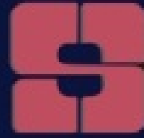
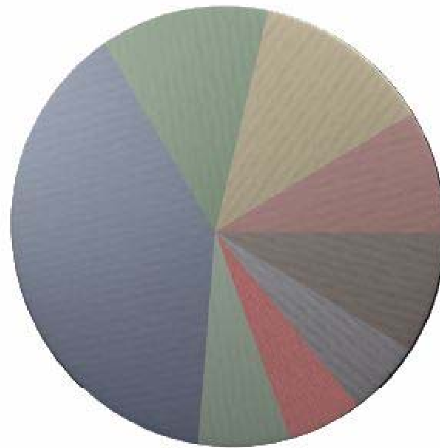


Value-Added Services



Structured Asset Class Investment Strategies

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Introduction

The collapse in growth stock prices following the Technology/Internet bubble of the late 90's, along with the current financial crisis and its resulting severe stock market decline have caused many investors to question long-held views on investing. One casualty of this reassessment is the belief that "active" management techniques (stock picking and market timing) add value over time.

During good times, investors seldom question the returns they receive from investment "gurus" even though research has consistently shown that the vast majority *underperform* an unmanaged stock index. These gurus (most mutual funds managers and independent advisors) gloss over this fact by suggesting that only nimble, active, and flexible strategies can protect investors in *down* markets. Unfortunately, their track record as a group is even worse during market declines.

Adding to investor frustration is the fact that mutual fund screening services, such as Morningstar, and brokerage firms and consultants tasked with the mission of recommending "beat-the-market" funds or advisors *only know the "winners" in hindsight*. Despite their claims (and consistent with SEC-required disclosures), the past performance of these advisors has little, if any, correlation to future returns. In other words, it's a lot of smoke and mirrors designed to perpetuate a disappointing truth. But lower expected returns are not the only potential result of this deception—a lack of basic scrutiny on the part of investors and transparency on the part of the gurus *and their facilitators* can also lead to the tragic and often massive fraud perpetrated by the likes of Bernard Madoff, Alan Stanford, and others.

These facts are causing a growing number of serious investors to become increasingly aware of *index funds* and their benefits. Passively-managed index funds offer much lower costs, much broader diversification, greater tax efficiencies, more style transparency, and higher return predictability over time than mutual funds and other portfolios "managed" by investment gurus.

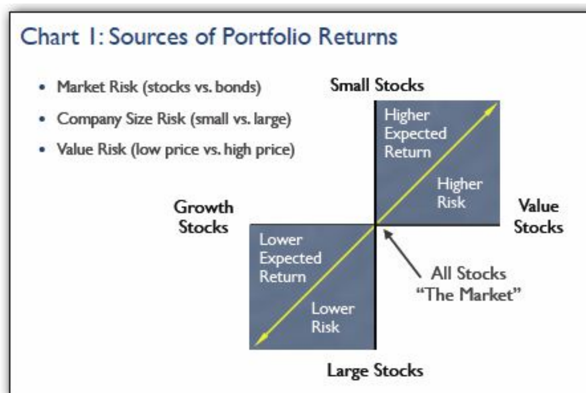
Simple indexed portfolios—particularly those based on the S&P 500 index, Wilshire 5000 Total Market index funds, or exchange-traded funds (ETFs)—significantly improve the odds of investor success over actively-managed funds. But they fall short in two crucial areas: 1) Fully capturing the primary sources of portfolio returns even though they are broadly diversified and 2) Eliminating the potential for the most costly aspect of long-term investing: market timing.

Schulmerich & Associates addresses both of these shortcomings as *core* value-added services. Our privileged access to the institutional asset class funds of Dimensional Fund Advisors (DFA) allows us to build portfolios with *higher expected returns* than traditional indexed portfolios with little, if any, additional portfolio risk. And our unbending commitment to a structured and disciplined investment approach eliminates destructive market timing moves from the equation—adding the single greatest boost to bottom line portfolio returns.

In summary, we believe the combination of our extensive experience in asset class investing; full transparency of our strategies and professional relationships; privileged access to superior asset class funds; and our commitment to structure and discipline around the investment process adds significant value to our client relationships.

