FRAMING FINANCIAL DECISIONS

AAII Los Angeles

Allan Roth

6/19/21

Asset Allocation Example – Dr. Pepper, MD

1. Assets
   - $500,000 stocks
   - $500,000 bonds
   - $400,000 house

2. Liabilities
   - Mortgage $200,000

Asset Allocation

Common Framing

- $1 million portfolio
    - 50% stocks - $500K
    - 50% bonds - $500K
- $200K home equity

Net worth: $1.2 million

Logical Framing

- $800K portfolio
    - 62.5% stocks - $500K
    - 37.5% bonds - $300K
- $400K home

Net worth: $1.2 million

Why?

- Debt is the inverse of a bond and not the inverse of a house.
- How you finance the house has no impact on the price you ultimately sell it for.
- It turns out borrowing money at 2.5% and lending it out at 1% is not a great strategy.
- The tax-law change makes it even less great.
- Most of my industry wants you to compare the 2.5% mortgage to overall portfolio returns.
- An offer from a “baboon.”

Cap Weighted Index fund

Common Framing

- Guaranteed to underperform the market.
- Just buying more of those overvalued Large Cap Growth companies.
- Since 1928, small cap value has trounced a cap weighted index.

Economic Framing

- A cap weighted fund must beat the average money invested.
- Picking parts of he market or weighting differently is active investing.
- I don't know anyone who has been investing since 1928. Alpha = 0 before costs:

AvoidingAlpha.com

Find as many patterns as you can

Pattern Recognition Exercise

COLUMN

ROW	A	B	C	D	E	F
1		XXX		XXX		
2				XXX	XXX	XXX
3				XXX	XXX	XXX
4				XXX	XXX	XXX
5	XXX			XXX	XXX	XXX
6	XXX	XXX		XXX	XXX	XXX

There are now more than 600 investing factors discovered to date. All of these smart beta factors worked in the past.

Dumb beta wasn't so dumb

5-Year Return (%)

	Value	Blend	Growth
Large	10.0	15.3	20.6
Mid	8.7	12.4	20.8
Small	7.0	10.7	18.6

- >20
- 10 to 20
- 0 to 10
- −10 to 0
- −20 to −10
- <−20

Gain on $10,000

	Value	Core	Growth
Large	$6,105	$10,377	$15,512
Mid	$5,176	$ 7,940	$15,724
Small	$4,026	$ 6,624	$13,465

As of 12/31/20 - Morningstar. Fama and French were clear this wasn't a free lunch. This was compensation for taking on more risk. Total Market (VTI) gained 15.33% annually equating to a $10,409 gain after fees.

Things Change – Most Valuable US Companies.

1980

1. IBM
2. AT&T
3. Exxon
4. Standard Oil of Indiana
5. Schlumberger
6. Shell Oil
7. Mobil
8. Standard Oil of CA
9. Atlantic Richfield
10. GE

