

Chapter Seven

Why Your Portfolio Tanked

If the last three chapters did not leave you screaming, “*How can I invest in these things?*” I suggest you have your thyroid checked. So, before we discuss specific emerging markets, we’ll get busy with an analysis of why your portfolio always seems to underperform, and with a specific investment strategy that I believe will serve you well in the future.

Why Your Portfolio Tanked

Here’s the deal: Your existing portfolio (or the portfolio you had before you went to cash *just* as the market bottomed), probably:

- Didn’t protect you much on the downside;
- Kept you primarily in mediocre U.S. “core asset classes”;
- Contains expensive, underperforming, actively-managed mutual funds;
- Left your advisor saying – with increasingly less conviction each time you met – “Don’t worry, we’re in this for the long term”; and
- Now relies primarily on U.S. “asset classes” for recovery – while much of the world soars ahead.

How, you ask, with all those expensive advisors and money managers helping you, could this have happened?

The Myth of Modern Portfolio Theory

The vast majority of investment portfolios prepared by, or for, ordinary investors, use a concept called, ironically, “Modern Portfolio Theory”, also known as “MPT”.

MPT is not very modern. It is a theory of investing which tries to maximize return and minimize risk by carefully choosing different assets within what became known as “asset classes”.

It was first posited as an economic theory in a 1952 article by Harry Markowitz. In 1959 he wrote a book on the subject.

Refined during the 1960s and early 1970s, the theory seemed so impressive that in 1990 Mr. Markowitz was awarded the Nobel Prize in economics for his work.

That the theory was developed in an era when personal computers did not exist, and that it utilized data that, by today’s standards, may now seem deeply flawed, did not stop an entire industry from rallying around it – an industry that largely remains intent on protecting itself from liability by invoking MPT as its defense.

In fact, the concept became so widely embraced in the U.S. that in 1992 the American Institute of Law incorporated the Principles of MPT in their revised legal definition of the “Prudent Investor”. In 1994 the Uniform Law Commissioners (a division of the American Bar Association) drafted the Uniform Prudent Investor Act, which states that trustees who use MPT are acting in the most prudent manner possible on behalf of beneficiaries.

What all this means is that your advisor cannot get in trouble if he applies Modern Portfolio Theory within your portfolio -- even if it doesn't work!

I take nothing away from Mr. Markowitz, or to those who helped refine the theory. At the time of their work – in an economy that was far from global, and when many “asset classes” were far less

interrelated – the idea that you could limit your risk by investing in a combination of certain asset classes, made sense.

It all worked pretty well for about 30 years. It still makes sense to some degree. If some asset classes zig, when others zag, you might prevent steep declines in the value of your portfolio by prudently mixing them up. Logically, you would prevent steep increases as well – but overall, the ride would be less volatile. Two asset classes are said to have an “inverse correlation” if, when one rises, the other declines in value.

But, in our complex global economy, asset classes today are not nearly as independent of one another as they once were; and today there are many investment vehicles – and investment venues (such as emerging markets) that simply did not exist back then. The net result is that there are very, very, few asset classes with inverse correlations to one another.

For example, 30 years ago, commercial and investment banks were kept entirely separate under the Glass-Steagall Act. Major portions of that bill were repealed in 1980 and again in 1999. Today, combined commercial/investment banks sell all sorts of exotic products, such as collateralized debt obligations (CDOs) and other derivative products. These are often hybrid equity/bond assets. Nor do banks and brokerage firms sell those products only in the U.S. We witnessed, for example, how integrated world markets had become when our own sub-prime meltdown almost took down the entire world of international finance. We continue to see reverberations of all this today.

Thirty years ago, when bonds went up, stocks went down. When U.S. stocks rose, it often spelled trouble for European stocks. Today, while bonds may be a viable hedge against the *volatility* of stocks, they do not necessarily rise or fall *inversely* to stocks.

As the inverse nature of many asset classes began to fall apart, advisors and companies who perceived their futures as inexorably intertwined with the viability of MPT began to speak of “low-positive correlations”, and of other often artificial distinctions that did not benefit investors much at all.

They also became particularly ardent supporters of the “buy and hold” philosophy of investing. Investment product providers were happy to help them perfect this message, as each wanted to retain as many assets as possible for as long as possible, regardless of performance. By reaching back far enough into the statistical abyss, they were able to find often-questionable support for the mantra too often repeated by your erstwhile investment advisor (who honestly means well, but who was trained this way): “Don’t worry. It will come back in the long term.”

But if you think about it, this is just another way of saying that even a stopped clock is correct twice a day.