Value Added: Superior Research

One irrefutable truth of investing is that risk and return are directly related. This relationship might not be obvious in the short-run (particularly concerning stocks), but it is certainly true over time. The relationship of risk and return in the financial markets is best explained by a body of research by Eugene Fama, Sr. (University of Chicago) and Ken French (Dartmouth)[1] and is illustrated in Charts 2.



Since we know that there is a direct relationship between risk and return over time, it is important for you to understand how this information is used to develop an appropriate asset mix for your portfolio. In some cases a blend of growth, value, large, and small company stocks is appropriate. In other cases a tilt toward one or more asset classes will serve as a hedge against other investments and/or career risks.

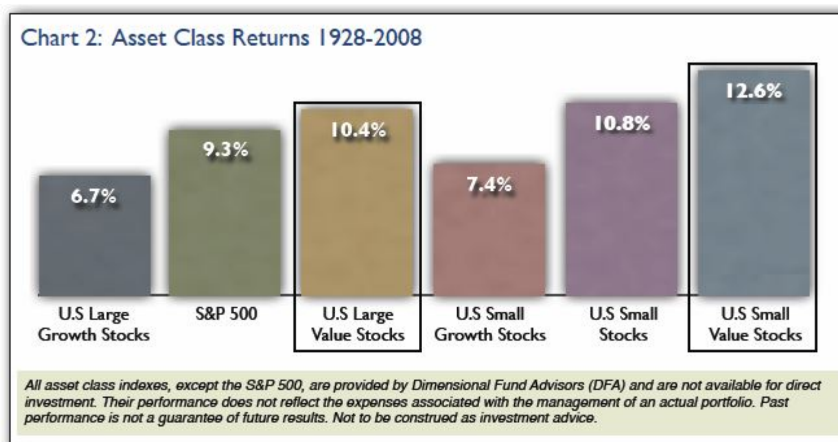
For example, consider an employee of Intel Corp. who holds stock options, Intel shares, and growth stock mutual funds in the company's 401(k) plan and shares of high-tech IPO's in a brokerage account. Not only is this person's investment assets dependent on the performance of the growth stock sector in general and the high-tech industry in particular, but his or her *job* is tied to this sector as well. Tilting an Schulmerich & Associates-managed portfolio toward value and/or small company stocks using well-engineered asset class funds can offset some of this risk.

Risk comes in many forms. The Intel employee in this example is exposed to "concentration" risk (i.e., too many eggs in one basket). But individual asset classes are also defined by their unique risk characteristics.

Most investors intuitively accept that small company stocks are riskier, in general, than large company stocks. It's not as intuitive, however, that value stocks are actually riskier than growth stocks. Most investors consider stocks of companies with slower earnings growth, lower product market shares, questionable management, and other challenges (value stocks) as riskier than companies with more optimistic earnings projections and rosier prospects (growth stocks). As a result, value stocks sell at lower prices than growth stocks. A lower stock price translates into a higher cost-of-capital for these companies which, in turn, translates into a *higher expected return* to investors. Growth company stocks generally sell at much higher prices on average, have a lower cost-of-capital, and thus produce a *lower return* on capital to investors.

[1] See "Characteristics, Covariances, and Average Returns: 1929-1997" by James Davis, Eugene Fama Sr., and Ken French

Most index funds are designed to track the performance of established "market" benchmarks such as the S&P 500 or Wilshire 5000. Although these benchmarks have consistently outperformed actively-managed mutual funds and independent money managers, investors in recent years have discovered how highly concentrated these indexes are in one asset class: large company growth stocks. During short one-dimensional market cycles, most recently experienced from 1995-1999, this concentration might be considered an advantage. Over the long-term we see a very different relationship.



Value Added: The Asset Class Mix & Discipline

It is commonly accepted that your portfolio *asset class* mix has the single greatest impact on future performance. The mix of stocks and bonds, your allocation among large, small, growth, and value stocks, as well as your division between domestic and foreign stocks explains approximately 96% of your portfolio returns. In contrast, efforts to "beat the market" through stock picking, sector rotation, and/or market timing tend to have a substantially negative impact over time.

