



Napa Wealth Management's The Sensible Investor

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Why I Prefer Actively Managed ETFs

By Tim Ayles, Chief Investment Officer



One thing I notice when lovers of indexing write about the underperformance of active managers is that they only focus on the idea of how the managers “don’t beat their index.” If I buy an ETF or a mutual fund for a client, I rarely choose it based on my hope that it will somehow beat an index. I am more concerned with how the manager goes about getting their returns.

Here is an example that I have used before but it is germane to this topic. It usually takes about 6 hours for me to drive south to Los Angeles from my home. Assume you approach me as your “driving manager”, and I give you a few options. Based on following the speed limit (indexing), I tell you that I can get you there in the 6 hours. We will take normal risk that goes along with driving the speed limit and risk getting in an accident from other drivers not paying attention, or from me being tired from driving so long. We have risk from other drivers behind us who want to go faster and are getting angry. Doing this, at least you won’t risk having to help pay for any speeding tickets! It is boring, but gets us to where we need to go. You will get the full risk and expected performance of one who fully abides the law.

Next I give you the option of getting there in 4 hours. To do this, we will need to average 90-100 MPH the whole way. You really like the sound of the outperformance, but the risks to get there are extremely high, and should not be ignored. Our chances of dying if we get in a crash go up something like 30% for every 10 MPH over the speed limit that we travel. Is outperformance still your goal if you have a much higher chance of dying?

Is outperformance in the stock market really your goal if you have the chance of losing more if things go wrong? Why do I say this? Those who speak against active managers, from what I read, unless they get you to your goals quicker through outperforming, these money managers are considered failures. What most forget to analyze is how many active managers take less risk than the index they are supposed to beat.

I would much prefer to own a fund of an active manager who underperforms the S&P 500 by 10 percentage points over 5 years if that manager took half the risk of the index. I would also run from a manager who beats the index by 10% over a 5 year period if that manager took 50% more risk than the index. Outperformance should not be the only consideration. Investors should primarily look at risk adjusted returns.

You can do this by looking at the Beta of a mutual fund or ETF. Don't stop at performance numbers. Know the risk the manager takes in the space that they invest to determine if they did their job well or not. As stated above, I will always choose the investment that underperforms but with much less risk. It is always a matter of math. Losses are so hard to make up mathematically. If the S&P 500 goes up 7% a year for 5 years, an investor who had \$100,000 at the start sees the investment grow to \$140,000+ after compounding. Another large cap fund that is compared to the S&P 500 offers half the risk, and only returns 5% per year during that same time. After 5 years this investor instead has only \$127,600. Everyone seems to want to harp on this manager and tell you that you should index because most managers can't beat the indexes.

Now for reality. If the market crashes by 40%, the indexer sees their account go from \$140,000 down to \$84,000. Ouch! But at least you can feel good that you matched the index? The underperforming manager who took half the risk saw their fund drop by 20%. The \$127,600 turns into \$102,080. Still a profit! The underperforming manager had much better risk adjusted returns.

So the next time you hear a sales person try to pitch you on the idea of indexing being better because most managers can't beat their respective index, know that the person saying it has a bias and sales bent. You should now know that there are plenty of active managers who run ETFs and mutual funds who are not beating the indexes, but are providing much better risk adjusted returns.

Read more from Tim at www.seekingalpha.com. Search for Tim Ayles.



Last month I heard an asset protection and long-term care specialist lecture on the risks to a family's wealth when our ability to care for ourselves is compromised. She expanded on the financial and emotional impact that a long-term care need has on a family. The statistics were eye opening and caused me to take a closer look at the potential impact on our clients.

Let's begin by looking at the life cycle of wealth. Once we begin working and are no longer in need of financial support from our parents, we create income through our jobs, professions or businesses. It's in this stage that we accumulate wealth through our investments and business ventures. Our primary objective is to create income from our investments. This leads to financial independence; where work is optional and retirement affordable.

A well endowed investment portfolio coupled with pensions, social security, etc creates income to provide for the needs of a couple for the rest of their lives. This wealth is typically transferred to loved ones and/or charities at the passing of the surviving spouse. This script would include the leading role (fill in your name here) passing in his or her sleep after leading a long and healthy life – a happily ever after ending - at least that's what we all hope for.

The statistics point to a substantially different scenario. We are living longer but not always independently. Consider these facts; the individuals over age 60 in California have grown from 1.6 million in 1950 to 4.2 million in 1990. This trend will continue and those over 60 are expected to reach 12.5 million by 2040, an increase of 232% from 1990. This is largely due to the huge Baby Boomer population (persons born between 1946 and 1964). Finally, look at this fact; the fastest growing population group in California is age 85 and over. Today, 1 in 62 Californians are more than 85 years old – amazing!

So what does this have to do with asset protection? Let's dig a bit deeper. Consider a financially independent married couple, enjoying the fruits of their labor when suddenly one spouse experiences a debili-

tating health event. This may require our couple to need a care giver, which typically begins with their spouse, *"My wife had to be available 24/7. She also became my chauffeur and needed to help me shower and dress – to help me move at all, really. It impacted her freedom and her lifestyle"*, (a quote from "Beyond Dollars, The Care Recipient Perspective").

In other cases, it might require a skilled professional, such as an in-home nurse, or moving to a care facility. The cost can be staggering and many couples don't factor this cost into their financial plan. We have several clients who are currently employing in-home help or living in a long-term care facility. The costs are substantial and we have seen the financial and emotional impact of spending down an estate to care for the long-term needs of our clients.

A common question; "how much does one need to be financially independent, including covering the cost of a long-term health care need?" Of course it depends on many things, too many to list in this article. In short, consider that long-term care cost averages about \$200/day (you can find lower or higher cost care – this is an average) or approximately \$72,000 a year. Add that to your retirement income needs and you will be on the right track to see if you truly are financially independent. As a simple guideline, those with over \$1.5million of income producing assets are in better financial condition to self-fund their long-term care cost, while those with less subject their estate to a spend down of their investments.

I am not writing this article to depress you. It is intended to keep you informed and help you seek ways to make sure you have factored long term care costs into your financial plan. Most of us have experienced the effects, both financial and emotional, from a family member requiring long term care. The statistics say one in two will require some long term health care assistance before passing. My dad had a stroke and died three weeks later. Dementia affected my mom and she lived with the disease for six years before passing. One in two – yes, I get it.

Warmly,

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