SMALL BUSINESS JOURNAL

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FEATURE

LEVERAGED FUNDS OF FUNDS:

A STRATEGY TO ADDRESS TODAY'S MARKET CHALLENGES

ABRAHAM BIDERMAN AND HOWARD HOROWITZ

Ethan Kahn, CPA
and Partner

WeiserMazars
Exactly Right.

THE RECENT AND FAR-REACHING NEW YORK STATE

NOT-FOR-PROFIT REVITALIZATION ACT ("NPRA")

Jonathan Blau
Fusion Family Wealth

SUCCESSFUL INVESTING GENERALLY REQUIRES ONE SIMPLE PRINCIPLE: BEHAVE

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INSIDE

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Equity markets are teetering at record highs. Bonds may well be heading for trouble if interest rates rise later this year. What's an investor to do?

Leveraged funds of hedge funds offer an excellent way to thread the needle. Unlevered (read: plain vanilla) funds of funds, with their second layer of fees and middling returns, have fallen from their once lofty

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Successful Investing Generally Requires One Simple Principle: BEHAVE

BY
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The principles of Behavioral Finance are critical for each investor to understand and incorporate into their investment planning construct in order to maximize the probability of achieving their financial goals and to avoid taking actions that create permanent capital loss.

Two of the most successful investors who have ever lived understood and, in Warren Buffet's case, still understand that the ability to keep emotions from influencing investment decisions is the single most important factor. According to Buffet, "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

Warren Buffet's mentor, Benjamin Graham said "The investor's chief problem and even his worst enemy is likely to be himself."

Sadly, led by the large wire houses (Morgan Stanley, UBS, Merrill Lynch, etc…) and firms like Morningstar, Wall Street's Marketing Machine creates a culture designed to exploit -- rather than to address to the investor's benefit -- the innate psychologically-driven tendencies that cause investors to maintain a short-term focus, chase performance, and abandon long-term planning efforts by attributing far too much meaning to the most recent performance trends and current events.

As we crave order and certainty, our minds are wired to constantly look for patterns. Few things are more elusive in the global financial marketplace than predictable patterns! As a result, one of the most pervasive and dangerous cognitive decision drivers is recency bias. Those with recency bias prominently recall and/or emphasize recent events and then extrapolate a future predictable long-term pattern where none exists.

Please see the chart below highlighting a Hong Kong elementary school first grade entrance examination. Please take no more than 20 seconds to try and determine which spot number the car is in.

The majority of people will automatically look for a pattern, which prevents us from exploring a more effective approach. It is almost impossible to resist our brain's automatic pattern-seeking programming. Please turn the chart upside down and you'll see that the brain's default method for problem solving -- seeking a pattern – prevented us from exploring an alternative and simpler approach to finding the answer.

HOW MUCH DO PSYCHOLOGICAL DECISION-DRIVERS COST INVESTORS?

One widely followed study, updated every year since 1984, actually quantifies how much psychological decision-drivers cost investors, and the numbers are staggering.

The Dalbar study [1] illustrates (see Exhibit I)that over the 20 year period illustrated, psychologically decision-driven market timing behaviors cost the average equity investor close to $4 million for every $1 million invested.

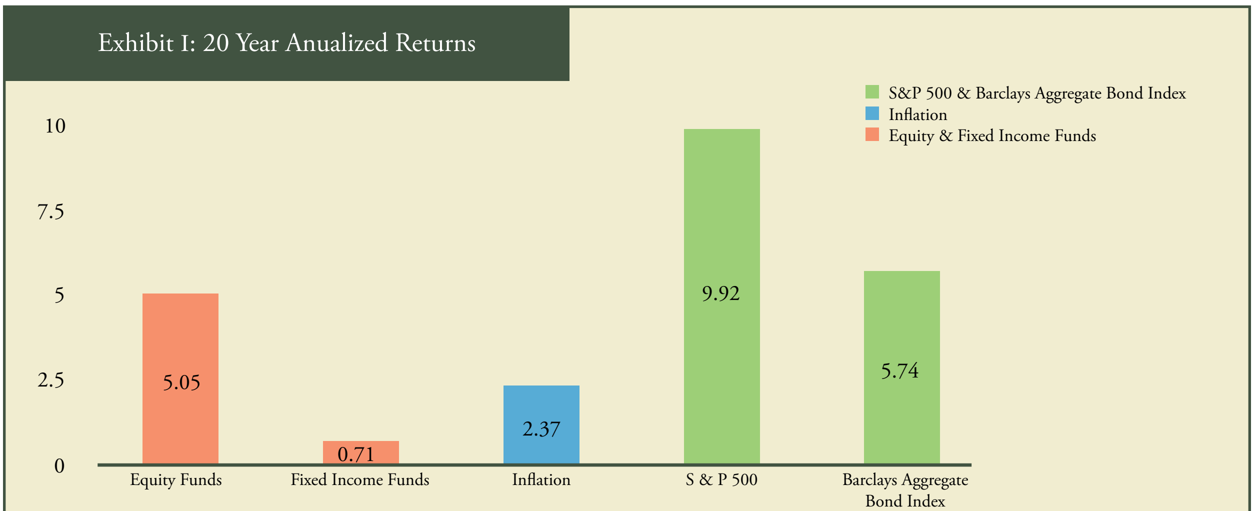
Investors should resist the siren call of brokerage firms touting their large equity research capabilities, along with fund companies touting their mutual funds that "outperformed" the S & P 500 index for the past 3 and 5 year periods and those that are rated 5 stars by Morningstar.

