asi

What We Do and How We Do It - An ASI Primer

Getting to Know You

It may sound like a scoop of marketing' ease but ASI's investment process is a dynamic process that starts by learning about each other. We need to learn about you, you need to learn about us. Each of us needs to drop our assumptions and start with a clean slate. This is not as easy as it sounds especially when it comes to money. The industry has long capitalized on investor emotions to create willing buyers of products not to create sound investment processes.

A large part of ASI's role is to teach, or re-educate, you about investing. For some clients this is difficult. Old habits die-hard and many of the methods we employ are designed to counter the emotional instincts that retail investing has always exploited. ASI strives to create a sound investment process that works for each client and every process is designed to provide an objective framework for the decisions that will be made and objective criteria to measure success.

So, to get to some specifics, we will start by talking with you about your goals and your perceptions. We want to know how you perceive risk and what kind of expectations you have and we will probably use this opportunity to start educating you about some investment realities. Armed with the information we glean from you we will go to work to develop a profile of you that quantifies some of these variables and, using them, we will design a portfolio to achieve your goals within your tolerance for risk.

Down the Investment Analyst's Looking Glass

When it comes to portfolio design we will first talk in terms of asset classes and not specific investments. Stocks, bonds and cash are three general asset classes but we will be more specific than that (we'll talk more about this later but the idea behind separating these investments into different categories is to differentiate by risk/return characteristics). When it comes to stocks we will first break them down by size: Large, mid, small, micro. Of course International stocks are also important to consider (The US market holds just over half of all the investment opportunities in the world), as is Real Estate.

Those are the primary choices when it comes to equity or ownership investments. But debt investments are equally important to consider so we will look at Fixed Income securities and break them down into domestic and international opportunities then categorize them by maturity: Long, Intermediate, Short, Ultra Short and Cash. We can also look at the differences between Municipal, Corporate and Government securities and finally all the hybrids (agencies, asset backed, etc.).

This categorization process is designed to help us make choices. First we separate the possibilities according to their different risk and return characteristics. For example, small growth stocks are much riskier than large growth stocks but they also have a higher expected return. Bonds with a long-term maturity carry more risk than those with a short maturity. Cash is thought to be the least risky asset class and can be thought of as bonds with a maturity of now. But cash is subject to inflation risk.

So when we separate these categories we can then try to choose the categories that will work best to achieve your goals. This is a simple concept but to make sure we get the most out of this process we are going to employ some Nobel Prize winning theories. Harry Markowitz won the Nobel for his theories of portfolio selection which were based on the behavior of an optimizing investor. What does an investor want to optimize? Return. What does an investor want to minimize? Risk. (The emotional corollaries here are greed and fear).

Markowitz helped lay the foundation for what we now call mean-variance optimization. This is a quantitative process that takes a collection of inputs (in this case the expected returns, risk and correlations of the assets classes we want to use) and, using a bit of calculus, finds the most efficient ways of combining them in portfolios. Efficiency for an investor means getting the most bang for your buck, or the most return for every unit of risk. One of the most poignant points Markowitz helped define was the fact that for every given level of risk there is only one possible portfolio that maximizes the potential return.

So ASI uses some of the most sophisticated quantitative tools available to help design your portfolio. This is good for you but only because we know what we are doing. In the computer age just about any advisor has access to these types of tools. But like anything else, there use without the correct knowledge and training is more often abuse. In the wrong hands these models can create some very unrealistic expectations.

We try to keep our models simple and we constantly apply our own common sense to the modeling process. The truth of it is that we can probably tell you what the model will look like before we even run it. Years of experience have made us cautious and reluctant to use a computer or 'black box' optimizer as the sole engine behind creating a portfolio.

