

## No Shell Game? Then What Is It?

By Dave Loeper

March 16, 2010

The following is in response to Roger Schreiner's article, [It's No Shell Game](#), which appeared on March 2, and is part of an exchange between Mr. Loeper and Mr. Schreiner. The exchange began with Mr. Schreiner's February 16 article, [The \\$100,000 Challenge to Passive Managers](#), and was followed on February 23 by Mr. Loeper's article, [The \\$2 Million Charity Challenge to Active Investors](#).



More information on this topic is available in our [Letters to the Editor](#).

In Schreiner's last article, he stated that I "misinterpreted and misstated" the rules of his challenge. This is not true – I accurately restated Schreiner's rules. I also accurately stated that a passive challenger could not win because of his rules. I don't make bets that I cannot win and I suspect he is right that he will not get any passive challengers, because most of them are smart enough to figure out there is no way to win based on his rules.

He claims this proves something...that passive proponents won't stand behind their process. All Schreiner may prove is that they aren't stupid enough to make bets they cannot win.

There is one thing about Schreiner's rules that have probably escaped most readers. That is, to win his challenge a portfolio must have both a higher return and lower standard deviation, *and if neither of the portfolios (his or his challengers') meet this criteria, the result is a tie...no winner or loser*. My original response never mentioned the possibility of ties. It only addressed the means by which Schreiner could ensure that no passive portfolio could win. A tie is not win. The existence of ties does not change the fact the rules of his challenge only permit two outcomes. Either Schreiner wins or he ties. The passive manager cannot win. Schreiner may not call that a shell game, but I do.

I care about my clients and the effect of the actions I take on their lives. Spouting bromides as Schreiner does about "risk control," when he is taking needless risks either through market timing or security selection that introduce non-systematic risk, is misleading. Schreiner inaccurately claims that active management is needed to control risk and that passive managers will uniformly experience large losses.



There is reasonable evidence that your allocation to stocks, bonds and cash might explain 90% or more the variance of returns in well diversified portfolios. (Less than 10% of variance is explained by foreign, real estate, market cap, style, alternatives, security selection and timing decisions.) Apparently Schreiner is making the assumption that all passive managers will automatically set an investment policy that is high risk. This is an understandable assumption because most of our industry stupidly identifies the maximum pain one can bear (risk “tolerance”) and proceeds to create a target allocation designed to ultimately experience that pain! Let’s assume this tolerance for pain exercise concludes that the appropriate policy would be a target allocation of 60% stocks, 37% government bonds and 3% cash as an example (like our Balanced allocation). Schreiner, by going to cash sometimes, perceives his portfolio will have less risk than a passive manager that rigidly maintains 60% equity exposure. Schreiner is actually correct in his assumption provided he also never exceeds 60% equity exposure.

But if policy explains 90% of the variance, what if a passive manager like us were a bit more sophisticated than merely identifying the client’s *risk tolerance* (pain) and setting a policy designed experience it? What if we examined the *risk capacity* (which is based on the personal goals of the client and the effect of the uncertainty of all capital markets on the funded status of their goals) and instead of setting policy at the maximum tolerance for pain *we set a policy that takes the least risk needed to confidently fund the goals the client has?* Why would one set the policy at more risk than needed merely because one can “tolerate” higher pain? Are we all masochists?

In our process, we may have a client who can “tolerate” 60% equity exposure, but all that is needed to confidently fund the goals and priorities of the client might be 30% (like our Risk Averse portfolio) or 45% (like our Balanced Income portfolio). This is more typical for our clients than the Growth allocation I used in my challenge. It is unlikely, however, that Schreiner would have less risk than our Risk Averse portfolio that never exceeds 30% equity exposure if he is sometimes (or normally?) at 60% exposure regardless of how aggressively he times the market and goes to cash. The asset allocation policy is the main decision and Schreiner understandably, yet erroneously, assumes that all passive managers set the allocation policy based only on risk tolerance. Well, this passive manager and those advisors who use the Wealthcare process know that the vast majority of clients can have allocations with far less risk than what they can tolerate and still have confidence of exceeding their goals.