sources: ETFDB.com; assetdash.com

2020

1. Apple
2. Microsoft
3. Amazon
4. Alphabet

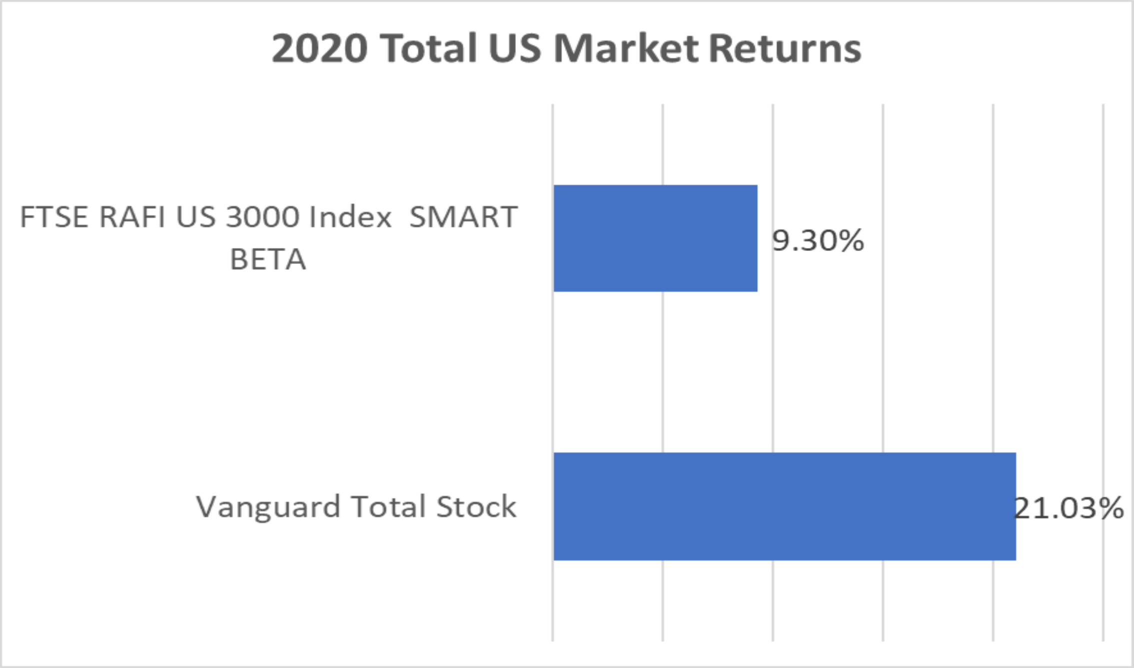
5 Facebook

6. Berkshire Hathaway
7. Walmart
8. Tesla
9. Visa, Inc.
10. Johnson & Johnson

source: Standard & Poor's

The majority of the stock market in 1900 was in railroads.

Drivers of 2020 US stock returns – Even weightings can be hazardous to your wealth.



Company Name	Ticker	Return%	Contribution
Apple Inc	AAPL	82.31	3.43
Amazon Com Inc	AMZN	76.26	2.1
Microsoft Corp	MSFT	42.54	1.64
Tesla Motors Inc	TSLA	743.44	1.41
Alphabet Inc Cl-C	GOOG	31.03	0.83
Nvidia Corp	NVDA	122.3	0.57
Facebook Inc	FB	33.09	0.5
PayPal Holdings Inc	PYPL	116.51	0.49
Netflix Com Inc	NFLX	67.11	0.31
Adobe Sys Inc	ADBE	51.64	0.27

Source: Wilshire

Addiction to Prediction
Real long-run predicted returns

Exhibit 1: Expert Forecasts for Long-Term Asset-Class Returns

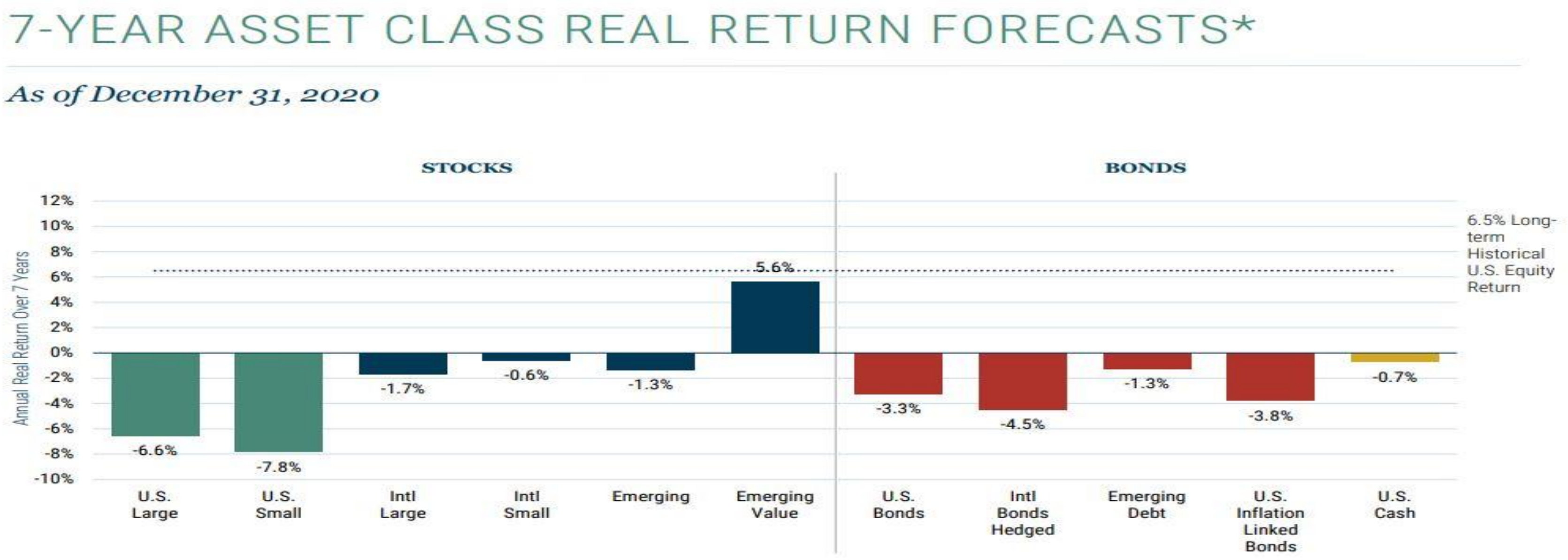
Firm	Date	U.S. Equities	Developed-Markets Equities	Emerging-Markets Equities	U.S. Bonds
BlackRock	Sep 2020	5%	7%[a]	6.40%	0.80%
JPMorgan[b]	Dec 2020	4.10%	5%-6%	7.20%	2.5%[c]
Morningstar Inv. Mgmt.	Dec 2020	-0.10%	4.80%	4.50%	1%
Research Affiliates	Dec 2020	2%[d]	6.30%	7.90%	1.10%
Vanguard	Dec 2020	3.7%–5.7%	7%–9%[e]	7%–9%[e]	0.75%–1.75%

