CHARTING THE COURSE

Special Series of Briefs About Beacon's Client Services

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About Beacon Financial Advisors Ltd.

Beacon is an independent fee-only advisor with a clear mission statement: To provide our clients long-term value-added financial counsel and investment performance with *exceptional service.*

Beacon is a Registered Investment Advisor with the US Securities and Exchange Commission.

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A NEW RELIGION: ~~Climate Change~~ Passive Index-Investing

We at **BEACON** really don't know much about climate change—except we weren't surprised when Houston didn't have a White Christmas. But, we do know a thing or two about investing. After all, you pay us to invest/manage your hard-earned money. In some circles, we might even be considered "experts" but we don't describe ourselves that way (humility goes a long way in our profession, because investment markets have a tendency to regularly humble "experts"). The WALL STREET JOURNAL features a sub-section named THE EXPERTS | WEALTH MANAGEMENT. In the 10/27/16 issue MIT finance professor Antoinette Schoar wrote a piece titled "We Put Financial Advisors to the Test—and They Failed". Well, naturally, such a catchy title caught our eye and we printed the piece for our reader file. Just a few days ago, this writer got around to reading the article. One section really got our attention (underlined text by **BEACON**):

"In a study with my co-authors Sendhil Mullainathan at Harvard University and Markus Noeth at Hamburg University, we set out to analyze the quality of financial advice commonly given to clients. We sent "mystery shoppers" to financial advisers in the greater Boston area who impersonated regular customers seeking advice on how to invest their retirement savings outside of their 401(k) plans. The mystery shoppers also represent different levels of bias or misinformation about financial markets. <u>What we learned is highly troubling</u>. By and large, the advice our shoppers received did not correct any of their misconceptions. Even more troubling, the advisers seemed to exaggerate the existing misconceptions of clients if it made it easier to sell more expensive and higher fee products. <u>In addition, advisers strongly favored actively managed funds over index funds. In only 7.5% of sessions did advisers encourage investing in index funds. This is exactly counter to insights from finance research, which suggests that the average investor should choose low-cost index funds over actively managed funds... As a result, we found that advisers appeared willing to make their clients worse off in order to secure financial gain for themselves"</u>.

Now, it's been awhile since any "mystery shoppers" visited **BEACON'S** office "impersonating" prospective clients. Nonetheless, we've no doubt if Ms. Schoar and her co-authors visited **BEACON** in Houston they'd have included us on their list of advisor's who failed their "test." After all, if we disclosed our existing list of *actively-managed* mutual fund partners that populate your portfolio the "mystery shoppers" would have been **"highly troubled"** (maybe so much so that our next set of visitors may have been "mystery regulators").

THE EXPERTS

The Experts are a group of industry and academic thought leaders who weigh in on topics covered in the The Journal Report.

Schoar proclaims **"insights from finance research"** from high atop the ***ivory tower:***

- <u>Observation</u>—passive-indexing is low cost, thus actively-managed funds high(er) cost.
- <u>Assertion</u>—investors should choose low-cost index funds over actively-managed funds.
- <u>Conclusion</u>—advisors recommending actively-managed funds are self-serving.

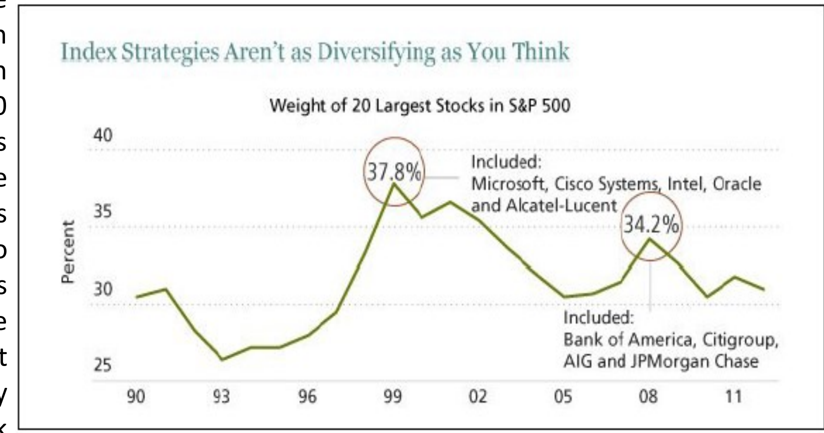
(NEW RELIGION continued p. 2)

A NEW RELIGION: ~~Climate Change~~ Passive Index-Investing (continued)

Consider the ubiquitous TV ad for SPDR® ETF's, the passive-index funds by State Street Global Advisors: "Why invest in a single _____ stock, when you can own the entire ______ industry?" The blanks represent companies and industries like banks, pharmaceuticals, technology, etc. Makes sense, right? It does to the passive investor. But, an active investor correctly understands all companies (stocks) in a particular industry are not equally worthy of investment. **BEACON** thinks the ads' grossly oversimplify investing.

Before we handcuff ourselves to our PC's and wait for the regulators to arrive, we'd like to say a few things in our defense as advocates of research-driven active investing. We think Ms. Schoar and her co-impersonators "advice" to investors to put *all* their money in passive-index funds is naïve for such learned folks. Among others, one key question arises: Is exclusively passive investing truly a suitable all-season approach?