All of these messages are often nothing more than results-oriented marketing campaigns designed to take advantage of what the industry knows well – that we humans are programmed to seek patterns to identify potential dangers and potential opportunities, and that we tend to focus more on recent patterns ("recency effect") than on longer term patterns. As it relates to investing, the recency effect induces us to believe that, based on recent performance results, we can extrapolate a future predictable pattern of returns where none exists. This is why so many investors engage in the "buy high, sell low, repeat until broke" investment pattern. They are forever chasing the elusive dream of persistent out-performance.

Morningstar's rating system specifically enables fund companies to take advantage of recency bias to the detriment of investors. A fund receives 5 stars as a result of having recently outperformed a majority of funds in its category. In other words, the higher star rankings indicate, in most cases, that those particular funds have gotten relatively expensive. The lower star-rated funds now likely represent better relative investment values. Logically, investors should peel some money from the more expensive funds and rebalance into what has become more undervalued. The problem is, most investors do not appreciate the backward looking nature of the star system and they have been led to believe that 5 star funds are "good" and that 1-star funds should be avoided.

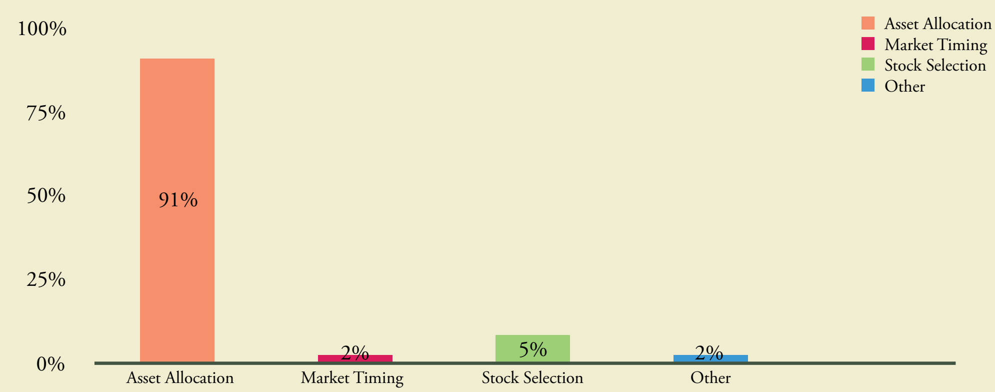
A study conducted by Vanguard shows that on average, the opposite is true. Vanguard's study revealed that for the three years following the year a fund received a 5-star ranking, 39% of such funds outperformed their respective style benchmark. During the same period, close to 50% of funds with the lowest 1-star ranking outperformed! Further the study looked at 36 month excess returns (versus the relevant style benchmarks)

1) Dalbar's 20th Annual Quantitative Analysis of Investor Behavior 2014 Advisor Edition.



"Psychologically decision-driven market timing behaviors cost the average equity investor close to $4 million for every $1 million invested."

Exhibit II: Determinants of Portfolio Performance



and found that, over time, the top rated mutual funds generated the lowest excess returns while the lowest rated funds generated the highest excess returns.[2]

WHAT IS AN INVESTOR'S BEST DEFENSE?

Investors need to avoid focusing most of their energy on trying to find stocks or funds that have the best past performance records in hopes of achieving a more "certain" future investment result. The fact is that studies have determined that the asset allocation decision accounts for over 90% of a portfolio's total value movement, while stock/fund selection accounts for 5% (see Exhibit II).

Similarly, since most actively managed funds do not outperform index funds, investors would be wiser, and likely far better off financially, if they focused most of their energy on developing an asset allocation strategy to reflect their long-term goals, while seeking out an adviser adept at identifying their individual decision-drivers and helping to mitigate the impact of such drivers in order to ensure the highest probability of plan adherence.