Source: Christine Benz – Morningstar

Vanguard forecast – international stocks will return more with less risk!

John C. Bogle continues to be right on avoiding international.

Addiction to Prediction
Jeremy Grantham: GMO



"U.S. stocks are grossly overpriced" – GMO

Nov. 2013 – Look at track records before betting your nest egg.

Interest Rates

Common Framing

- Interest rates are at an all time low.
- It was once so easy to get income from bonds.
- Interest rates have to go up – avoid bonds except ultra short-term and floating rates. Better alternatives.
  - Ultra short bond funds (VG)
  - High yield bonds (floating rate)
  - Dividend stocks
  - REITs (private) – NRIA – 10%+ safe.
  - Master Limited Partnerships
  - Most annuities
  - Indiv. bonds rather than funds

Economic Framing - Get Real

- Interest rates were far worse in 1981.
  - Taxes
  - Inflation
- The purpose of fixed income has never been income.
- Top economists have called the direction of rates correctly 30% of the time.
- Better ways to earn more.
  - Most stable value funds
  - TIAA annuity (legacy)
  - Thrift savings Plan – G fund
  - Direct CDs
  - Insured savings accounts
  - Paying down the mortgage

Insurance and Inertia

Common Framing

- Protect yourself and your family no matter what.
- Buy as much insurance as you want.
- If you love your family, buy permanent life insurance.
- 99% of term life policies never pay out a dime.
- You insure your house – why not insure your portfolio? (variable annuity, universal, etc.).

Economic Framing

- Insure only for what you can’t afford to lose.
- As wealth grows, *most* insurance needs dissipate. (not umbrella or malpractice)
- Permanent insurance is an indirect investment.
- Economics of term life vs. disability.
- Fight inertia.
- You don’t insure your house for a decline in value.

Muni Bonds

Common Framing

- Muni's provide safe tax-free income in retirement.
- During the great depression, the loss on muni bonds was only 0.5 percent.
- Muni's are an inefficient market where buying bonds yields 2x or more than a muni bond fund.
- A recent portfolio yielding over 5% federal tax free.

Economic Framing

- Munis have $2-$6 trillion of unfunded pension and health care liabilities.
- Munis could have new correlation to stocks.
- Baby boomers hadn't retired during the great depression.
- Framing return of principal as income should be illegal.

Muni Bonds – the nasty trick – MSRB approved

The Illusion

- Buy a bond with a $5 coupon for $112. Yield = 4.46% ($5/$112).
- Bond will mature or be called in 3 years at $100.
- So roughly $4 of that $5

  yield is return of principal.
- Actual yield = 0.89% ($1/$112).

