

WHAT THE COACHING CAROUSEL CAN TEACH US ABOUT MANAGER SELECTION

As most readers of this newsletter know, I'm a huge sports fan and enjoy drawing parallels between sports and investing. A few months ago I gave a presentation to a civic group on behavioral finance and included the analogy below as an example of how difficult it is to try and divine future performance from past results.

Assume you've been named athletic director at Alpha State University (ASU) and your first task is to hire a new basketball coach. ASU competes in a Power 5 conference, against many of the traditional basketball powers like UNC and Duke. You've narrowed your list to three candidates, all of whom have recommendations from some of the top coaches in the game. Your stack of resumes includes this one:

Coach Hugh has been a Division I head coach for five seasons at a lower level Division I program with high academic standards. His record has been the following:

SEASON 1 (11-14) SEASON 2 (20-8)
SEASON 3 (19-9) SEASON 4 (14-11)
SEASON 5 (9-17)
TOTAL: 73-59 (.550 winning percentage)

DO YOU HIRE COACH HUGH?

Let's assume you do hire Coach Hugh, then fast forward three seasons. Coach Hugh's initial season went well, with a 17-13 record, but his second and third seasons both resulted in losing records, 10-17 and 11-17 respectively.

Coach Hugh is in the final year of his four-year contract and your board of trustees is voicing concern over the direction of the basketball team. One booster sent you the following note:

Dear AD,

Coach Hugh's career record: 111-106.

Record at ASU: 38-47.

We can do better!

DO YOU FIRE COACH HUGH?

Now consider for a moment if instead of a basketball coach, Coach Hugh was an investment manager. And instead of an athletic director, you chair the investment committee of a foundation. Your fellow members (and your investment consultant) are advocating for a change.

Now for the rest of the story. The coaching example isn't a hypothetical, but an actual one. At the conclusion of his eighth season as a head coach "Coach Hugh's" record was a pedestrian 111-106. Despite media and alumni pressure to fire him, his AD stuck with him. Over the next 34 years his teams went 932-215 and captured five national championships. His name...Mike Krzyzewski.

Investors often approach investment management in a similar way. It's easy to find a mutual fund with great three or five-year performance history. And certainly there's appeal in changing to what *seems* to be a better investment manager. But history shows that these changes rarely produce the desired result. The annual DALBAR investor survey illustrates how chasing performance produces inferior results for investors. The chart below shows the difference between the aggregate equity fund return and the actual investor return. As of the end of 2015, investor behavior (moving in and out of the market and making poorly timed manager changes) resulted in 3.5% less return annualized over 20 years. Assuming the investor started with a \$1 million investment portfolio that would equate to a \$2.4 million difference!

	Investor Returns ¹			Inflation	S&P 500	Barclays Aggregate Bond Index
	Equity Funds	Asset Allocation Funds	Fixed Income Funds			
30 Year	3.66	1.65	0.59	2.60	10.35	6.73
20 Year	4.67	2.11	0.51	2.20	8.19	5.34
10 Year	4.23	1.89	0.39	1.88	7.31	4.51
5 Year	6.92	3.28	0.10	1.58	12.57	3.25
3 Year	8.85	3.81	-1.76	1.07	15.13	1.44
12 Months	-2.28	-3.48	-3.11	0.95	1.38	0.55

¹ Returns are for the period ending December 31, 2015. Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges for each period.





FINANCIAL ADVISOR FEE DISCLOSURES: HIDING IN PLAIN SIGHT (BUT IN VERY FINE PRINT)

In April the Department of Labor issued a proposed rule that adopts a fiduciary standard for financial advisors managing retirement accounts effective April 1, 2017. Before the ink was dry various industry trade groups mobilized legal action seeking to overturn the new higher standard.

Fee-only financial advisors (of which I am one) embraced the new DOL rules, hoping the ruling might start a movement to make commission-based advisors' hidden fees a little less difficult to spot. Fee-only financial advisor David Marotta recently outlined just how difficult it can be to determine how much one pays brokerage firm advisors, the guys and gals from firms like Edward Jones, Wells Fargo, Merrill Lynch and Ameriprise, just to name a few.

Brokerage firms often have multiple regulatory filings making it very difficult to know which record applies to your particular service. Very few consumers actually read the SEC filings for the firms they have engaged and the disclosure forms often run hundreds of pages.

Marotta examined Ameriprise in detail, and started with the Client Disclosure Brochure for Ameriprise Financial Planning Services. Their ADV Part 2 has a list of hidden fees running from page 13 through page 19 describing how they get paid. The list is broken down by who pays them and the types of payments.



