On Course Financial Planning

Facing the Future with Optimism and Courage

July 2017

Vectors

geo@oncoursefp.com

425-861-9997

Proprietary Funds

Whenever I'm asked to give a second opinion about someone's portfolio, I have a pretty good idea of what I'll discover. Typically, it will contain shares of a few well-known large company stocks, junk bond funds (to increase yield in today's low interest rate environment), actively managed mutual funds (cleverly allocated to avoid commission breakpoints) and the inevitable variable annuity. Rarely, if ever, have I been able to detect any strategy behind the portfolio's makeup.

Frequently, the portfolio contains proprietary mutual funds which are managed by the investor's current brokerage firm, insurance company, bank or custodian. Most large financial institutions have their own family of mutual funds which are sold to clients to keep their money in-house and generate income from fund management. Firms often pay higher compensation or offer other incentives to encourage their brokers and agents to recommend in-house funds.

Non-proprietary funds are managed and sold by an outside institution; either directly or through financial advisors. This arrangement separates the firm that sells the fund from the firm that manages it. Non-proprietary funds usually carry the name of the managing institution, such as T. Rowe Price, Vanguard, American Funds, Fidelity, etc. These funds operate in a more competitive arena than do proprietary funds and typically employ more experienced fund managers. Their shareholders are more likely to have researched several different funds before investing and are more likely to jump ship if fund performance lags. Companies that manage non-proprietary funds know that investor loyalty is not high and they must protect the reputation of their brand.

To make things more confusing, proprietary funds often avoid using the issuing company's name. This is not an oversight or done without malice aforethought. For example, Ameriprise in-house funds carry the RiverSource brand name. In 2015, the brokerage firm Edward Jones added $15.6 billion of new money to its in-house Bridge Builder funds. The potential conflict of interest in this type of arrangement is obvious and undeniable. It allows a broker or financial advisor to take advantage of unsophisticated clients; never mentioning any financial incentive behind the recommendation to purchase in-house funds instead of outside funds. Once you own a proprietary fund, it's unlikely that your broker will recommend selling the fund due to poor performance and replacing it with a better performing, non-proprietary fund.

If you or someone you know is being pitched a proprietary fund, ask if the advisor also sells non-proprietary funds. If yes, ask why the in-house funds were recommended first. Don't just look at past performance but also at the fund's fees. A firm may charge little or no sales commission on its in-house funds but higher ongoing management fees can wipe out any savings over the long term. For example, let's say you tell your Wells Fargo "advisor" that you want to invest in a S&P 500 Index fund. He might recommend the Wells Fargo S&P 500 Index fund (WFILX), which charges a 5.75% commission and has a 0.48% annual expense ratio. You can buy the Vanguard 500 Index fund (VFINX) with no commission and an annual expense ratio of just 0.14%, so you decline the offer. Then he might recommend a share class of the Wells Fargo fund that has no commission (WFINX). It's unlikely that he'll mention that the annual expense ratio of the "commission-free" fund is an outrageous 1.27%. $25,000 invested in the Vanguard fund 15 years ago would have grown to $81,536 by June 30th of this year - $12,556 more than the commission-free Wells Fargo fund. Had you bought the fund with the 5.75% commission, the current value would be $4,407 less than the Vanguard fund. In both cases, the difference went from your pocket directly into Wells Fargo's pocket.

Many proprietary funds cannot be transferred out of the issuing firm. If you transfer your account to a different custodian you'll have to sell the fund (which can generate capital gains taxes and commissions) – a Wall Street sucker punch that too many investors never saw coming. Nontransferable proprietary funds should be avoided like Superman avoided kryptonite.

Regulators have been cracking down on firms that fail to disclose the conflict of interest between a firm and its clients when it comes to proprietary funds; arguing that investors have a right to know that the advice they receive might be biased. In December 2015, J.P. Morgan paid a $370 million fine for preferring to invest client funds in the firm's proprietary investment products without properly disclosing this preference to its clients.