Exaggeration?

- Recent typical client review.
  - Average Coupon = 5.0%
  - Yield to worst (best case scenario) = 0.4%
  - Manager fee = 0.35%
  - Net yield before bid-ask spreads = 0.05%.
  - Spreads can easily be over 1%. Largest was 10.25%.

What to do with the expensive Dog Fund

Analysis

- Pay higher fees vs. paying capital gains tax.
- Time value of money (deferred taxes = interest free loan).
- Tax efficiency of fund.
- Usually not binary – use specific lots tax treatment.
- Turn dividend reinvestments off (now)!

Easy Example – Sequoia (SEQUX)

An incredibly hot fund for decades, it stumbled with Valeant Pharmaceuticals but still grossly underperformed. Morningstar one star -9.6% annualized 5-year vs. peer underperformance.

- 1.00% annual expense ratio.
- Death spiral. $123.35 / share distribution over 5-years.

Financial Advisor

Common

- You should stick with a fiduciary.
- A fiduciary is legally obligated to put your best interests ahead of theirs.
- CFP Board enforces a higher standard with planners being thoroughly vetted.
- Look for advisors who have been publicly recognized.

Reality Framing

- Fiduciary standard isn't enforced.
- I've given data to the CFP Board for years to show advertising campaign is false.
  - Higher standard.
  - Thoroughly vetted.
- Jason Zweig publicly exposed hypocrisy of the CFP Board.
- Awards are for sale to any ~~person~~ mammal.

A Nationally Known Advisor

<u>Awards:</u>

- America’s Top Financial Planner – Consumers’ Research Council of America

- Best Financial Advisors for Doctors – Medical Economics (Exclusive List)

Dog nearly fetches prestigious financial advisor honor

Note: Max Tailwagger was approved but I did not pay the advertising fee so he did not make the Medical Economics list. I deeply regret that decision.

Why I took Social Security at age 62 …the way I framed it in my mind.

- Mentally, I’m receiving ~$2,400 a month.
- I’m buying an inflation adjusted deferred annuity at a ~40% discount ***back when one could buy an inflation adjusted annuity.***
- It would be okay to spend this money if needed.
- The best social security calculator by far:
  - ***OpenSocialSecurity.com***

Note: This is illustrative as I’m under full retirement age and earned income would result in no payment.

Tax strategies when you retire.

- Tax gain harvesting.
- Partial Roth conversions.
- Tax-deferred withdrawals managing to marginal tax rates.

Roth Conversions – 7 things to consider

1. Is the Roth pot of money small compared to the taxable and tax-deferred pots and can you pay the taxes from a taxable account?
2. Is the current marginal tax-bracket low? This could be the case if retired before taking Social Security or RMDs, or if starting a pass-through business (LLC or Sub-S) with very little income or even losses.
3. Will you have high income in retirement, such as pension income?
4. Will the RMDs be burdensome if you don't convert some money to the Roth?
5. Do you have any after-tax money in your tax-deferred accounts and, if all IRAs are converted, will that allow for future backdoor Roth contributions?
6. Will you benefit from a possible state income tax-exemption for amounts converted?
7. Are there some estate planning benefits from conversions?

** I do not predict what Congress will do with tax rates.*

Financial Wealth

Common Framing

- Measured in net worth – dollars.
- Someone with $10 million has 10x the wealth of someone with $1 million.
- There is no way to get rich quickly.

Economic Framing

- Measure in years - $ / how much a year you need to be happy.
- Who is richer?
  - Person with $10M but needs $5M a year. (2 years)
  - Person with $1M but needs only $50K a year. (20 years)
- You can get rich quickly by spending only on what brings happiness!

