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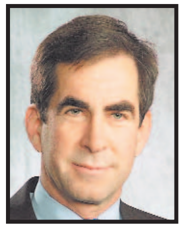
Know the odds of the game before investing



ALLAN ROTH

Most of us have seen the data on how expensive mutual funds perform versus the indexes they are trying to beat. They fail miserably.

The hot funds of today revert to the mean and tend to underperform going forward – a pretty bleak prospect in desperate need of a solution. Well, what about separately managed accounts?

Would paying a tiny 1 percent of your assets so a top professional can manage your money seem like a good solution?

On the surface it does, 1 percent seems a small price to pay to know that someone is watching out for you with the knowledge of when to get in or out of an investment. But let's look beneath the surface.

How small is a 1 percent fee?

Say that you expect your portfolio to increase an average of 8 percent a year. Since you're paying 1 percent, your new expected return after costs declines to 7 percent. That translates into a reduction of your earnings by more than 12 percent.

Given that it's your real after inflation return that matters, if we assume 3 percent inflation, your 5 percent real return is reduced to 4 percent. Now we're at a reduction of 20 percent of your real return.

I wish I could say that your costs stop at the 1 percent fee, but they don't. Your money is probably invested with some high-performing private money mangers. If their fee is part of the 1 percent you are paying, you might think there are no additional costs.

In reality, all portfolios have two additional costs – trading and taxes.

Trading costs are commissions paid and, even more importantly, the spreads between the bids and the asks.

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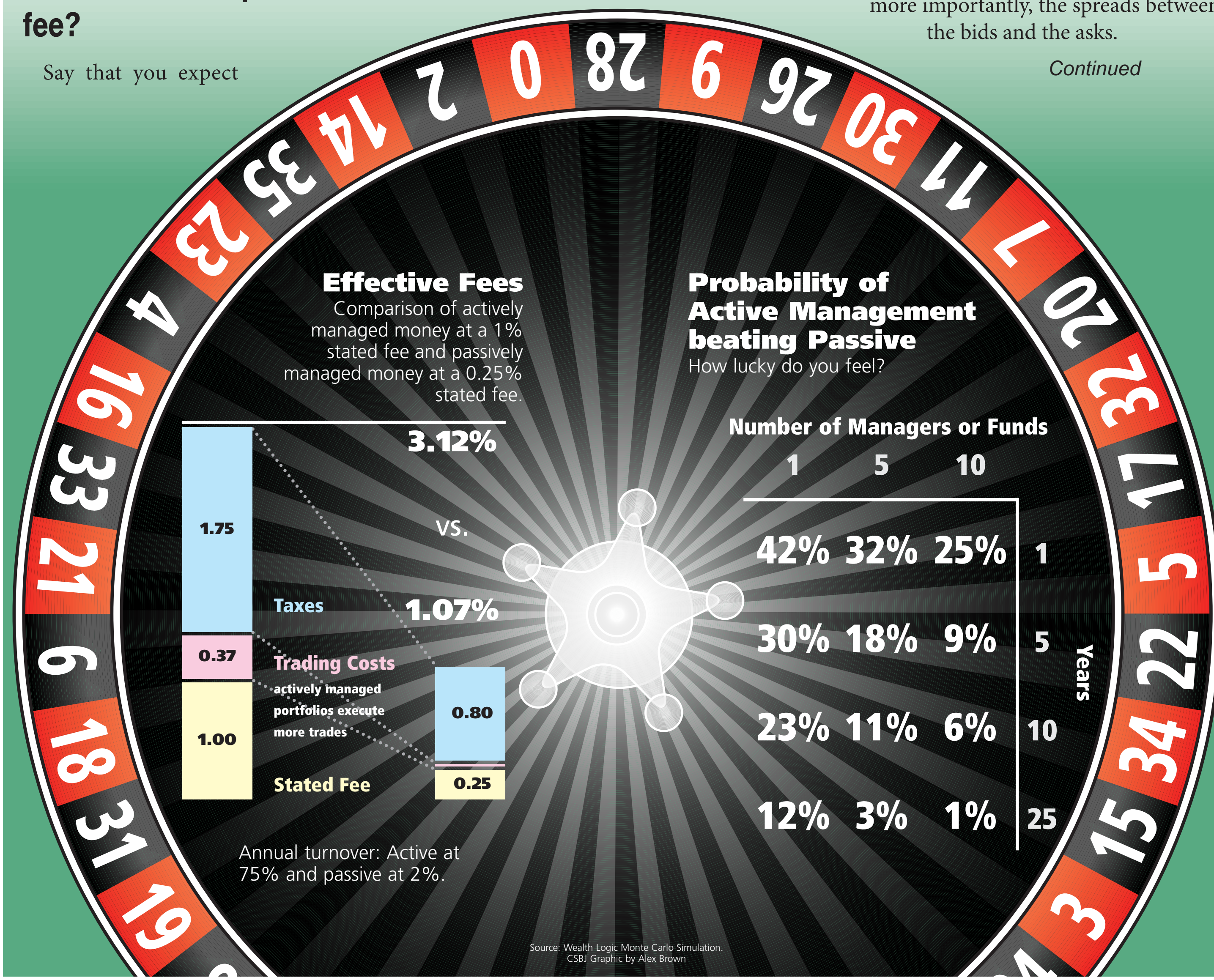

