e., owning a variety of stocks and/or stock mutual funds while the market is tanking, is **NOT** a way to protect your assets against loss. In fact, it's really just a way to make sure you don't lose a lot of money in any one stock. In most cases, you'll just lose a lot of money in a wide variety of stocks. The bottom line is today's so-called modern portfolio theory, which calls for holding a “diversified” basket of equities—particularly during bear markets—is really just a pretend form of buy-and-hold investing.

Think about it this way: what sense does it make to have a variety of stocks in your portfolio when all of them are tanking?

If your answer is, “Rod, it doesn't make any sense,” then you and I are on the same page.

## Passive Strategy #2

### Actively Managed Mutual Funds

Many people believe that their mutual fund manager is actively managing their money for them.

#### **But is this really true?**

Money in an actively managed mutual fund is, as the name implies, constantly being moved around from one stock to another depending on the focus of the specific mutual fund in question. But mutual funds have a charter that impels them to be either fully invested, or very close to it, nearly all of the time regardless of market conditions. A mutual fund manager can only operate within the parameters of this charter, which means managers can't simply take the money in a mutual fund and go to cash when the market plunges.

Sure, they can rearrange some of the deck chairs by liquidating some equity assets and moving into others, but due to the covenants in their charter, they must stay nearly fully invested even while the market goes down like the Titanic. Do you not see trouble (an iceberg) ahead?

Another problem with actively managed mutual funds is that you pay a whole lot in fees for the privilege of letting the fund manager rearrange the deck chairs on the Titanic. According to a survey by the Investment Company Institute, in 2008 the average stock mutual fund expense ratio was 1.44%. That's an average of four times more than an equivalent exchange traded fund!

But if a fully invested mandate even during bear markets and high management fees isn't enough to dissuade you of the notion that actively managed mutual funds are bad for your health, then how about the fact that so many mutual fund managers fail to outperform even their peer group average?

If you think owning an actively managed mutual fund is a way to avoid the buy-and-hold trap, then I say think again. By virtue of its vary DNA, a mutual fund must stay nearly fully invested all the time. Sure, you might own different stocks over the course of any given year, but you still are just buying the market and holding it in virtual perpetuity. This buy-and-hold pretender is no friend of the rational investor, so whatever you do, don't be hoodwinked into thinking an actively managed mutual fund will keep your money safe and sound.

## Passive Strategy #3

### Asset Allocation

You've no doubt heard the drumbeat of "asset allocation" pounding into your ears from nearly every corner of Wall Street. This is a strategy that recommends a mix of stocks, bonds and cash for your portfolio and it's usually based on factors such as your age and your risk tolerance. Generally speaking, an asset allocation model that is higher in bonds and cash than it is in equities is considered the safer and/or more conservative model, while an asset allocation with a higher stock allocation is considered more aggressive.

Most advisors, especially those affiliated with the larger brokerage firms, want to sell you a selection of mutual funds (not surprisingly, managed by their firm) to achieve the desired asset allocation for their clients. The theory here, of course, is that bonds will do better when stocks are falling, and vice versa. This asset mix is purported to lower the volatility in your portfolio and to smooth out your returns over time.

So, what's wrong with the asset allocation model?

Well, it's really little more than just a slightly complex version of buy and hold. Let me explain.

What happens in most cases is an investor will come to an advisor who's operating under the asset allocation philosophy, and then tell the advisor about his or her situation. The asset allocation advisor will then plug in factors such as the persons age, stated risk tolerance, etc., into the firm's asset allocation software and voila!— you have an instant portfolio. The advisor will then buy—and hold—the asset allocation model for the investor, usually until either the investor leaves the firm or until something goes haywire with the portfolio.

You see, asset allocation advisors are basically just peddling a "sit down and shut up" approach to investing. Most advisors aren't constantly monitoring your personal situation to see if the asset allocation model is serving you well, or if the model is holding up in a bear market. Most asset allocation models never account for a big drop in the equity or bond markets, and most are immune to paradigm shifts in the economy such as interest rate changes, inflation and deflation, political change and other headline news such as global terrorism and pandemic diseases. By assuming a buy-and-hold stance toward the market via asset allocation, you basically ignore the "conditions on the ground" as they say in military parlance. And ignoring conditions on the ground is no way to win a war when your money is at stake.

## Passive Strategy #4

### Value Investing

Value investing; investing for value—sounds good, right?

I mean, we all want to get the most bang for the buck whenever we purchase anything, be it a home, a car, clothes, etc. But what does value investing really mean?

The basic premise of value investing is to search for companies considered “cheap” based on their fundamental balance sheet. Terms like P/E ratio, PEG ratio and debt-to-equity ratio all are bandied about by value players as the Holy Grail to finding those undervalued diamond-in-the-rough stocks that, for some reason, Wall Street just hasn’t fallen in love with yet.

