



Letters to the Editor – A Charity Challenge and the Cassandra Portfolio

March 16, 2010

The following is in response to Dave Loeper's article, [The \\$2 Million Charity Challenge to Active Investors](#), which appeared on February 23, and to Bill Sawyer's [response](#) on March 9:

David,

Let's be clear. My practice is not solely based on the premise behind your challenge of active only versus passive management. Indeed, I advocate for active management as a component in most investors' portfolios, just like Harvard and Stanford and a myriad of other institutions that manage serious money...trying to build more efficient portfolios.

My March 9 proposal for your bet with Roger Schreiner was to better reflect at least a few representative investor realities. Why have just one scenario? That's like having Tiger and Phil compete in a par-three-only one-hole golf match.

Many advisors are trying to evaluate the pros and cons of active versus passive management. Both styles are fretfully employed in our industry.

Passive indexing generally provides market returns and is based on an elegant *theory* (much of which I personally acknowledge and respect), *but* its practice has clearly revealed some serious flaws this decade. And we all know, and many point to, the fact that MPT was awarded the Nobel Prize. But then again, Dr. Egas Moniz was awarded a Nobel – in physiology – for a procedure known as the lobotomy. It, too, was considered a good theory at the time.

Good active managers exist and do add value (particularly, I must add, if utilized in a multi-manager format, so as to reduce specific manager risk...but that is for another discussion) .

Both passive and active money management styles have a place in our world. I think Harvard and Stanford agree.

Let your challenge begin.

Sincerely,



Bill Sawyer
Conservative Asset Management, Inc.
Louisville, KY

Dave Loeper responds:

Bill:

I don't care about what Harvard and Stanford are doing; I care about my clients. Your defense of active management sounds like the same argument that caused many "credible" and "serious money" investors to deploy billions in Madoff's scheme.

Your proposal of using multiple client scenarios reflects an admission that you can't manage the wealth for *one* client's personal goals. Instead, you want enough scenarios so that the uncertainty of the unfortunate timing of when returns will occur (by taking non-systematic risk) will be overcome for enough of your clients. On average, across the widely varying nature of client goals, you might win. Those clients whose wealth (and personal goals) are harmed by your needless risk are just collateral damage in your war against the markets.

When you are presenting your approach to clients is that what you represent? Do you state that your compensation is to make a bet against the markets – one that even if you win on a return basis you might lose on a dollar basis?

Our patented Wealthcare process is designed to make the most of the one life each client has and that is what our value is to our clients. It is *not* based on MPT (you can read my paper, [Modern Portfolio Reality – The Failures of MPT](#))

When your value to your client changes from *market relative returns* to managing *life relative goals* you must consider the risk of underperforming at the wrong time for *any* client. Needless collateral damage in a war against the markets contradicts making the most of each client's life.

Are you accurately (and clearly) exposing this risk to your clients? When presenting your process to potential clients, do you say something along the lines of the following:

Mr. & Mrs. Client, my approach to investing your portfolio is about beating the underlying markets (on a risk-adjusted basis?) that introduces the potential opportunity to outperform, but also introduces a risk of



underperforming. Also, your goals are different than other clients and I'm not managing your portfolio relative to your specific goals, but instead relative to markets. Even if I outperform on average, unfortunate timing of when I outperform and underperform could end up compromising your goals because of reduced wealth. The approach I use undeniably costs more, has higher trading commissions and bid/ask spreads and will unquestionably subject you to higher taxes than might be needed. I do this for two reasons. First, I'm hopeful that more of my clients will benefit than will be harmed, even though I do not know and cannot control which clients those will be. I hope you are one of the lucky ones. The second reason is that Harvard invests this way...the same institution that trusted Bernie Madoff. (see story in [The Harvard Crimson](#))

So long as you are accurately making these disclosures and clients understand this is what you are doing and why, have at it!

We will stick with controlling the things we can control, like expense, taxes, and turnover, in the context of making the most of each client's life considering the continuous vast uncertainty of the capital markets.

David B. Loeper, CIMA[®], CIMC[®]
President/CEO
Finaware, Inc. DBA Wealthcare Capital Management
Richmond, VA



The following is in response to Bill Rafter's article, Modeling the Active versus Passive Debate, which appeared last week:

Dear Editor,

Where do I begin? There are so many holes in this article that I could write for days and not cover everything fully. I'll summarize instead:

1. If we are creating a fantasy land, with no taxes, no transaction costs, and no risk, why not just buy the *best* stock available instead of 200?
2. Why discard the papers? If I bought stock A on day one and then found that stock B on day two would perform better, wouldn't I be better off selling stock A on day 2 and buying stock B? This reminds me of the entire premise from *Back to the Future 2*, which was equally fictional and far-fetched.
3. Why 15 days instead of 16? What about 14? This smells like data mining to me.
4. If you are selling your holdings every five, 10, or 15 days (or monthly or bi-monthly for the quarterly argument), isn't that the *definition* of rebalancing?
5. Since when is a one-month holding period, or even a quarterly holding period, considered buy-and-hold?
6. Cause-and-effect are completely thrown out the window.
7. You draw conclusions based on the most illogical of fake circumstances, and then completely manipulate the fake scenario even more to reach your predetermined conclusion.
8. Why use a fake scenario to "prove" active trading works when we have *real* proof every year when roughly 65% to 70% of active managers fail to beat their benchmarks? What more proof can you ask for? If every year the same managers were to beat their benchmarks, I would argue *for* active trading, but they don't, so I can't.

Yours truly,

William A. Mertes, CFA
American Financial Advisors
Rexford, NY



Bill Rafter responds:

1. Of course this is a far-fetched example. No one has access to newspapers a month in advance. The conditions were only set up that way to illustrate a perfect buy-and-hold strategy. Everything was identical except the one condition to be tested: Having perfect knowledge, can you increase your returns by active management? Surely one can test this premise with only one stock, but doing so would be subject to considerable criticism. Selecting 200 stocks makes the test valid statistically. Researchers will disagree on the required minimum number of stocks, but 30-50 seems to be the accepted minimum.
2. Cassandra has to compete against the perfect monthly buy-and-hold portfolio. She can do that a lot of ways, but the test here was to see how time-dependent the perfect buy-and-hold process was. And we found out that it was extremely time-dependent.
3. There's no curve-fitting in the test. The monthly portfolio was tested over five, 10 and 15 days, and the quarterly portfolio was tested over one and two months. Also both the monthly and quarterly portfolios were each tested over an additional day. That's a proper test.
4. My hypothetical test embodied active management, not rebalancing. Rebalancing increases or decreases the amounts of the various stocks held in a portfolio, usually to maintain a relatively constant relationship to one another. In rebalancing one does not change the stocks completely. That process would be defined as re-selection, recasting, or simply choosing a new portfolio.
5. It may be only monthly or quarterly, but it is definitely buy-and-hold or buy-and-ignore.
6. Yes, cause and effect is definitely thrown out the window. The perfect portfolio cannot be beaten over the exact period. It does not matter how or why. But it can be beaten over shorter periods, and it still does not matter how or why.
7. There were no presuppositions on my part. In my company we make forecasts every day and we want to learn how long we should value those forecasts. What we learned from this study was that even the perfect portfolio should be reevaluated over a shorter period than we used in our original forecast.



8. The fact that certain managers meet or fail to meet benchmarks does not prove anything other than perhaps they might be better employed elsewhere. The industry is chock-full of incompetent active managers as well as incompetent buy-and-hold managers. For someone to be a consistent winner he needs a regular supply of losers. To be the former and not one of the latter, my research suggests reevaluating your portfolios more often.

Bill Rafter
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