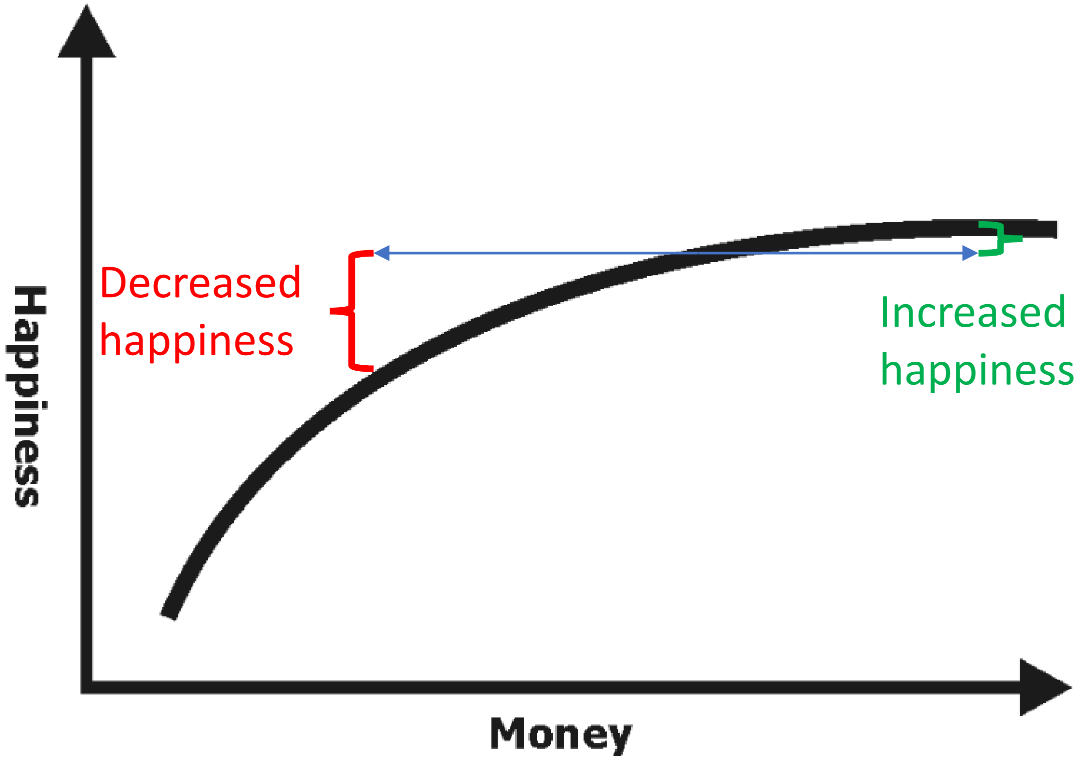
Millionaire's car – How I made millions and how you can get rich quickly.

- Depreciation
- Sales tax
- Ownership tax
- Insurance
- Gasoline
- Maintenance

2013 Chevy Volt: Acceleration 0-60 eventually.
Previous car: Pontiac Grand Prix bought mostly with GM Credit card points.

Note: I am not what I drive. Proud to have the worst car in the neighborhood.