However we do use the box as one of our tools and there are many other benefits from this process. Most importantly it lets us look at the possibilities and quantify them. We can compare one portfolio to another and tell you how likely each is to suffer losses in any given year and how large those losses may be. It works the same way for gains. We can also back test those portfolios and see how they behaved in different markets. We can test theories on rebalancing, on dollar cost averaging. And we can run Monte Carlo simulations. Monte Carlo is the latest and greatest statistical method to add to all this quantitative computer mumbo jumbo. Basically we can run a portfolio through thousands of iterations of possibilities and see how it behaves.

Bottom line is we will design a portfolio to meet your specifications using these tools, our experience and our common sense. Then we will show you how we expect it to behave and help you develop investment expectations that we think are realistic.

Implementation with Style

The next step is implementation. At this point we should know how much money we want to devote to each asset class so the next question is what to buy to represent that asset class. First let's talk about style. When it comes to investing in stocks there are two schools of investing. Growth and Value (you can combine the two into a third and call it Blend). Simply put, value stocks are usually bargains. They trade at prices less than what the assets of the company are worth (low price to book ratios). Growth stocks are at the opposite end of the spectrum and generally sell for prices many times current earnings (high price to earnings ratios). The reason we separate our choices this way is because these two styles of stocks behave differently at different times. The 90's was the decade of growth stocks, while value stocks performed modestly growth stocks carried investors to extraordinary annual returns (fyi value has outperformed growth through the total history of the market).

The most important lesson we can ever teach you about investing is DIVERSIFICATION. That's what we are doing when we combine different asset classes and that is also what we are doing when we combine different investing styles. When you look at historical returns and see which style outperforms the other you will notice that growth and value ebb and flow. The same is true with the asset classes we break down by size and you can combine size and style to create a new set of classes to look at (see attached periodic table of asset classes).

Back to implementation. Now that we have our allocation by asset class determined (and we could run our models using classes broken down by style as well but we prefer to use the style decision in a different manner) we can start searching for specific investments in each category. There are lots of ways to do this. 1) We could classify stocks by style and size and pick the best stocks from each category; 2) instead of picking 'the best' stocks from each category we could buy all the stocks in each category (this is a passive strategy often called index investing and is a very important thing to learn about, more later) or; 3) we could hire someone to pick stocks for us, a money manager. We tend to use the terms money manager and mutual fund interchangeably. Behind every mutual fund there is a money manager running the show, the term mutual fund simply specifies the vehicle we use to access the manager. Other vehicles for money managers include separate accounts and commingled funds.

This stock picking business gets pretty complicated and is not necessarily easy. It has always amazed us that thousands of stockbrokers make their living doing this for small investors when those same investors can get access to some of the best money managers in the world through mutual funds. We think about it this way, if a broker is so good at picking stocks why isn't he doing it for hundreds of millions, or billions, of dollars. If he were really good at it investors would flock to him right? Peter Lynch could pick stocks. He left Fidelity in 1990 but there is still over $60 Billion in the Magellan fund today.

Some Decisions Are More Important Than Others

For many reasons ASI has chosen not to pick stocks. We talk about it now and then and if we put our talents to it we could probably be pretty good at it. But the other decisions you need to make as an investor are also very important and this is where we have dedicated our resources. In the 1980's and early 1990's an important study was performed and re-performed by some economists. Originally released by three gentlemen with the names Brinson, Hood & Beebower the study is often referred to with one or all their names. They sought to calculate which investment decisions were most important to long-term investment performance. Understanding that pension plans were mostly invested with long-term perspectives they chose a group of these to provide their study data.

Basically they surmised that there are three basic choices made by investors: 1) Investment Policy, or how much of your assets to devote to each asset class; 2) security selection, or which stocks or bonds you buy to implement that policy and 3) timing, or when you buy or sell those securities.

The goal of the study was to determine how much of a portfolio's long term return could be credited to each of those decisions. Presumably, if we know which decision is most important we can devote the most time or resources to that decision. The answer they found was emphatic. More than 90% of the return achieved in these pension plan portfolios could be attributed to the investment policy decision.