Investors should avoid choosing random benchmarks like the S & P 500 or their neighbor's broker's performance to measure their success. Using such arbitrary benchmarks tends to lead to unrealistic expectations that are not based on the risk tolerance and objectives of the individual investor. This type of arbitrary benchmarking often leads to inappropriate asset allocation moves and long-term plan abandonment, usually at the worst times.

2) Christopher B. Phillips, CFA & Francis M. Kinniry Jr., CFA – Mutual Fund Ratings and Future Performance – (Vanguard June 2010) http://www.vanguard.com/pdf/icrwmf.pdf.

Helpful benchmarks are generally goal-based and customized. For example, an investor who defines an annual retirement spending need of $300,000 and an anticipated retirement time horizon of 20 years can periodically track whether the recommended plan's likelihood of achieving the goal by measuring periodically how close they are to the balance needed at retirement.

SOME SPECIFIC RULES TO LIVE BY

- **Avoid frequent portfolio monitoring** - Investors should be most concerned with maximizing the overall level of their wealth over time. Instead, they tend to be preoccupied with monitoring short-term changes in the level of their wealth. This behavior drives them to make decisions that reduce the probability of maximizing long-term wealth.

  Frequent monitoring causes us to adjust our portfolio in reaction to what we see, and can have extremely negative implications for the ultimate level of our wealth. This behavior is a result of what is known as myopic loss aversion – when investors focus too heavily on short-term declines and forget how important it is to remain invested for the long-term to grow their wealth. As there are many more daily declines than monthly or annual declines, investors who view their portfolio less frequently will see fewer losing periods and are far more likely to stick to their plan and discipline, increasing the odds of their achieving financial goals.

- **Recognize the contradiction in viewing all past market crashes as opportunities, while viewing all future market crashes as risks.** As a general rule, when we buy investments at lower prices, we should expect a higher future return. Warren Buffet tells investors to be greedy when others are fearful and to be fearful when others are greedy (buy low and sell high). He is a credible source of investment advice.

- **Avoid short-term thinking** – The market rewards patience and discipline more than any other skill. Those who can focus on the next 5 years, rather than on the next 5 days, are more likely to avoid behaviors that impede their ability to reach financial goals.
- **Don't follow "expert forecasts"** – Expert forecasters have been shown to be accurate only 48% of the time, about the same accuracy as a random coin toss. The more confident the expert was in their opinion, the less accurate their forecast was. The trouble is that the more confident experts are listened to or followed the most.
- **Avoid outcome bias** – Judging whether or not your portfolio has been well diversified or whether you have been advised properly based only on the investment outcome is dangerous. This bias led many investors to hire advisors in the late 90's who imprudently chased technology stocks to be able to generate performance statistics in line with the popular indices. The prudency of their "advice" was poor and outcome bias led investors to make costly choices in terms of the advisors they chose to rely upon. Seek out prudent advice and well thought out processes, rules and disciplines.
- **Select advisors held to a Fiduciary standard of care** -Unfortunately, the large wire house firms – UBS, Morgan Stanley, Merrill Lynch, Wells Fargo, etc… -- are held to a far lower "suitability" standard of care. Conflicted models can tend to take advantage of investor behavior biases – rather than try to help investors identify and mitigate the impact of biases -- to sell high commission-generating products like annuities. A fee-only Registered Investment Adviser is held to a legal fiduciary standard of care and is required by law to place client interests ahead of their own. Investors likely increase their odds of success by shunning those held only to the lesser suitability standard of care.

"Expert forecasters have been shown to be accurate only 48% of the time."

Most people wouldn't hire a doctor who refuses to sign the Hippocratic Oath. Similarly, if an advisor won't put in writing that he or she will act as a fiduciary, then you may want to think twice about hiring them. ■

Jonathan is the President and CEO of Fusion Family Wealth, a financial advisory firm he founded in November 2013. Behavioral finance is an important aspect of his business and he brings a fresh perspective and clarity on his work with clients. For more than two decades Jonathan has acted as a "trusted advisor to trusted advisors" with deep experience working with accounting and law firms on a wide array of financial services capabilities.

Jonathan holds an MBA in Accounting and an MS in taxation. He honed his extensive planning and technical skills during his tenure in the tax and Family Wealth Planning division of a "big 6" accounting firm from 1992 to 1996.

He has held a series of wealth management positions in the financial services industry. In recent years, he worked as a senior advisor at Sanford C. Bernstein & Co., Inc., Morgan Stanley and UBS.

Jonathan has been a lecturer for the Foundation for Accounting Education (FAE) and the New York State Society of CPAs on the topic of "Taxation of Financial Instruments."

Mr. Blau is also an active board member of the Gurwin Jewish Nursing & Rehabilitation Center.