Money and happiness



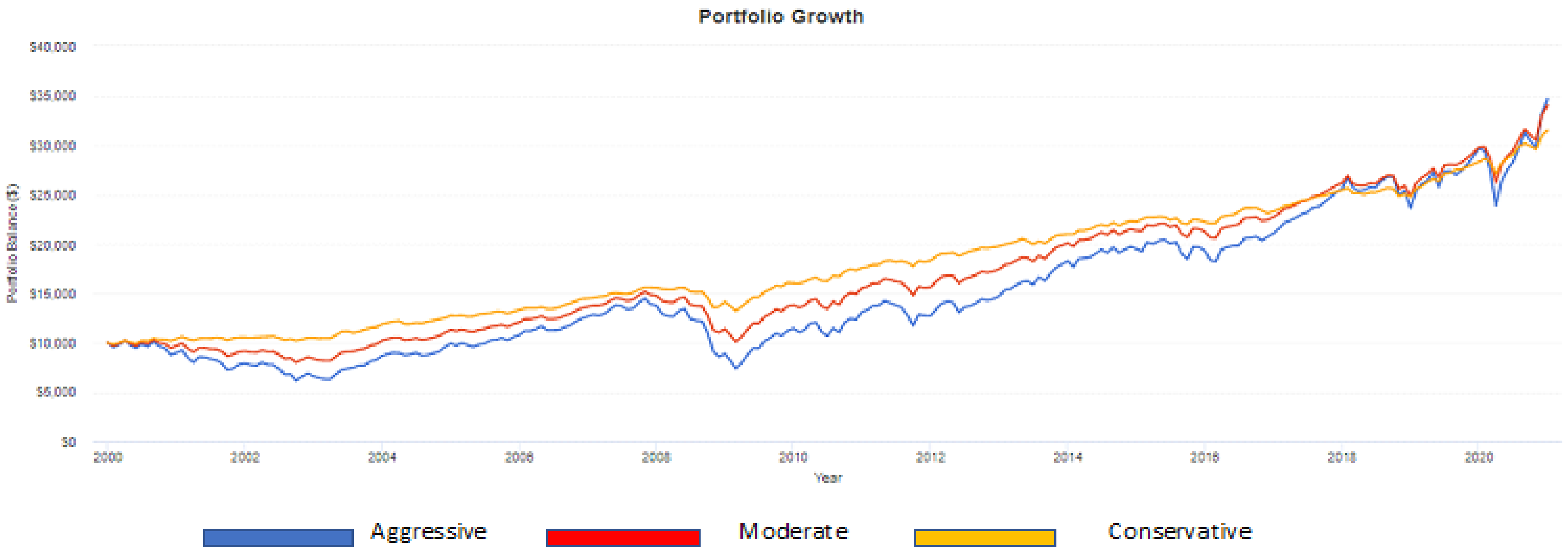
Implications

- Probabilities & Consequences.
- When you've won the game – quit playing (W. Bernstein).
- Implications for asset allocation (prospect theory).
- Dangers of risk-profile questionnaires.
    - Concrete consequences.
- Stuff vs. experiences (I was dead wrong).
- See work by Jonathan Clements.

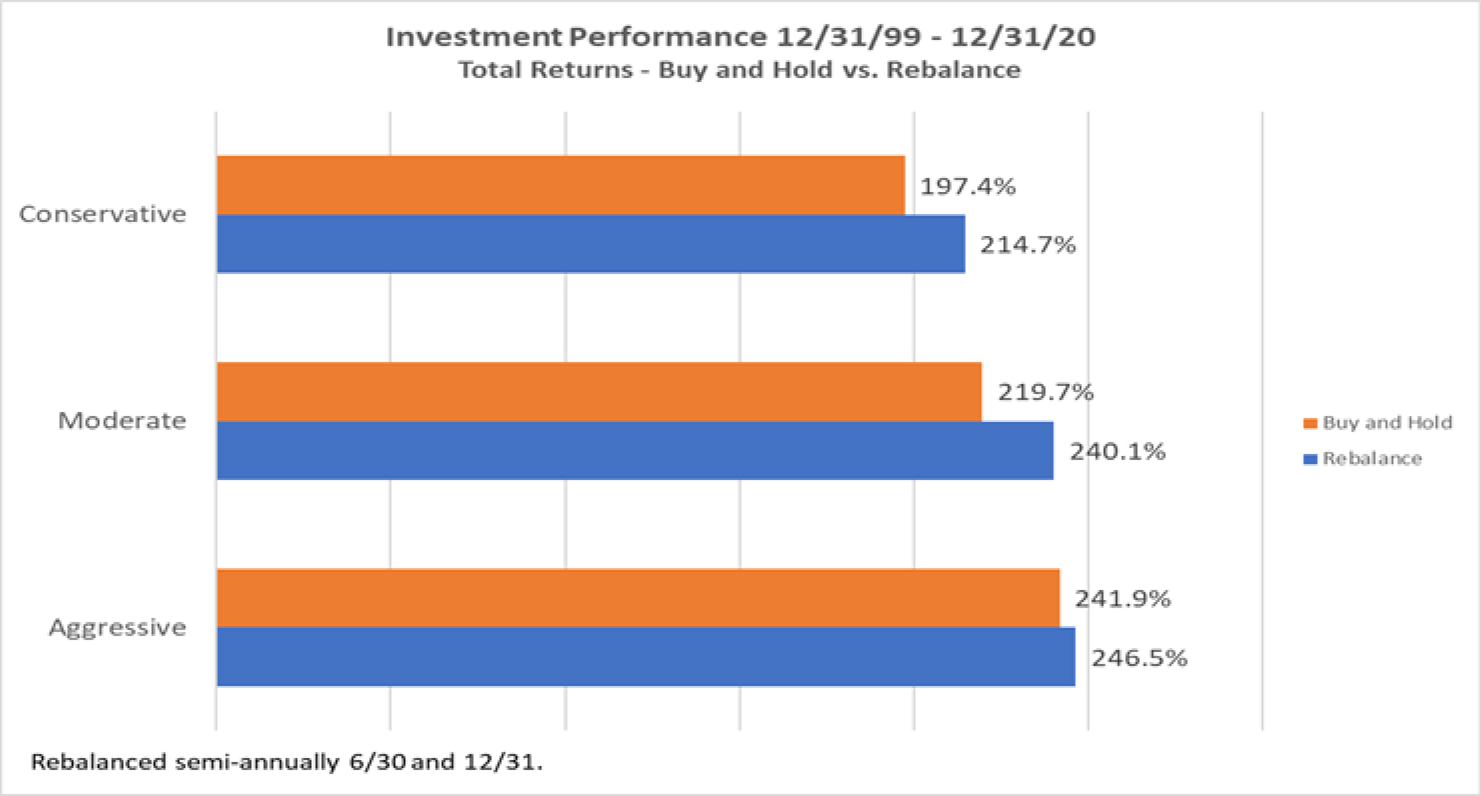
Second Grader Portfolio – Performance this Century. Risk didn't pay off.