If you think about this for a minute you will realize how much folly we have often pursued as investors. All those stock tips, all those attempts to get out at a market high or get in at a low, all the stock picking or market timing newsletters, columnists, radio talk show hosts. All the things most of us associate with investing and all the things we devote all our time and attention to add up to only 10% or less of our returns.

Turn the table once more and go back to the question of which decision is most important. Knowing the significance of the investment policy decision doesn't it make sense to devote a significant amount of resources to these choices? That's one of the reasons we don't pick stocks. It is also one of the reasons that passive, or index, investing has become so popular. If stock selection is not that important why bother, why not just buy all the stocks in any given category? There are many good things about index investing and almost all of them have to do with cost. Money managers charge fees but it costs almost nothing to buy an index.

ASI often recommends index strategies and we use them widely with our individual clients. But we have also found many money managers that are worth the fees they charge. This dichotomy puzzles some people as the academic arguments in favor of index investing usually dismiss completely the value of active management. In some ways we are fence sitters on this issue but we like to use the best of both worlds and we think that these combinations bring some advantages.

Hopefully it is clear that when it comes to implementation we do not pick stocks. What we do is pick managers (and sometimes indexes or passive managers). This is the classic role of an investment consultant as played in the institutional investing world. Consultants have long served the largest corporate and foundation investors by helping them determine policy and then finding money managers to run portions of their portfolios as prescribed by the policy. ASI does this for many large corporate clients. But, seeing the value and integrity of this process as it is applies to these institutional investors, ASI also chooses to offer the same process to individual investors.

Recapping, first we want to learn about you, your goals, expectations, etc. Next we develop a portfolio model or asset allocation or investment policy as some call it. Then we implement the policy by choosing investment managers both active and passive.

Who's in Your Bullpen?

The selection of money managers is an important part of ASI's role. We know how little impact stock picking can add to your long-term returns but we also know that some managers almost always outperform the others. If we are going to use active managers in your portfolio we want to make sure they are the best of what's available and have an ability to beat not only the indexes but also the rest of the managers (and hopefully with less overall risk).

ASI has a great deal of experience with money mangers. We used to work for money managers. We know what goes on in their offices and in the companies that own them. This experience has given us lots of insight and helps us separate the good from the average (the bad usually stand out on their own). So we will pick the best managers available to handle each portion of your portfolio.

We will also negotiate the best fees possible from these managers. You will get the same service and same process and the same results as clients with hundreds of millions of dollars, even if you have only $1,000,000. The main difference for smaller portfolios is that you will access money managers through mutual funds instead of separate accounts or commingled funds. But we will still make sure you get the best managers available at the lowest possible expenses with the least trading costs as well as all the other benefits.

Now you have a portfolio of money managers designed specifically to reach your goals. Maybe one, maybe two, maybe three managers in each asset class. Active managers, passive managers, US stock managers, international managers, value and growth managers, fixed income managers, etc. You've got it all set up, invested and working. Is that it?

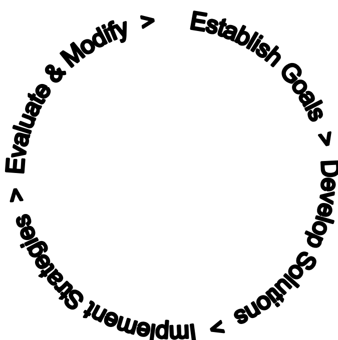
Begin the Beguine

This is only the beginning. Remember, this is a dynamic process. Things change all the time and they change again and again. You change. Your goals change. Expectations change. Money managers change. Someone has to keep an eye on everything to make sure it is all working the way it is supposed to work. Your portfolio is not a static collection of assets. It is part of a process, a system if you will, and someone has to monitor the system and make sure it is working. ASI watches it all. We have developed sophisticated reporting systems to show you and us just what's working and what isn't. We spend tens of thousands of dollars every year on analytical systems that help us figure out what is what and who is who and where your money should be invested.