In order to arrive at an appropriate long-term asset mix for your portfolio it is critical to understand the following issues and their impact on your personal risk/return objectives:

- **Which asset classes add value in a diversified portfolio and which do not.**

- **The long-term risk/return characteristics of each relevant asset class.**

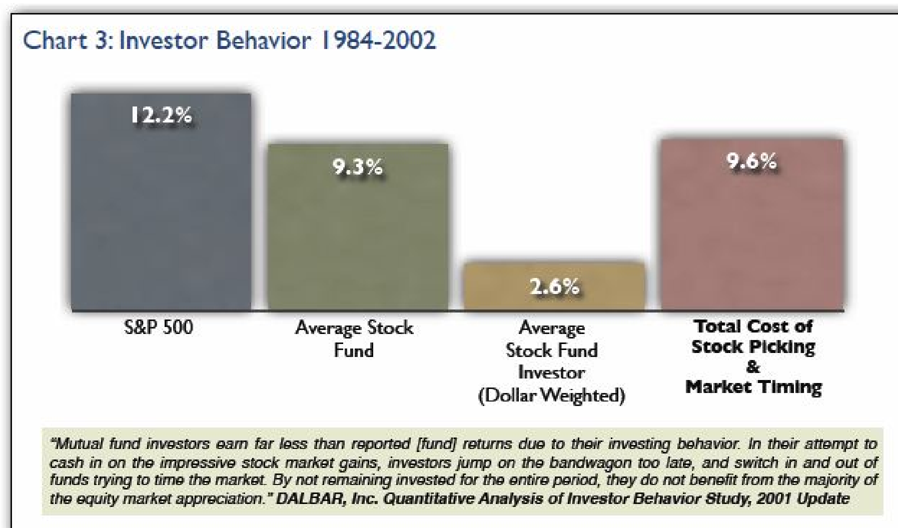
- **How combinations of asset classes affect the long-term risk/return characteristics of your portfolio.**

- **How *all* of your investments, including real estate, stock options, company stock positions, your job, IRA and 401(k) investments, and other factors influence your portfolio allocation.**

- **How your expectations and emotions may affect your portfolio allocation and the performance of your structured asset class portfolio.**

An investor who does not adhere to an appropriate long-term asset allocation (what we refer to as the "Investment Policy") and instead engages in any form or degree of market timing subjects the portfolio to the *single largest potential cost*.

Consider the following data from DALBAR, Inc., a firm that studies the behavior of mutual fund investors. Not only does the average equity fund manager under perform an unmanaged index, the average equity fund *investor* does much worse due to market timing mistakes.



In order to prevent common investor mistakes, Schulmerich & Associates spends whatever time is necessary to broaden your understanding of the risks and expected returns of individual asset classes and combinations of asset classes. Our goal is to develop *realistic* expectations and then develop portfolios that have the greatest chance of meeting those expectations. Special software programs and investment questionnaires are not sufficient for this task and are not good substitutes for personal meetings and ongoing reviews.

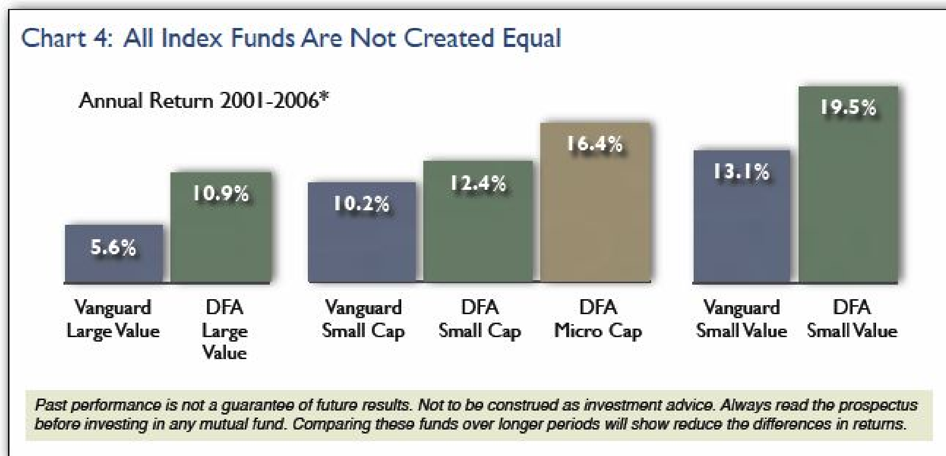
Our experience in working with clients in discussing their goals, risk tolerances, biases and beliefs, and our ability to communicate our principles effectively has resulted in greater investor confidence and discipline—and long-term relationships.