The problem with this strategy is that in most cases, you have to have the patience of Job to see any significant returns. This strategy rewards investors who don’t mind if their capital is tied up in a stock for months and months—even for years and years—waiting for a bounce that, in many cases, just never comes.

I think you now can see why I regard value investing as just another version of buy-and-hold investing. In fact, most of the time trying to pick value stocks is an exercise in buying and holding that very stock in the hopes that the “valuation model” you rolled the dice on is going to come up a winner.

Unfortunately, and particularly during bear markets, much of the time your valuation roll of the dice is going to come up snake eyes. Consider that the Fidelity Value mutual fund lost more than 46% in 2008 and you can see that a value investing strategy is a recipe for disaster when stock prices are falling.

Oh, there is one more problem with the value investing philosophy that’s never talked about by its advocates. The counter to the value investing thesis is something called the efficient market hypothesis. This hypothesis claims that the price of a given equity always reflects all of the relevant information about that equity, and thus the price of a stock is always as it should be.

Now, whether the efficient market hypothesis is correct, or whether those in the value investing camp have a claim on truth is an academic debate that will rage on for decades. But one debate that is already settled is that in order to benefit from buying so-called undervalued stocks, you have to buy them and hold them—and usually for a substantial amount of time in order to see any returns even if your valuation model proves correct.

## Passive Strategy #5

### Dollar-Cost Averaging

A lot of investment advisors subscribe to the notion that it’s impossible to time the markets.

Many advisors even take a self-deprecating stance on this issue by uttering phrases like, “Well, I’m not smart enough to time the market.”

Hey, if they want to admit their short comings, then let's take them at their word. Unfortunately, their admitted inadequacies often lead them to one of the more dangerous buy-and-hold pretenses—the so-called strategy of dollar-cost averaging.

I think the better name for the dollar-cost averaging strategy would be the “buy, buy, buy, hold, then just buy more” strategy. This “technique” if it can be called such, consists of buying a fixed dollar amount of a particular investment on a regular schedule, regardless of the share price. Through dollar-cost averaging, more shares of a particular security are purchased when that security's prices are low, and fewer shares are bought when prices are high.

I think this upside-down philosophy is akin to throwing good money after bad. I mean, if a stock is tumbling, why buy more of it? When you originally bought the stock (or mutual fund) did you expect it to go down? Of course you didn't. So why should you reward its disappointing behavior by adding more of your hard-earned capital to it?

If you had been dollar cost averaging shares in General Motors (GM) for the last 10 years you would have seen your total investment capital all but disappear.

The truth is that dollar cost averaging is not just a buy-and-hold pretender, it's actually much worse. The idea that you should pick a security and just pour money into it regardless of reality and the objective fact that it is going down is about as unthinking a strategy as any I can imagine.

In fact, I'd rather throw darts at the tables in the Wall Street Journal to find my next stock pick. At least with the dart-throwing strategy you have a chance of actually picking a winner. With dollar cost averaging you know you are pouring money into a loser, and you are doing it with the explicit consent and assistance of an advisor who is supposed to have your best interest at heart.

Whatever you do, don't fall into this pit, as it is a very difficult position to recover your losses.

## Passive Strategy #6

### Sector Rotation

Although not as destructive as dollar-cost averaging, our next buy-and-hold pretender can also be a recipe for big losses. It's the strategy known as sector rotation. Basically, sector rotation is a strategy that requires an investor to overweight his or her portfolio into the strongest market sectors, while underweighting the portfolio in the weakest market sectors.

Now at first glance, this strategy does have some appeal. I mean, we all want to be allocated to winners while staying away from losers. Of course, sector rotation is not as simple as just being in the right areas of the market at the right time.

To be certain, the sector rotation model is a lot more active than some of the other pretenders we've seen thus far, but the real problem with this form of “active management” is that it is usually behind the eight ball when it comes to identifying what sectors are hot—and which ones are not. What ends up happening with most sector-rotation strategies is that investors end up chasing the hot sectors well after they've made a substantive move to the upside. Conversely, they end up selling out of weaker market sectors way after they've made a decided turn to the downside.

Another downfall of this strategy is that it calls for you to be fully invested all the time. This “all in” investing mindset is absolutely the worst strategy you can employ during bear markets, and as we’ve seen since November 2008, a bear market is something you must avoid at all costs lest you want to see your money evaporate into the financial ether.

Because sector rotation requires you to be all in, all the time, it can properly be considered just another buy-and-hold pretender. And when it comes to your money, you don’t want to take a chance on any form of pretense.

