Is Wealth Really 'Simple'?

Violence on the African Plain
Financial markets are home to hedge funds and investment banks that are high on *animal spirits,* and seek to exploit unsophisticated money – and they have teeth.

Those teeth were bared on Monday August 24th, 2015. At the opening the S&P 500 fell as much as 5.3% in the early minutes of trading. The worst hit market was the exchange traded fund market (ETF) where: the $65 billion iShares Core S&P 500 **ETF** fell as much as 26%, some 20 percentage points below its fair value. The $18 billion Vanguard Dividend Appreciation **ETF** and the $12 billion SPDR S&P Dividend ETF plunged 38% apiece, while the Power Shares S&P 500 Low Volatility **ETF** fell as much as 46% before clawing back an hour after markets opened. Each of these ETFs are marketed as passive, safe and lower volatility choices.

The morning of August 24th was, in African plains terminology – a quick and bloody kill. The predators moved back to the high grass quite well sated from the feast – the **ETF** investors (friendly animals with no teeth) didn't.

Is Wealth Really 'Simple'?
Conventional wisdom seems to have arrived at the proposition that: wealth, can in fact, be simple.

In typical fashion, the mainstream financial press has leap-frogged over proposition to conclusion. Late in November a center spread Report on Business article suggested that traditional advisors are under siege by low cost ETFs, and ROBO advisor platforms that also execute portfolios into ETFs. Discount brokerages, and ROBO advisors are also fueling the perception with clever ads parodying the old school stock broker.

In fact, markets for ETFs have launched into the stratosphere in the trillions of dollars. When DoubleLine 'Bond King' Jeffery Gundlach announced that he was tired of fighting ETFs so he was going to join them – it was a big win for the concept. At the end of the day an ETF is an accessible financial structure, and nothing more.

Self-Improving Individuals.
Becoming an ETF investor is a willing act of drinking the passive investor Kool Aid. Each passive investor thinks that they are doing what is best for them – investing in a product with low fees while effortlessly achieving market returns. It is enlightened self-interest in its purest form. And it does sound very simple. *Simple* resonates with the millennial generation. And enlightened self-interest resonates with every generation. Add in a glitzy online interface and it gets even 'Simpler'.

Self-harming Crowds
If you dip beneath the surface – or delegate responsibility for your wealth investments to an algorithm that allocates your money into a single asset structure (ETFs) it might appear so. But no Virginia – it really isn't. Or so writes Geoff MacDonald whose decades of experience as a pension and portfolio manager says otherwise. He wrote a thoughtful commentary specifically about ETF's – and how the actions of many self-improving individuals can actually turn into self-harming crowds.

Essentially he says if you don't do the homework, and ask tough questions (or delegate someone to do it for you) – then you are in for a nasty surprise at some point. ETF investors are in his words: 'friendly animals with no teeth, a group with no questions, and seeking effortless mediocrity'. It's akin to driving by a house seeing a 'for sale sign' and making an offer sight unseen on that house: without price discovery, hard questions, or negotiation. He puts it more poignantly ETF's are – 'the blind leading the blind, or dumb money' – to which he sees opportunity, profits and exploitation taking place, by sophisticated institutional market participants, and active managers.

Real Intelligence is hard to program.
So conventional wisdom, in some people's minds is a contradictory phrase, may prove to be misguided. So what's to be done about your wealth?

Possibly: Get some 'teeth', do the homework, and ask tough questions (or delegate someone to do it for you), and avoid the false allure of effortless mediocrity. If driverless cars are 20 years away from hitting our streets – *don't buy one now*.

In the coming weeks ETF providers will ramp up the advertising volume as Client Relationship Model (CRM2) changes are implemented by the regulators beginning in 2017. Their primary target is mutual funds – because that's where significant wealth remains. Mutual funds cost structures remain stubbornly high, and ETFs cost structures are low: so that's the message that will be delivered. Everyone should be mindful of costs (we most definitely are) – but focusing on costs alone can be misguiding. In 2008, 2011 and last year people were less concerned about the annual cost structure than they were about overall market losses, *plus* the annual cost structure which added insult to injury.

Artificial intelligence and algorithms (ROBO advisers) have their growing pains to endure. Those growing pains come out of financial dislocations or crises - It is arguable that the ETF phenomenon may actually contribute to that crisis. It may be premature to trust wealth to a faceless team of algorithm writers, and financial engineers – and the minds that employ them.

Real intelligence in the meantime comes from doing the work, using technology to its limits, gaining experience, asking lots of questions to navigate a difficult landscape with good judgement and sound decisions. These are human skills – which is why, despite the conventional wisdom - true wealth will probably continue to seek good, sound advice. A physical handshake, and being able to look someone in the eye still matter.

Phil Richmond & Doug Goodman are human portfolio managers.
They look after a pool of capital for a terrific group of clients – who value hard work, good judgement, sound advice, and stingy cost structures.

1. *Barron's The Great ETF Debacle Explained, The stock market slide on Aug. 24 led to ETF prices falling more sharply than the stocks they owned. By CHRIS DIETERICH. September 5, 2015*
2. *Geoff MacDonald "Stairway to Heaven or highway to hell?' Sept 30,2016*