Value Added: Superior Investment Options

We find that many do-it-yourself investors who adopt a simple indexed strategy place much greater emphasis on fees and transaction costs then they do on accessing better asset class funds and maintaining long-term discipline. We are not suggesting that these indexing "details" are not important. They are. But some investors fail to see the forest through the trees—usually with very disappointing results.

It is important to capture risk and return dimensions as fully and as efficiently as possible using the best passively-managed funds. We can test this during periods when value stocks and small company stocks do particularly well. The chart below shows such a period and we

can clearly see the result of the superior index structure underlying the DFA funds. Since we expect these asset classes to outperform over the long-term *and* we cannot predict the shortterm cycles when asset classes behave differently, it's important that we get on the right "horse" from the beginning and stay on it through all market cycles. In this regard, we fully expect index funds, such as Vanguard's and similar exchange-traded funds (ETFs), to occasionally outperform (such as the 1998-1999 period that favored larger, higher priced growth stocks), but not over longer time frames.



In our effort to use the best tools available in developing client portfolios, Schulmerich & Associates regularly reviews all current research on the dimensions of stock returns and screens all passively-managed asset class, index, and exchange-traded funds (ETFs) funds (including the new "fundamental index"-based funds) for those with the best combination of low cost, diversification, fund management and trading skills, tax efficiency, and, most importantly, asset class focus.

Value Added: Maximizing Tax Efficiency

Index funds are known to be more tax-efficient than actively managed funds. This is due primarily to the lower portfolio turnover (less buying and selling). As a result, indexed portfolios generally have higher *after-tax* returns.

Some mutual fund companies like DFA have taken tax-efficiency even further. Since value funds tend to have higher dividend yields and both value and small cap index funds incur higher turnover than S&P 500 or "total market" index funds, certain techniques can be employed to lessen taxable distributions. Special "tax-managed" asset class funds have been developed as a result. Schulmerich & Associates also positions bond portfolios in tax deferral accounts to reduce ordinary income and positions equities in taxable accounts when possible to reduce tax liability. Schulmerich & Associates will work with your tax advisor using other strategies to further reduce you income tax liability.

Value Added: Rebalancing, Quarterly Reporting, and Ongoing Review

As asset class returns fluctuate, portfolio allocations change. If market movements are large enough, up or down, the risk and return characteristics of the portfolio can be adversely affected and rebalancing is needed to restore the target balance. Emotionally, this can be a very difficult thing for you to do on your own since there is a natural aversion to selling "winning" asset classes to buy "losing" ones. However, this buy low, sell high discipline can enhance portfolio returns without resorting to the destructive market timing behavior associated with predicting future market movements.

Schulmerich & Associates uses customized portfolio management software to track your current versus target allocations and we make adjustments when appropriate (considering transaction costs and tax consequences).

We also report portfolio holdings, changes in the account, and the progress of your portfolio(s) on a quarterly basis. These reports enhance and complement the monthly reports you receive from our primary custodian, TD Ameritrade.

Finally, Schulmerich & Associates communicates with you regularly through meetings, phones calls, and our *Schulmerich & Associates* newsletter to reinforce the asset class principles, review portfolios, and, if appropriate, update investment objectives.

Summary

Schulmerich & Associates provides value-added services to investors who have made the wise and rational decision to index their portfolio assets. These services include extensive upfront communication of investment principles and strategies; development of appropriate and realistic investment objectives and expectations; custom-tailored asset allocation recommendations; ongoing review and reinforcement of investing principles; access to restricted and better engineered asset class funds; committed long-term discipline; and comprehensive portfolio reporting.

We are confident that these services will result in better portfolio performance and greater peace of mind for you for many years to come.