## Passive Strategy #7

### Writing Covered Calls

Well, we’ve come to our final buy-and-hold sheep in wolves clothing, and this one is perhaps the most sophisticated and well-camouflaged of the all the buy-and-hold pretenders. It’s the strategy of writing covered calls on your existing portfolio holdings, and a close look at the leaves of this options tree reveals its buy-and-hold roots.

The practice of writing covered calls entails selling call options on the equity positions you already own in your portfolio. The way it works is, let’s say you own 100 shares of ABC Corp. You want to generate some income for your portfolio, yet you don’t want to sell any of your ABC stock. What do you do? Well, you sell (write) a call option on your position. By selling a call you collect the premiums from the sale of the option, and if everything goes as planned, those options will expire worthless and you’ll keep the premium you collected.

But what if everything doesn’t go as planned? What happens if your ABC shares get “called away?” Well, then you will be forced to sell your ABC stock regardless of whether you want to or not.

Now, many advisors regard writing covered calls as a great way to reduce risk and generate income in a portfolio.

But the one major problem with this strategy is that it only works when the volatility in the market is extremely low. So, if you sell a call with both a distant strike price and expiration date, and the underlying shares don’t move much in terms of price during the life of the call option, and then you’re fine. But what if the underlying stock’s value starts getting volatile?

When this happens you run the risk of having to sell an equity position you wouldn’t otherwise want to sell. So, in order for the covered call strategy to be successful, it requires a buy-and-hold stance on the underlying shares. You have to be committed to holding a stock, and then convinced that the call option you sell won’t be exercised.

I think there are a lot better investment vehicles out there for generating income in a portfolio than one that involves essentially piggybacking on a buy-and-hold equity position. It’s this reliance on the buy-and-hold underpinnings of the covered call strategy that makes it just another—albeit well disguised—buy-and-hold pretender.

# What's An Investor to Do?

Now you know that despite what they are called, many of today's most popular investment strategies are really just new versions of the same old, played-out buy-and-hold tune.

So, what can you do to avoid doing the same old song and dance with your money?

You can start by putting a firm on your side that doesn't believe in Wall Street's pretend active management.

At ESP Financial Services, LLC, we're committed to real active management, and we dispense with the pseudo-forms of pretend active management we've discussed in this report. Our real active management consists of taking action to help protect your assets from the ravages of a down market, and positioned properly to take the utmost advantage of the market as it fights its way higher.

In today's quick-changing and complex market environment, we believe every investor needs to have the following five advantages on their side:

P r o m i s e	A d v a n t a g e
1   True Active Management	For the purpose of capital preservation and asset growth. We aren't afraid to go to cash in a bear market, and we aren't afraid to go "all in" during bull markets.
2   Liquidity	A key component to remaining flexible enough to shift between investment vehicles when needed, and to not get stuck holding unwanted assets when the market turns.
3   Transparency	Transparency in all your holdings, along with clear reporting that makes it easy for you to know what you own, and why you own it.
4   Reduced Fees	In the form of never requiring an upfront management fee, or a penalty to exit a position (no redemption or surrender fees.) Fees are paid monthly with an "earn as we go" attitude.
5   Trusted Custodian	Egis Capital and Shareholder Services are our custodians, and they both hold your account in your name. At ESP Financial Services, LLC, your investments are always completely visible to you online and via monthly statements.



At ESP Financial Services, LLC, we've broken the mold of traditional asset management firms in two very distinct ways. First, our investment philosophy is that risk must first be carefully managed, because in our view, large losses are unacceptable.

Our second mold-breaking feature is our near-exclusive use of cost-efficient investment vehicles. We are an asset management firm that specializes in exchange-traded funds (ETFs), and they make up the majority of our investment positions. Why? Because ETFs offer diverse investment options, outstanding liquidity, low expense ratios and the highest degree of transparency.

At ESP Financial Services, LLC, we are always accessible so you will have a direct connection to us. We realize just how important your money is to you, which is why communication is an important part of our everyday philosophy.

We send our clients a monthly performance report and client newsletter so that they are always in touch with us. In addition, we schedule regular meetings to review your goals and make sure that we are meeting YOUR objectives.

Our clients love the close, personal relationships we build with everyone who chooses us, and we are proud of the high degree of personal attention and service we strive to provide to all our clients.

If you realize that you are now invested in a “pretend” active management plan with your advisor - you may not be in the right relationship. We invite you to take a closer look at true active management that we believe is better equipped for the future. Give us a call @ **805-376-8070** or **877-883-8080** or visit [www.espfinancialservices.com](http://www.espfinancialservices.com) and let's talk about your portfolio to see what makes the best sense for you.

**Now more than ever, you need to determine if your advisor is prepared—and if your assets are positioned—for the bumpy road ahead.**



To your prosperity,

*Rod S. Hormell*

Rod S. Hormell  
CCO, ESP Financial Services, LLC