Your U.S.-Centric Portfolio

There are several reasons why you are probably way over-allocated to U.S. stocks and bonds within your portfolio. See if any of these fit:

- Frankly, you are not all that familiar with how to access the world’s most promising markets and sectors outside the U.S.;
- Frankly, your investment advisor isn’t either;
- Modern Portfolio Theory (MPT) portfolio management software typically reaches so far back for data that foreign investing – particularly emerging market investing – appears, incorrectly, to be an extremely high-risk crap-shoot; and
- Nobody has gone out of their way to describe how easily you may access many foreign stock and bond markets through U.S.-traded exchange traded funds (ETFs).

As a result of these factors, and perhaps others, you are stuck in a groove, doing the same thing over and over, while hoping for different results.

Please don’t over- or under-estimate your advisor. On the one hand, they are almost always honest and well intentioned, and just trying to make a living. On the other hand, they typically spend half their time trying to attract new clients, half their time trying to

service their existing clients, and half their time trying to get educated about which investments are truly best for you. Yes, I know it doesn't add up. Guess which half usually gets the least attention?

The Cost of Underperforming, Actively-Managed, Mutual Funds

The manufacturers of American investment products spend billions of dollars each year to inform, and excite, you – *and* your advisor -- about *their* products. They will of course spend the most money pitching the products that make them – not necessarily you – the most money. That is absolutely their right; but it does not provide you with the information you need to efficiently access the world's most promising investments. Nor does it remotely inform your advisor, who typically relies on the information provided by such investment-product manufacturers, to construct your portfolio.

Actively-managed mutual funds are the most common investment product in America. Providers do not spend billions of dollars each year to promote them out of the goodness of their hearts. They promote them because they are profitable – to the providers. Millions of Americans invest in them. Yet, they are typically a horrible investment. Period.

Please, don't take my word for it. Here is what Standard and Poor's had to say in their Year-End 2009, SPIVA scorecard (Standard and Poor's Indices Versus Active Funds Scorecard):

Over the last five years, the S&P 500 has outperformed 60.8% of actively managed large-cap U.S. equity funds; the S&P Mid-Cap 400 has outperformed 77.2% of mid-cap funds; and the S&P Small-Cap 600 has outperformed 66.6% of small-cap funds. The five-year data results are similar for actively managed fixed income funds. Across all categories, with the exception of emerging market debt, more than 70% of active managers have failed to beat benchmarks.

What this means: The great majority of actively-managed mutual funds – the types of funds you are probably in -- fail to outperform the very indexes against which they compete.

If the cost of their underperformance was not enough, here's another staggering set of numbers. With actively-managed mutual funds, you may incur any of the following expenses:

- Purchase fee
- Redemption fee
- Exchange fee
- Management fee
- Account fee
- Transaction costs
- Front-end load, or back-end load

Management fees for U.S. domestic mutual funds average about 1.3 percent annually. Funds are not required to report their transaction costs separately, but several studies indicate that those costs average an additional 1.45 percent per year. These fees combined average about 2.75 percent per year. That is the hurdle that you as an investor must overcome each year before you make a dime. When your fund loses money, these costs compound your loss.

No wonder these funds fail to outperform the indices against which they compete! Add to that the fee your investment advisor may be charging you to select these funds for your portfolio, and your annual expenses might easily top four percent per year – whether you make money, or lose money!

On the other hand, the typical, non-leveraged, index-tracking, domestic, exchange traded fund (ETF) costs you about .30 percent each year. That's 30/100ths of one percent (30 basis points) annually, all in. Yes, you have a transaction charge each time you buy and sell an ETF, just as with a stock, but among major brokers that charge, in most instances, has dropped to less than \$9.00 per trade.

Bottom line: ETFs are frequently *ten times* more cost efficient than actively-managed mutual funds. We'll discuss them in more detail in the next chapter.

Why hasn't your advisor told you more about ETFs?

They don't pay commissions.

A Toxic Inertia

All of these influences, and others, have created a toxic inertia that will probably harm many investors for years to come. They include:

- MPT, and its frequent lack of applicability to today's world;
- The "blessing" of MPT by courts;
- The "buy and hold" mantra of U.S. investment product manufacturers;
- Your lack of familiarity, and your advisor's lack of familiarity, with non-U.S. investments;
- The emphasis by U.S. investment product manufacturers on the products that *they* sell, and your advisor's reliance on that information; and finally
- The lack of incentive for most investment advisors to bring cost-efficient ETFs to your attention.

Again, millions of Americans have been harmed, and will continue to be harmed, by this toxic mix of inertia, misinformation, misdirection, and good-old fashioned greed.

I urge you not to be among them.