WILLINK
ASSET MANAGEMENT LLC

January 2010 Your Portfolio Part I : Indexing

Remember the Syms Clothing Store slogan, "An educated consumer is our best customer"?

It's helpful from time to time to review what we do, how we do it, and the benefits you can expect. In light of market events of the past several years, we are writing a longer than usual commentary that will be published in multiple installments. Over the next few weeks we will discuss what we do, how our strategies have performed over time, common misunderstandings and pitfalls in planning and investing today, and why we think our approach is valuable in dealing with the ongoing malaise in the markets.

How do you build my portfolio?

Client circumstances will help determine whether financial planning services by our firm will either be a central component or ancillary to management of the client's portfolio. In any event, planning sets the stage for designing and managing the portfolio successfully.

The principal strategy driving our portfolios is widely known (if somewhat inaccurately) as "indexing". We think that it's grounded in common sense. Since the late 1990's our firm (or its predecessor, FRF Advisors) has employed index investing as the foundation for client portfolios. We believe Willink is one of the few firms in upstate NY who has such experience spanning several market cycles and climates.

We start with what we regard as the best of traditional money management for our type of client. This includes broad diversification among the stock and bond markets, an emphasis on long-term investing tasks over short-term trading activities, the management of portfolio tax liabilities, and more. Client expectations of performance are documented at the beginning of an engagement. The strategies used to meet those expectations are illustrated and discussed, to help ensure client understanding.

We minimize reliance on activities— promoted by others as "active management" that offer little reliable benefit or are likely to compromise desirable outcomes. These include frequent trading, most attempts to "time" when to be in or out of the markets, or attempts to forecast which economic sectors, mutual funds or stocks will post above-average performance in the near term. [1]

[1] *These investment activities may well suit other investor capital, and do help to establish market prices and maintain market liquidity.*

We aren't surprised when new clients and even some long-time clients have trouble grasping the powerful ideas behind index investing. That may be in part because much of what one hears or sees from the financial media, mutual fund firms and Wall Street houses promotes those money management activities that generate high revenues for these firms. It may also be because indexing seems counter intuitive to clients whose life experience equates "action" and frequent adjustment to events (think nursing, fire fighting, construction, trial law, politics, a myriad of sports activities, and more) as vital to success. The benefits of indexing, if acknowledged at all by Wall Street, are often only grudgingly granted. But today, indexing has emerged from the fringes of money management practice as a proven strategy that is capturing a growing volume of investor assets.

How does indexing work?

Broadly stated, indexing is an investment strategy that capitalizes on the trading activity of other market participants by capturing the average rate of return achieved by them. To better understand this concept and the benefits of such an approach, we should start with some background.

Institutional and ultra-wealthy individual investors across the globe search the world's stock and bond markets (and other capital markets also—but we will focus here on stocks and bonds) for investment opportunities. They allocate investment capital where they believe gains will be earned, in accordance with various appetites for risk taking.

These investors may be loosely characterized either as **traders**—who typically seek profits over the shorter term by making concentrated bets on a company or sector, or as **long-term investors**—who may be more patient and whose more conservative goals are better served by diversified portfolios.

These traders and investors select from a smorgasbord of strategies in pursuit of gains. They may research the stocks and bonds issued by companies and governments; rotate in and out of industry sectors based upon economic forecasts; or make dramatic moves between the markets and cash in anticipation of events. They may chart the price movements of stocks in hopes of divining future trends; leverage investment with borrowed funds, bet against the prevailing "wisdom" with hedging strategies, and more.

The aggregated result of all this trading activity can be understood as the weighted average price of the multitude of trades. From this the average return of the market—or a segment of the market like the "S&P 500" for large US companies or the "MCSI EAFE" index of companies in Europe and the Far East, can be derived for a given period. By its very definition, this **weighted average rate of return** for stocks or bonds, implies that, of all the investment capital invested, one half has earned more than the average rate of return—and one half has earned less. (No great insight here; we presume that, at minimum, you would like your money with the managers in the top half.)

Some forty years ago, a handful of theoreticians and practitioners working independently began to document **the inability of traditional money managers to sustain any degree of above-average performance over any meaningful time frame**.

The researchers questioned the benefit of many money management activities for long term investors. They shined a light on high investment expenses, needless tax liabilities, and suspect measurement methods employed to claim "top performance". The next step was the development of **financial products that would minimize reliance on non-value added activities and costs and seek instead to turn the short-term average investment results of the markets into a long term desirable result.** Think about this.

On the left index fund pioneer & Vanguard Fund founder John Bogle
On the right investment guru Warren Buffet who has defied the odds as a winning money manager but has cautioned that investors would do better to index than to follow most active managers.

Given any group pursuing the same goal (math students, bricklayers, PGA golfers, heart surgeons, etc.) some are going to do better than average, some worse, some about average. However, unlike bright students, skilled tradesmen, winning golfers, and top heart surgeons—where success often extends for decades, the research showed that "last year's top money

managers" could not sustain their above-average results over even shorter time-frames. Was something else at work here? Were "above- average" results almost always a statistical anomaly? The product of luck? Was the nearly inevitable fall to "average" or "worse than average" the result of inevitable misjudgments? High investment expenses? Tax inefficiencies? All of the above?

What about those traditional managers who had demonstrated above average performance over the last three, five, even ten years? Weren't they worthy of consideration and praise?

In most cases, apparently not. While a few posted great three year averages, fewer of these earned five year accolades, and only a tiny number went on to claim bragging rights ten years later. In many cases it was discovered that managers claiming to beat an index like the S&P 500 of large US companies did so by investing a portion of their portfolio in something else; bonds or small companies not found in the S&P 500. This hardly allowed for apples to apples comparisons. In any event, whether the money managers were wonderfully skilled or merely lucky, the trick of course was to identify these managers at the beginning of their run, before it ended in mediocrity or worse. The research then and now strongly suggests that no one knows how to do this.

In contrast, early proponents of indexing counted these benefits for portfolios built with index funds as compared to older fund construction: **greater transparency and consistency of fund holdings to better control risk, lower expenses, higher tax efficiencies, and lower volatility than typical portfolios built of mutual funds or individual stocks and bonds. Odd as it seemed at the time, designing index funds to attain "average returns" in the short term was promoted as a virtue.** It was anticipated that index funds would eventually and inevitably move toward the top of the longer-term performance charts as other investment strategies stumbled. While indexing would rarely if ever earn the top spot; it would rarely be very far behind, over the long-term. **Now, after years of real world experience that is exactly what has happened.**

Next Installment: Not all index mutual funds and exchange traded funds (ETFs) are designed the same way. Not all methods of portfolio construction using indexing yield similar results. We look at the recent and longer term performance of popular choices for index investing; such as stock mutual funds from Vanguard Funds and ETFs from Barclays and elsewhere. We have had experience with many of these. Our decision years ago to employ the resources of Dimensional Fund Advisors (DFA)—one of the least known of the indexing strategies—and unavailable to most investors—is explained. The results should please our long time clients and may peak the interest of others searching for a better solution.

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