

What every affluent investor must know about money management

If you knew you had money managers, investment techniques, or mutual funds that on average tilted the odds in your favor (relative to passive management/indexing), you would bet on those managers all day long and as many times as you could.

But, what if the stake of the bet is the only life you have? What if the stake is your family's financial security? What if you only have one chance on the bet? What if it is too late to do anything about it by the time you find out whether the bet paid, or you lost?

We hope that no one who uses active investment management – money managers, investment advisers, mutual funds – is naïve enough to think that any discipline is certain to outperform. Regardless of how smart the money managers are or what type of track record exists for their exceptional performance, objectively we must acknowledge that nothing is certain and there is some risk of failing to achieve what we think (hope?) to produce.

A whitepaper by Wealthcare's CEO David Loeper "Active Versus Passive: The Debate Continues" exposes the uncertainty in not knowing how an active management discipline will perform relative to a passive portfolio that will track the markets, less expenses.

Imagine you own a profitable casino and each day there are many winners and many losers. With thousands of bets being made each day, you average a profit based on how the odds are "tilted" for your "take."

You have \$100 million of cash backing up all those chips on the tables and Bill Gates walks in. He steps up to the roulette wheel and sees the \$3,000 maximum bet you gladly accept many times each day. Feeling like he would like a little entertainment, he asks if you would be willing to raise the table limit for one bet on black, to \$100 million – his pocket change and your entire bankroll.

Do you take this bet? Your "take" on roulette is

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among the best odds for you in the entire casino. There is a 47.4 percent chance you will lose and a 52.6 percent chance you will win. You make this bet every day. In fact, you wouldn't mind making it more often for more gamers. The only thing that is different about this bet is that if you lose, you lose everything.

Even though the odds are to the casino's (your) advantage and you like making that bet all day long, the stakes of this bet risk everything: your whole financial future. If you lose (and remember there is a 47.4 percent chance you will) you will not have another chance to make the bet again.

This is the same way we need to look at active money management, even if the odds are to your advantage, which is a big "if."

You might say we are not talking about risking everything in gambling on active management as the "worst case" is that we underperform by 1 percent to 2 percent over the long haul.

While this may be true, do you know how much more at risk "everything" is? Do you know what winning the bet buys or what losing costs?

For this article we'll assume that we are comfortable taking on some risk to buy a lifestyle that provides reasonable confidence (80 percent chance of exceeding

your targeted goal) of a \$225,000 retirement income.

The active bet of using money managers or mutual funds introduces additional potential risk (and potential reward) beyond that which we consciously accept with the markets.

The passive implementation, with its certainty that it will track the markets, less expenses, barely increases this risk. It represents our true odds (80 percent chance) of exceeding our goals if we invest in "the markets," as defined by Wealthcare's model allocations.

(Caution: This isn't your typical simple passive indexing strategy and is a complicated story in itself.)

If we plan to beat the markets, using active management, by 1.5 percent a year for the rest of our lives (how likely is this?) and spend as though we will (i.e. we spend \$288k vs. \$225k) there is a \$63,000 a year reward to our retirement income if we win our active bet.

However, in accepting that extra uncertainty we risk underperforming the market and facing a disastrous scenario: A 53 percent chance of running out of money in retirement if our active bet is wrong.

We have better odds on our bet with Mr. Gates.

Would you rather risk a 53 percent chance of running out of money in retirement by betting on the active management with the higher income, or would you use a proven high probability passive investment plan with an 8 out of 10 chance of exceeding everything that is important to you?

To request our newest whitepaper, "Four Factors The Affluent Must Know To Avoid Financial Disaster And Secure Their Dreams," send an e-mail to FourFactors@PillarOnline.com.

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