just accept market returns?

After more than twenty years of investment consulting I have seen the results of both active and passive management. Professor Ken French of Dartmouth College has extensively researched the passive versus active debate and has concluded that passive nets better results over time (there is that caveat again), especially after the higher costs of management, trading, and taxes. French said, "We know some people are going to get lucky. When you have more funds than you have stocks on the NYSE, some of them have to work out. And even on an *ex ante* basis, surely there are some people out there who have a positive risk-adjusted expected return. But it's amazingly hard to identify them *ex ante*." [*CFA Magazine* Sept-Oct 2005, pg. 41]

If I were to be a purist, I would look to the evidence and say that "history shows that…" and we could all relax. But recent history now shows two significant downside *outliers* that have negatively impacted strategic-only plans. As we all get older (sometimes I think I'm ageing faster than others), it is harder to believe that we have *enough* time to plan solely based on the *over time* expected returns. I am looking where appropriate to refine our portfolio recommendations to employ additional options, including this PAST paradigm for the future. It may not be good for everyone, as we all have different situations, risk tolerance, etc. but I do believe it is an idea worth sharing and exploring with you.

Finally, as I listen to a great deal of the different economists, managers, and commentators in reference to what to expect over the next several years, I have heard none who believe we will soon return to robust growth that would become a driver for stock market returns like we had from 2003-2007. There are significant disagreements as to the affect of the extraordinary deficit spending that the Obama administration maintains is necessary to revive the economy. Some feel that the extremely low capacity utilization and slow recovery will keep inflation and interest rates low. Others maintain that we will see significant inflation. As with the returns from equities, no one **knows**, and my recommendations will be made to try to avoid getting run over in the crosswalk.

FINANCIAL CATALYST GROUP

4030 Moorpark Avenue
Suite 105
San Jose, California 95117
Phone: 408-261-7600

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Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

The Future of PAST: PassiveActiveStrategicTactical

Planning for our future is really hard work. We would like certainty and seek assurances that if we do everything "right," that it will work out. The marketplace is filled with companies, managers, and funds that exude confidence and trumpet results (past, of course) with the caveat that "*past performance is not a guarantee of future results, etc., etc….*" History teaches us such concepts as "over time stocks outperform bonds…" and "… the stock market is a leading indicator…" These generalities, while **statistically** true, can lead to serious problems where reality collides with expectations.

First it is important to understand that we make virtually all decisions based on our past experiences and set expectations on an internal calculation of the probability of success of a given action. We think we know when it is safe to cross the street on a crosswalk. It is a marked place where we have the right-of-way and vehicles are legally obliged to yield to us. There is a speed limit. We can see traffic approaching from the right and the left. Years crossing the street with a 100% success record indicate that a safe crossing is a certainty. We step into the intersection. But then, distracted by a disturbance across the street and slightly to the left, we don't notice a car on the right making a quick left turn heading right toward us. The driver was also distracted. Our certainty of a safe crossing collided with an extraordinarily unlikely, but deadly, speeding object. The odds were with us, but the reality was not.

Statistics is generally defined as "the science that deals with the collection, classification, analysis, and interpretation of numerical facts or data…" (source: dictionary.com) These numerical facts or data that have been "collected," must exist in order to be collected and are therefore, *per se,* already past. Statistics measure past observations. To make decisions for our financial futures, we combine what statistics tell us with probability theory to make a more informed decision. Probability theory is that "branch of mathematics that deals with analysis of random events. Probability is the numerical assessment of likelihood on a scale from 0 (impossibility) to 1 (absolute certainty).

For many years I have used data, and the statistical evaluation of the data, along with probability theory to help make "informed" decisions regarding portfolio construction and management. The idea was to evaluate the data and select the methodology that had provided (note the past perfect tense) the "best" results over time. We could adjust for various measures of risk and even esoteric statistical calculations. Programs that would run thousands of iterations of *what if* calculations, most commonly called *Monte Carlo simulations,* would report that we should have (that slippery, forward-looking evaluation) a 95% likelihood of reaching the goal we set for our financial future. Not a bad chance to take.

When we look to the probability of meeting a goal, defined as "success," we often ignore the

(Continued on page 2)

Third Quarter 2009

(Continued from page 1)

consequences of the binary consequence of "not success." If the goal is to die with $1,000,000 in financial assets, and we die with $999,999, we technically failed; but that is much better than going to $0 before death. The raw calculations can show every calculated amount that we would theoretically have at any point in time, but with thousands of numbers, most professionals look simply at the summary numbers at various waypoints. It makes great sense to focus on what is most likely, not on the not likely – the minimal chance of failure.