Most investors assume that all financial professionals are fiduciaries who are required to act in their clients' best interests and disclose all potential conflicts of interest. But most financial "advisors" are salespeople who do not have a fiduciary relationship with their clients. Brokers and insurance agents operate under a less stringent "suitability" standard. They merely must recommend suitable investments and don't have to disclose potential conflicts of interest unless asked. In our example, the Wells Fargo fund is a suitable recommendation for a client who wants to own a S&P 500 Index fund. But it cannot be considered to be a recommendation in the client's best interest.

Brokerage firms and insurance companies do everything they can to give the impression that their representatives always act in their clients' best interest. It's hard to find any firm that uses the word "sales" in the titles it bestows upon its financial representatives. These firms have multimillion dollar marketing campaigns that use a variety of intentionally deceptive titles to give the impression that clients receive expert, personal advice. Financial advisor is the most commonly used title. Financial consultant, chartered wealth advisor, retirement consultant, wealth manager and retirement counselor are a few of the common, meaningless, non-academic titles used by transaction-based employees of broker-dealers and insurance companies to hide the fact that they are commissioned salespersons.

It’s easy to understand why insurance companies and brokerage firms promote their in-house funds. It's like the captive travel agent system that legacy airlines used for decades. The system worked well for airlines and travel agents but not for consumers. Today, educated consumers have replaced captive travel agents with websites as their go-to source for airline tickets and pricing information. Many legacy brokerage and insurance firms still sell overpriced, proprietary, fee laden products to uneducated consumers. An occasional regulatory slap on the wrist will change nothing. Only educated consumers, willing to take their money elsewhere, can change the system.

The Non-Persistence Scorecard

Most do-it-yourself investors and too many financial professionals use past performance as the primary factor in determining which mutual funds to buy. They make the faulty assumption that a manager's past success is indicative of skill – despite the repeated warnings that past performance is no guarantee of future returns. At the heart of the active passive debate is whether an active manager or active trading strategy can outperform market returns consistently over the years. Generating outperformance over consecutive multiple year time horizons is the only way a manager can prove that the returns were created by skill rather than luck. If the number of funds that outperform over consecutive multiple year time horizons is less than what we would expect from random chance, investors have no way of knowing if the top managers are skilled or just lucky.

Twice each year, Standard & Poor's publishes the *S&P Persistence Scorecard* which tracks the performance of top ranked actively managed mutual funds over consecutive multiyear periods. The *Scorecard* provides ongoing evidence of the inverse relationship that exists between the measurement time horizon and the ability of top-performing funds to maintain their laurels.

The latest scorecard analyzed the subsequent performance of the 370 actively managed domestic stock mutual funds that produced top quartile (top 25%) performance for the five years ending March 2012. Random chance alone would lead us to believe that 25% (92) of the funds would remain top quartile performers over the subsequent five years. Yet only 22% (83) managed to do so. Even more disheartening for fund managers and their investors is the fact that 28% (102) became bottom quartile performers over the ensuing five years.

Does the fact that the number of repeat winners is less than what we would expect from random chance mean that there are no skilled managers? On the contrary. There are so many skilled, capable managers that none can get a consistent edge on the competition. It's often hard to identify why or how a top performing manager outperformed the competition and, more often than fund companies would like to admit, Lady Luck picks the winners. A few standout managers may add value for a time. But they're competing in what might be the world's most competitive game; the opposition is fierce and makes few mistakes.

There is some benefit to past performance data. The *Persistence Scorecard* reveals that bottom quartile (lowest 25%) funds tend to remain poor performers. Of the 370 bottom quartile funds for the five years ending in March 2012, 108 (29%) were liquidated or merged into better performing funds by March of this year; erasing their dismal performance from the record book. Another 47 (13%) managed to survive and stayed mired in the bottom 25%.

The Persistence Scorecard and similar studies reveal the difficulty that active fund managers have in identifying and profitably exploiting mispriced securities. Even though there will always be a few fund managers who outperform, it is difficult for any of them to do so consistently. Top-performing active stock funds in one period often become bottom performers in the next and the number of active managers who have a long-term track record of outperformance has declined in recent years.