We help establish benchmarks for each of the managers in your portfolio and for your portfolio as a whole. We report your performance every quarter so you know just where you stand relative to the markets and other investors. We continually watch for signs that a manager or strategy is not doing what we expect, not doing what we hired them to do and as soon as there is the slightest indication we re-evaluate them completely to find out what's going on. If something's wrong they go. We fire them.

And we help you benchmark us. Earlier we noted that we might have to help you develop realistic expectations. Well no matter what your expectations are we have to meet them if we are going to keep our job. You are the client and you can fire us at anytime. We not only want you to be happy, we want you to be thrilled. To summarize the process we have discussed thus far: Establish your goals. Develop an investment policy. Pick managers and implement policy. Monitor and report ongoing results. Repeat.

Another way of looking at it:



Looks pretty simple when we put it that way doesn't it. Simplicity is at the heart of all good things.

Costs and Conflicts

One of the biggest mistakes investors make is paying too much. The second biggest mistake in not knowing how much they are paying and the third is not knowing how much their brokers/agents/advisors are really making. These three 'mistakes' usually go together. The fact is that the investment industry has done a very good job of hiding costs and compensation. When was the last time you read a fund prospectus? How about a statement of additional information? We have been told more than once that we were the first advisor to ask a fund company for their statement of additional information, a document they must produce under law and which outlines many details a prospectus does not.

Part of the point here is that *Cost* rarely equals *Price*. Even when you figure out what you are paying that is only half the story. Your costs include not just the dollars you pay in fees and expenses but also the sacrifices you are led to make by some recommendations. ASI, by the way, provides clients with an annual fee audit to show them how much they pay, where the money goes and who benefits from it. We think you ought to know.

asi

Imagine two large growth funds with equal expense ratios. One has significantly outperformed the other over the last one-year, five years and ten years. The under-performing fund offers brokers a 1% finder's fee in addition to the trailing commission that both of these funds pay to brokers. Which one do you think brokers will prefer to sell? Which one did your broker sell you?

You can change multiple variables of this story and still come out with conflicts. Think of stocks instead. Your broker is putting together your portfolio. His firm has underwritten an initial public offering in a technology company. Because of their underwriting commitment their salesmen have to sell a certain amount of this offering, so the firm sends him a research book on the IPO stock with a dozen reasons to buy it printed in bold on the first page. This is a sales script. To encourage him further they provide extra commissions for sales of this IPO. The IPO ends up in your portfolio, your friends' portfolios. Did it get there because it was a good investment?

These stories are just the tip of the iceberg. We have been there, we know. There are so many deals going on behind the scenes it would make your head spin and they are not required to tell you about half of them. Who pays for all these? Who bears the cost? Investors. Small investors, retail investors. You. What does it cost you? Hard to say exactly but you can bet it costs you plenty.

In 2003 we saw ten of the largest brokerage firms pay $1.4 Billion to regulators to stop investigations into whether or not their investment advice to individual clients was tainted by their dealings as investment bankers. Basically they were selling stocks they knew were crap but they were making so much off the investment banking end of the deal they didn't care about the individual investors getting stuck with these dogs. They lied, misrepresented the stocks they were selling and they got slapped on the wrist.

The scary thing about this is that it was all over the news for more than a year and despite that fact these firms saw an increase in the number of dollars investors were giving them. So investors knew they were being screwed yet they kept investing anyway. One study into this phenomena sought to ask investors why they kept investing with these firms when they knew what was going on and one of the leading answers was (we are not making this up) that they thought since the whole industry was corrupt it really didn't matter where they put their money.

At ASI we think it does matter. We also think that you deserve an advisor that can give you the objective advice that is in your best interest and your best interest only. That's why ASI has remained completely independent. We have no affiliations with brokerage or insurance companies; we accept no commissions, no finder's fees, no trailers, no soft dollars, no free trips and no gifts from anyone except our clients. The only revenues we accept are the fees our clients pay us.

So when we give you our advice you can rest assured it's the best advice we can give and it's entirely in your best interest.