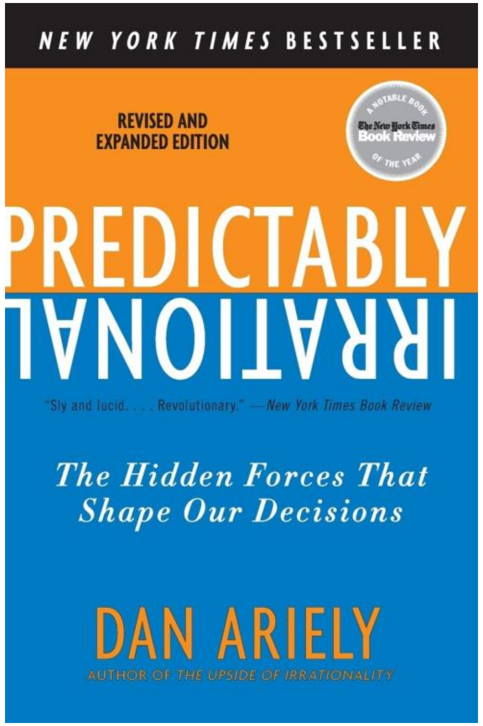
PORTFOLIO GROWTH 12/31/1999 TO 12/31/2020

Semi-annual rebalancing 6/30 & 12/31



Second Grader Portfolio – Buy and Hold vs. Rebalance (Rebalancing paid off)





The End

Appendices

To do list

1. Consider paying down the mortgage or other debt.
2. Stop trying to outsmart laws of arithmetic and ignore forecasts.
3. Embrace pain and rebalance Get rid of the expensive underperforming fund (or donate to charity) or turn off dividend reinvestments.
4. Get real on interest rates but earn thousands more <u>safely</u> with a little effort.
5. Ask your bond manager for your yield to worst after fees.
6. Work on tax-diversification (taxable, tax-deferred, and Roth).
7. Check to see if you are over insured and shop.
8. Redefine wealth and get rich quickly (inventory what makes you happy).
9. Be your own fiduciary (no one cares more about your money than you).
10. Work to minimize expenses and emotions; maximize diversification and discipline.
11. Carefully consider both probabilities and consequences.

Roth’s Rule’s

1. People are out to separate you from your money.
2. They are very skilled at using your emotions against you.
3. Don’t count on a regulator to protect you.
4. There is an inverse relationship between the quality of the food and booze and that of the investment opportunity.
5. Never buy an investment you don’t completely understand.
6. Always ask yourself:
   a) What’s in it for the person selling you this product?
   b) How the company providing the product makes money?

Roth’s Rule’s (Cont.)

7. Don’t ever believe that you are too sophisticated to fall for one of these scams.
8. Get them to put in writing why they think this product is suitable for you.
9. If it looks too good to be true, be especially careful in your due diligence. Facts over emotion – get data.
10. If they tell you that you have to buy now – run and run fast.