In **BEACON'S** view, there are large risks hard to navigate by hugging a benchmark, and meaningful opportunities that cannot be captured by being all-passive. A decision to go all-passive should not be undertaken without understanding the potential consequences. Investing in an S&P 500 Index-like fund feels like effective diversification but index funds are "price takers." When stocks or sectors become expensive or bubbly, or when the opposite is true in deteriorating entities, the index fund will still own these. Prior periods just before the S&P 500 Index collapsed it included large distortions in weightings—energy stocks in the early 1980's at 27%; 20 technology stocks in early 2000 constituted 38% of the index; financial stocks in 2008 such that 35% of the S&P 500 Index's capitalization was in the largest 20 stocks including big banks like Citigroup whose share price declined from $45 to $0.95 (dollars to cents)! The risk of rising interest rates demands attention today, and indexes hold many stocks that historically have a negative-sensitivity to rising rates. Think about disruptive innovation in which rapid technological change threatens traditional businesses and products. Disruptive innovators can be considered game changers—recent examples include cameras in smartphones replacing digital point-&-shoot models, or Amazon.com replacing brick-and-mortar bookstores. Index investing isn't very good at avoiding tomorrow's Border's Bookstore. Then there is political (or geopolitical) risk that sometimes unfolds abruptly or on slow-boil—like when government meddles in companies or industries (e.g. presently the U.S. coal industry is under assault by EPA regulations). Active managers, as "price makers", can manage risk and pursue opportunity, whereas as "price takers" passive indexes simply cannot.



BEACON has penned several client SERVICE BRIEFS that expand on our thinking in regard to passive v. active investing. These are available at our website (www.bfaltd.com) in the tab BEACON LIBRARY. Dodge & Cox, one of our mutual fund partners, recently prepared an excellent white-paper on their website (www.dodgeandcox.com) under FEATURED RESOURCE Understanding the Case for Active Management. **BEACON** highly recommends it to you, our client. Oh, and we also recommend it to the impersonating "mystery shoppers" helping promote the NEW RELIGION of passive-index investing. In 2016 *active-manger* Dodge & Cox Stock (DODGX) gained 21%+ and Dodge & Cox International Stock (DODFX) gained 8%+, substantially outperforming their respective passive indexes. Of course, past performance is not a guarantee of future results. And yet, we can't wait to read what THE EXPERTS have to say about that! ■

Asset Allocation (aka diversification) divides your funds into different asset types that typically provides exposure to the period *best* and *worst* returners, generating a blended return designed to achieve your financial goals. The matrix chart below is instructive. Over a decade and a half from 2002-2016—a notable period including the "Great Recession" of 2007-2009—a 60/40 **Asset Allocation** returned 6.9% annualized. Indeed **Asset Allocation's** solid return was more than the returns of the worlds' developed stock markets, over 5X greater than **Cash** (i.e. money in the bank), with risk (volatility) about half that of stocks. In 2016 **Asset Allocation** returned 8.3% as the *best* returner was **US Small Cap** at 21.3% versus the *worst* **Cash** at 0.3%. 2016 witnessed positive returns in most major asset classes after a rather dismal 2015. In not uncommon fashion, the 2015 laggards with negative returns became 2016 leaders with double-digit returns (compare 2015 to 2016 **US Small Cap**, **Emerging Market Equity**, and **Commodities).** Restated, effective diversification (aka Asset Allocation) means always owning some of the *best* performers while limiting exposure to the *worst*. The white Asset Allocation boxes clearly produced that *smoothing* result across the full length of the turbulent 2002-2016 years. Sometime ago a wise fellow named King Solomon wrote:

"Divide your investments among many places, for you do NOT know what risks might lie ahead." Ecclesiastes 11:2 (New Living Translation)

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2002 - 2016 Ann.	2002 - 2016 Vol.
Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	REITs 10.8%	EM Equity 23.8%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	EM Equity 9.8%	REITs 22.6%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	High Yield 9.2%	Small Cap 20.1%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap [illegible]	DM Equity 19.2%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 6.9%	Comdty. 19.0%
Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	Large Cap 6.7%	Large Cap 15.9%
EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	DM Equity 5.8%	High Yield 11.7%
DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 4.6%	Asset Alloc. 11.0%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Cash 1.3%	Fixed Income 3.5%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Comdty. 1.2%	Cash 0.8%

CHART FROM J.P. MORGAN ASSET MANAGEMENT 2017 Q1 GUIDE TO THE MARKETS - PAGE 60

"Asset Allocation" portfolio assumes the following index weights: 25% S&P 500, 10% Russell 2000, 15% MSCI EAFE, 5% MSCI EMI, 25% Barclays Capital Aggregate, 5% Barclays 1-3m Treasury, 5% Barclays Global High Yield, 5% Bloomberg Commodity Index, 5% NAREIT Equity REIT Index.

(NOTE: An investor cannot invest directly in an index, and its performance does not reflect investing costs).