Years	1	5	10
1	42%	32%	25%
5	30%	18%	9%
10	23%	11%	6%
25	12%	3%	1%

Source: Wealth Logic Monte Carlo Simulation.
CSBJ Graphic by Alex Brown

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Money managers have to be actively managing your funds, in part to justify the fee. This creates more trading and more trading costs and taxes. An estimate of the total long-run all inclusive expenses are shown in the table – more than a 2 percent differential that results. Over time – this will cost you more than half of your real return.

What are you getting for your money?

Now I admit that getting good data on private money managers is nearly impossible. They are not as easy to expose as those Wall Street Wizards running mutual funds or picking stocks on network television.

In fact, you're not likely to meet an active money manager who doesn't claim to be able to bring "beat the market" to the table.

It should bring a sense of security to know that your money is invested with top money managers who have disclosed their results, and a track record of five years or more. Yet according to a Monte Carlo simulation model I've built, nearly a third of the money managers should beat their benchmark over a five year period.

That leaves thousands of managers to take your money. How great is that?

Past performance is, unfortunately, a lousy predictor of their future performance. Even the "Ultimate Investment Club," as determined by Money Magazine, underperformed the market by a whopping 14 percent over the next year.

If you're pondering what your odds are of beating the low cost portfolio, consider that the more money managers you have working for you, and the longer the period of time, the lower your odds get.

For example, if you have five money managers, your odds of beating the low cost portfolio are about 11 percent over five years and only 3 percent over 25 years.

You may be saying that firing underperforming managers and changing to the best will boost your odds. Actually, it only guarantees your money will be invested after the manager is hot and withdrawn after he has underperformed.

In other words, you will buy high, sell low, and increase taxes paid.

Now you do get an intangible with professional money managers. You embrace a well-established culture where the market is beatable, and your all-knowing money manager is guarding the gates of your financial future.

While this feels great, I would advise you to weigh it against the strong possibility that you are making a bet few will win. It is likely to set your financial goals back many years.

The stock market is almost completely comprised of "professionals." Last I checked, we don't live in Lake Woebegone and all of those pros can't be above average.

Mathew Emmert of Motley Fool says, "The best thing you can do as an investor or a gambler, is to know the odds of the game you're playing – because not knowing them will cost you."

If you want to achieve your financial goals more quickly, try a simple low-cost and tax-efficient portfolio that Wall Street has no incentive to show you. Let me show you the way to cut that 1 percent and juice your returns.

For now, critical thinking readers, just ask yourselves, "do I know the odds of the game I'm playing?"

Allan Roth is a CPA and Certified Financial Planner. He is the founder of Wealth Logic LLC, an hourly based financial planning and licensed investment advisory firm, and is an adjunct finance faculty member at the University of Colorado at Colorado Springs. He can be reached at 955-1001 or at ar@DareToBeDull.com.