In my challenge, I said we would use our “Growth” portfolio, which is the riskiest portfolio we normally recommend. Perhaps Schreiner erroneously assumed we use that portfolio for every client? The only reason I chose this risky portfolio was because I was challenging Buffett and he chose an S&P500 index fund in his original bet. I was also challenging Buffett to bet on Berkshire Hathaway stock. With Buffett setting the policy as 100% equities I chose a policy that has 90% equities. This is consistent with our premise of avoiding needless risk. I chose a policy that has somewhat less risk as we normally would do. We do have an allocation model with 100% equities, but there are few if any clients that benefit by the miniscule theoretical and uncertain additional return for extra risk that is introduced; we don’t recommend it, even if the client’s policy is 100% equities.

While our Growth model was an example of an equity portfolio we might occasionally use for certain high *risk capacity* clients, it is far more common for us to use our passive Risk Averse allocation. This “risky” (according to Schreiner because it is passive) allocation had one down year in the last decade (a loss of 3.09% in 2008), a ten-year net-of-fee compound return of 4.57% and a standard deviation of annual returns of 3.91%. This doesn’t prove anything...the markets are always uncertain and track records are only useful if you own a time machine.

I’m not sure how Schreiner’s return and risk compare, but a passive portfolio can be designed to avoid risk. Our patented Wealthcare process is designed to achieve exactly that goal. Most of our clients are in portfolios that subject them to far less risk than they can tolerate.

The bottom line to me in all of these commentaries on this topic from various people (including Schreiner) is that they ignore the client. Clients have become deservedly mistrusting of Wall Street – a skepticism that is frankly long overdue. Active activists all want to measure market-relative returns and risk. They cannot open up their mind to recognize that neither market relative return nor risk can necessarily be spent at the grocery store by the client.

Are you a return manager or a wealth manager? There is a big difference because return managers are battling a war against the markets, and even if they win that war on a risk-adjusted return basis they will still have clients whose lives are sacrificed as collateral damage. It’s very nice to pay a fee to needlessly sacrifice your life, isn’t it?



Ethically, advisors should not misrepresent their value. Active managers introduce a risk of underperforming (that can be avoided by indexing) for the potential to outperform. They charge a fee to manage market-relative returns, but the sequence of those returns will help some clients and harm others based on each client's personal goals. In essence, they are charging a fee to clients to manage something they cannot manage. You can't control which years you will outperform and which years you underperform, but that control is what is needed to add wealth the client can spend. Measuring return and risk in isolation of each client's goals is a shell game, much like Schreiner's bet. This is why active activists don't want to measure performance in dollars as my challenge required, yet that is the only thing that matters and what clients care about. Clients can't perceive the difference between a standard deviation of 12.22% and 11.93%, but they can appreciate buying the boat they always dreamed of owning.

I recognize the industry product peddlers that use advisors as their means of "distribution" for their products have giant marketing budgets and teams of wholesalers that market their often misleading risk and return spin. The advisors that parrot this misinformation to clients become victims along with their clients. The value of the advisor, however, doesn't have to be tied to being a croupier in the market-relative performance game. Advisors with the right process can actually help clients make the most of their lives. They can deliver this value proposition with confidence. They can increase their value by ignoring the product sellers, controlling the things that can be controlled and putting their clients' lives first, above those of the product vendors.

To learn how to increase your real value to clients while lowering their expenses and improving their lives, I suggest you clear your mind of everything the sales machine of the industry has pounded into your head, and take a step back and objectively consider the content in the papers below. Those who have the courage to truly put their clients first are the winning advisors of the future, and their personal careers are so much more satisfying because they are making a meaningful difference in their client's lives.



Suggested reading:

[Confidently Produce 1.5% in After Tax Alpha](#)

[Winning by Not Losing](#)

[Active Passive Management](#)

[The Difference between Measuring and Managing Investment Results](#)

[Measuring Temperature with a Ruler - Is Your Wealth Manager Really a Return Manager in Disguise?](#) (This is a 40 page paper, if you prefer [here](#) is a 60 minute recorded webinar)

David B. Loeper, CIMA<sup>®</sup>, CIMC<sup>®</sup>  
President/CEO  
Financeware, Inc. DBA Wealthcare Capital Management  
Richmond, VA

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>