If we get so frozen by fear of failure that we can't accept any risk, the probability of failure actually increases. When it comes to life-long financial independence as defined by the vast majority of the affluent (say from $1 to $25 million in assets), there is no such thing as "risk-free." It is a matter of which risks people will take. Given the uncertainty of everything from interest rates to cost-of-living, from lifespan to healthcare, risks are much more complicated than volatility-of-portfolio returns. The bottom line is that *un*certainty is about the only thing that is certain. One thing I frequently state for any projected set of returns and cash flows is "Actual results are guaranteed to be **different** from those shown." I know that I don't **know**, and neither does anyone else.

Continuing experience and research leads me to conclusions of what has worked best over time. However, the extraordinary market meltdowns of 2000-2002 and 2007-2009 (and beyond??) pointed out that no one technique works over each time period, and no one knows what "over time" will look like. Standard portfolio construction for non-institutional portfolios [individuals frequently have timeframes of 5-30 years, with the overlay of emotions, while institutions like endowments and foundations often have timeframes over 100 years and little personal emotional overlay] will take a relatively strategic simple approach, attempting to match a "long-term" expected return to long-term personal goals. It is usually very cost effective, and for those with enough time and intestinal fortitude it can be quite successful. But then comes the rare Black Swan.

Black Swan theory is articulated by Nassim Nicholas Taleb in his 2007 book *The Black Swan*. His basic claim is that *almost all consequential events in history come from the unexpected*—while humans convince themselves that these events are explainable in hindsight (bias). Taleb's theory holds that predictability, no matter how refined the statistical model, is flawed. He believes "a simple model of daily stock market returns may include extreme moves such as Black Monday (1987) but might not model the market breakdowns following the September 11 attacks. A fixed model considers the "known unknowns" but ignores the "unknown unknowns" (source: wikipedia.org). It is like the walk in the crosswalk I mentioned at the start. From a stock market perspective, a Black Swan would be the unprecedented six-month fall following the collapse of the credit markets and the banks after the bankruptcy of Lehman Brothers and the bailout of AIG.

So, how can we use the reality of uncertainty to plan for our economic future? I believe the answer is to not only use established concepts like asset allocation that dampens volatility (but does not necessarily increase returns), but to use the various investment techniques that may not work *consistently,* but which often work at times when other methods do not.

(Continued on page 3)

(Continued from page 2)

First, the last part of PAST – Strategic versus Tactical. A *strategic* portfolio is built around the idea that you allocate assets for the long term (like 60% stocks and 40% bonds), and you leave it essentially unchanged until your goals or risk tolerance changes. You may even re-balance to the allocation if it gets too far out of its target range. Since it is well established that most people cannot consistently predict the direction of the markets and the best time to increase or decrease stock exposure, holding to the strategic allocation reduces mistakes and minimizes tax and trading costs. I tend to agree with this, and for many it can work well – just not all the time. Investors with inadequate time to make up inevitable losses, those with inadequate money forced to live with lower incomes, as well as those without the intestinal fortitude to hang on during very volatile times, need to integrate other techniques.

The *tactical* approach is very different, and it is far less predictable. Here a manager is selected to make macro tactical (essentially timing) decisions. Responding to or anticipating market movements, the tactical manager will go from stocks to bonds, or even build short positions if she anticipates an extended down market. As markets often move rapidly up or down before consolidating and turning again, most tactical portfolios underperform the strategic portfolios, especially after the higher costs of trading and taxes. BUT, in times like the one we are currently going through, getting out of the way of a crashing wave saves principal and makes long-term positive results more likely. This happens in part because human emotions make many individual portfolios *per se* tactical because investors sell out when the pain is too great, and buy back in when greed gains control. Perhaps it is better to have a manager who is making tactical decisions in some rational way. While I do not believe that a tactical approach is the best one for the long run, it can be beneficial for part of an overall portfolio. ST – strategic and tactical together.

The other part of the changed paradigm is the Passive-Active combination. *Active* management assumes that a manager can add value by buying individual stocks that his research indicates is currently underpriced (some would say *mis*priced). Through any one of a number of approaches, the manager will decide that others do not really understand the *real* value of a stock and by buying at the right time and the right price, he will add value. Rather than buying the broad market holdings, the active manager will buy 25-100 of his "best ideas," and sell them when they reach his "target" price. Sometimes he's right, and sometimes he's wrong. History shows that no manager always beats his benchmark. A lot of people believe in active management because they feel that the manager is "doing something" when he sells, taking gains, or losses. Few people watch to see what happened to a given position **after** it was sold. Fewer still look at the taxes and other costs of turnover. That being said, there are times when given active managers outperform the passive benchmarks.

Passive management is closely aligned with index investing. As a matter of fact, index investing is one kind of passive investment. Its basic tenet is that markets are essentially efficiently priced, and the chance of finding the bargain (mispriced) stocks that the active manager pursues is not worth the cost of trying to do so. With a highly diversified passive portfolio covering all market sectors, you receive "market returns." While the investor will not really outperform, neither will she underperform. Over time equities have proven to provide a higher return (compensating for the higher risk) than bonds or cash, so why not