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HERE'S A PARTIAL LIST:

PAYMENTS FROM CLIENTS

- Financial planning and advisory service fees
- Sales charges
- Periodic fees
- Periodic expenses
- Interest

PAYMENTS FROM PRODUCT COMPANIES & DISTRIBUTION SUPPORT SERVICES

- Mutual fund and 529 plan marketing and sales support payments
- Marketing and sales support
- Marketing and sales support payments
- Full participation firms
- Limited participation firms
- Mutual fund and exchange traded fund recommended list participation aka the "starting point list"
- Investment research group as portfolio strategist

PAYMENTS FROM OTHER NON-PROPRIETARY PRODUCT COMPANIES

- Payments from hedge fund offering sponsors
- Payments from unit investment trust sponsors
- Payments from non-proprietary annuity and insurance companies
- Payments from non-traded REIT and non-traded business development company sponsors
- Payments from structured product sponsors
- Payments from managed futures fund sponsors
- Payments from exchange fund sponsors
- Payments from private equity offering sponsors
- Payments from non-traded closed-end fund sponsors
- Payments for referrals to structured settlements agents
- Underwriter's compensation
- Transaction charges

(continued)



It is difficult to comprehend the number of conflicts of interest generated by each of these payments. Each bullet point listed above contains an overwhelming amount of information. For example, Ameriprise's explanation of how they are paid for "distribution support relationships" reads:

"Ameriprise Financial Services also has arrangements with firms for distribution support services. These firms make payments of up to 0.18% on sales and 0.10% on assets to Ameriprise Financial Services for these services, which support the distribution of the fund's shares and 529 Plans by making them available on one or more of Ameriprise Financial Services platforms, commonly known as shelf space. These mutual fund firms do not provide marketing and sales support to Ameriprise financial advisors and do not participate in the mutual fund list (as described in the section above)."

And the disclosures are endless in referencing all the different entities Ameriprise Financial Services has payment arrangements with. They pay Charles Schwab & Co., Inc. for access to certain mutual funds, they pay Columbia Management as a sub-advisor to their RiverSource variable annuity. They pay BlackRock Advisors, LLC, and Fidelity for marketing support.

Just the knowledge that "distribution support relationships" refers to plans and funds paying to be featured on Ameriprise's "shelf space" is enough for me to know that Ameriprise's clients are not getting what is best for them. Ameriprise has an incentive to sell clients only the funds that pay Ameriprise for the opportunity to be offered to clients.

And just in case you don't understand how all of these revenue streams can affect your so-called financial advisor's decision making, Ameriprise makes that clear as well:

"Generally, Ameriprise Financial Services receives more revenue for securities or products sold in a fee-based account than for those sold with only a sales charge or commission..."

To be fair, Ameriprise isn't the only culprit. All brokerage firms have similar compensation disclosures. For example, did you know that your Edward Jones financial advisor gets a cut of the compensation from your Edward Jones MasterCard? Or that Raymond James suggests "you should feel free to discuss with your financial advisor how he or she is compensated following your annuity purchase." Isn't that something that would be useful to know *before* purchase?

We believe the financial services world would be a lot better place if every advisor served his/her clientele under a fiduciary standard of care. As a fee-only financial advisor, we receive compensation from only one entity—our client. No payments for shelf space, no payments from fund companies to hawk their wares, no payments from brokerage firms for "distribution support." In short, we're not conflicted by a structure that pays us more based on the investment you make.

SHOULDN'T ALL INVESTMENT ADVICE BE THAT WAY?



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IN THE NEWS

SAVE THE DATE • Educational Event For Clients And Friends

Ark Royal will host an educational event for clients and friends of the firm on November 16 at 10 AM at the NC Museum of Art. The program is titled "Some Call It Art: Making Sense of the Absurd" and will be presented by Rob MacNeill, Designer, Design Lines, Ltd.

Contact Lisa Shirley (lshirley@ark-wealth.com / 919-710-8665) if you would like to attend.

Mike Palmer recently attended the [DFA Advanced Conference](#) in Austin, Texas.

Want to learn more about Behavioral Finance?

Ark Royal will host a lunch and learn at The Frontier in RTP on October 20 from noon–1 pm.

Contact Lisa Shirley at 919-710-8665 for a reservation.

*He taught me to
love what you love,
even if the world
just doesn't understand.*

QUOTE FROM ROB MACNEILL'S BIO PAGE • WWW.DESIGNLINESLTD.COM

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To nurture a culture that puts our client's interest first—always



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A commitment to lifelong learning, and a passion for applying our wisdom efficiently and effectively every single day



Align what you say, what you do and what you think to honor yourself, your family and our firm