Brokers and financial advisors often tell clients that, although the number of outperforming funds is small, the funds they recommend are sure to be winners. But these claims cannot be backed up by empirical data because outperforming funds are not identifiable in advance. Whenever I've found myself engaged in an active/passive debate with advisors who prefer active funds, they always use past performance to defend their fund choices. They should know better. They do know better. Their clients deserve better.

The unpredictable, erratic performance of most actively managed mutual funds is clear evidence that trying to outsmart the market is a fool's game. Investors should forget about outperforming the market and concentrate on matching the market's return by using index funds. Setting and appropriate asset allocation, focusing on costs, consistently funding and periodically rebalancing your portfolio remains the best strategy for most investors. By doing so, you'll outperform most other investors by avoiding the higher fees, unnecessary taxes and other added costs of active management.

In the News

For the first six months of 2017, global stock markets had their best first-half performance in eight years - 26 of the 30 largest global stock markets produced a positive return. The US stock market was up about 8% and the best performer was the South Korean stock market (go figure), which was up 18%. The four losing markets were Canada, Israel, China and Russia. Just to put icing on the cake, this excellent first-half performance was accompanied by lower than normal volatility. Investors who own a globally diversified portfolio of stock funds should be celebrating.

Over the past eight years, domestic stocks have outperformed international stocks by a wide margin. This led many commentators to claim that global diversification is unnecessary. But the performance of domestic stocks relative to international stocks has always been cyclical and the wise investor uses annual rebalancing to prepare for the inevitable reversion to the mean.

The winner of June's dumbest financial headline contest is this one from the online edition of the *Wall Street Journal* on June 30th – "Global Stocks Post Strongest First Half In Years, Worrying Investors". I can understand why investors become worried when the market is in a precipitous decline. But when stocks perform above and beyond our expectations, why should we be worried? According to the article, we should be worried because the strong performance of the first six months may not last. "*The tricky part now, investors say, is picking which regions will continue rallying."* The investors who are saying this weren't mentioned – perhaps the now infamous "unnamed sources"? This quote is a typical financial media misstatement – insinuating that successful investing requires insight into the future. The article didn't mention that the simplest, least expensive and most tax-efficient way to own the best-performing global markets in the second half of 2017 is to own an international index fund.

Speaking of index funds, a recent op-ed piece in the *Wall Street Journal* claimed that the increasing popularity of index funds is bad for the economy. The authors noted that investors are leaving actively managed funds for index funds – "*leading to serious problems for shareholders, employees, consumers and the economy.*" So, apparently, index investors are a greater threat to capitalism than Bernie Sanders. How can this be?

According to the article, 88% of public companies have State Street Global Advisors, Vanguard, or BlackRock (the top three providers of index funds) as their largest shareholder. The authors maintain that index fund managers pay little attention to corporate governance because there's little or no impact on an index fund when a company suffers from poor management. Any decline in its stock price will be offset by gains in the stock prices of competitive firms. The authors would like to see passive funds forgo voting their share proxies on issues involving corporate governance. "*Their abstention would concentrate the voting power of active investors that have the motive and information to vote intelligently."*

Motive and information? According to Morningstar, for the 15 years ending December 2016, only 17% of domestic stock fund managers possessed enough information to outperform their benchmark index. As far as motivation is concerned, these desperate, performance addicted fund managers would likely support any corporate action that might yield a short-term bump in the stock's price so they could quickly sell their shares at a profit.

The authors of this article would like active fund managers to have a greater voice in how corporate managers run their businesses. Let's not forget that Bear Stearns, Merrill Lynch and Lehman Brothers employed the smartest analysts and spent billions of dollars gathering information to find companies that would outperform the market. Along the way, they couldn't even save themselves from bankruptcy during the financial crisis. I wonder how many of their proprietary stock fund managers held company stock in their funds or in their own 401(k)s. We shouldn't allow active fund managers to have more impact on corporate governance than they already have – for the same reason we don't let children play with razor blades.