First Ascent Asset Management

SO YOU WANT TO DO IT YOURSELF?

First Ascent Asset Management
firstascentam.com

SO YOU WANT TO DO IT YOURSELF?

> "Everything should be made as simple as possible, but no simpler."
> **- Albert Einstein**

> "Simplicity is the ultimate sophistication."
> **- Leonardo da Vinci**

The quotations above are widely attributed to two of the most brilliant men who ever lived. Yet, in both cases, it is dubious whether those men actually uttered those words. However, there's no doubt about the benefits of simplicity for long-term investors.

Elegantly Simple Portfolios

First Ascent builds portfolios using an "elegantly simple" approach. We hold few positions. We keep fees and expense low. We trade infrequently. We make no effort to time the market.

Although our approach to portfolio management is elegantly simple, it's not easy. As Steve Jobs said, "It takes a lot of hard work to make something simple—to truly understand the underlying challenges and come up with elegant solutions."

Our portfolios look simple by design. But looks can be deceiving. It takes a lot to build portfolios that target client-specific return and risk objectives by combining investments with different performance characteristics.

Accomplishing all of that in a portfolio that is highly liquid, has very low expenses, and is transparent and understandable to clients takes proficiency and confidence.

There's More to It Than Meets the Eye

Since most of the hard work that goes into managing our portfolios is not apparent to an outside observer, some prospective clients ask, "Why don't I just manage my own portfolio?"

These days anyone can buy mutual funds or ETFs and build their own portfolio. But here are some things to consider before going down that path.

Fund Selection

Selecting building blocks for your portfolio takes skill and experience. Yes, anyone can buy funds, but choosing the right ones is not as easy as it looks.

First, you must decide whether to use actively managed funds, passively managed funds, or a combination of both. In any case, you need a disciplined process for selecting them.

Active managers have a hard time beating their benchmarks after fees and past performance is not a reliable way to select them. More often than not, today's winners are tomorrow's losers.

Standard & Poor's (S&P) regularly tracks the performance of active managers. As of June 30, 2019, S&P found that over the preceding year, 71% of all domestic equity funds had underperformed their benchmarks after fees. Over the preceding five years, 82% had underperformed. Over the preceding 10 years, 88% underperformed.

Active managers that outperformed in one period were not necessarily the ones who outperformed in subsequent periods. S&P found that less than 1% of the domestic equity funds that were in the top quartile of performance for the one-year ended September 30, 2015 remained in the top quartile over the ensuing five one-year periods.

Selecting passively managed funds seems like it should be easier, but there are still important decisions to make. For example, which index do you track? Not all US large cap index funds track the same index. Not all US small cap funds track the same index. Which should you choose? Performance will vary depending on your selection.

Passively managed funds have widely varying expenses. For example, some funds that track the S&P 500 Index have management fees of .05% or less, while others charge over 1%. Choosing one versus the other could either cost or save you hundreds of thousands of dollars.

Passively managed ETFs also differ in terms of their "liquidity." Liquidity is measured in terms of the magnitude of an ETF's "bid/ask spread"—that is, the difference between the amount you receive when you sell the ETF and the price you pay when you buy it. Building a portfolio with ETFs that are more liquid (i.e. have a smaller bid/ask spread) can save you money over time.

Selecting either active or passively managed funds calls for a review of the reputation and stability of the firm offering the fund. Over the last 3 years alone, over 400 ETFs have gone out of business.

Combining Funds

Once you have selected the building blocks you want to use in your portfolio, you must decide how to combine them to give you the outcome you desire.

First you must decide how you will allocate the assets in your portfolio among the various "asset classes" that make up the investment universe. For example, how much will be allocated to stocks, how much to bonds, and how much to other asset classes?

Maybe you want to build a portfolio with 60% allocated to stocks and 40% allocated to bonds.

How much will you allocate to US stocks and how much to international stocks?

How much will you allocate to developed markets and how much to emerging markets?

How much will you allocate to small-cap, mid-cap, and large-cap stocks?

How much to growth stocks? How much to value stocks?

How much will you allocate to Government bonds and how much to corporate bonds?

SO YOU WANT TO DO IT YOURSELF?

Do you know how to combine the different building blocks to target the long-term returns you need? Do you know what that target is?

Do you know how to combine the building blocks to limit portfolio volatility to a tolerable level? Do you know what level of volatility is tolerable for you?

Do you know how to build a broadly diversified portfolio so that declines in the value of some portfolio assets are minimized or offset by smaller declines or gains in others?

Rebalancing
Once you have selected the appropriate building blocks and decided how to allocate them, you should adopt a rebalancing strategy.

As securities markets rise and fall, the allocation of the investments within a portfolio will change. For example, after a year or two of a rising stock market, the 60% stock/40% bond portfolio that you wanted might have shifted into a 75%/25% portfolio.

You will need to develop a regular program for monitoring your portfolio and periodically resetting or "rebalancing" it to the allocation that is right for you.

Taxable Portfolios
Managing portfolios to reduce taxes for taxable investors requires another level of skill and effort.

Taxable portfolios are often constructed and managed differently than non-taxable portfolios. This may involve using different building blocks, like municipal bond funds, that aren't subject to Federal tax. Or it may mean investing in more "tax efficient" asset classes.

Managing taxable portfolios also presents the opportunity to engage in "tax loss harvesting." This is a practice that involves intentionally selling positions that have declined in value in order to realize, or "harvest," a loss in the current tax year.

If you are going to do-it-yourself, you will want to develop a regular program for monitoring and harvesting tax losses to reduce your annual tax bill.

How Hard Can It Be?

Many articles in the popular press encourage individual investors to build and manage their own portfolios. In fact, many say that "asset management has become a commodity," suggesting that portfolios are essentially interchangeable.

These articles are misleading. It is certainly possible for a person who devotes sufficient time to build and manage their own portfolio. However, portfolios are far from interchangeable.

Research shows that no matter what universe of managers you look at, there is almost always a wide dispersion of returns within the universe. If asset management truly was a commodity and anybody could do it, this level of dispersion would not exist. Skill matters.

SO YOU WANT TO DO IT YOURSELF?

In its recent Robo Report™, Backend Benchmarking conducted a performance comparison of over 50 asset managers at the end of 2019. They all manage portfolios with similar investment objectives through digital advice platforms.

Here's what they found:

> For the one-year period ending December 31, 2019, the lowest performing portfolio returned 15.35% and the highest performing returned 22.20%. A difference of **6.85**%.
>
> For the three-year period ending December 31, 2019, the lowest performing portfolio returned 7.84% and the highest performing returned 9.59%. A difference of **1.75**%.

A review of any category of asset manager in the Morningstar database shows wide dispersion of returns. For example, a comparison of the returns of over 100 managers who manage ETF portfolios with allocations of between 50% and 70% to equities shows the following:

> For the one-year period ending December 31, 2019, the lowest performing portfolio returned 8.05% and the highest performing returned 25.15%. A difference of **17.10**%.
>
> For the three-year period ending December 31, 2019, the lowest performing portfolio returned 3.93% and the highest performing returned 12.30%. An **8.37**% difference.

Asset management is clearly not a commodity! These portfolios were far from interchangeable. Differences in returns of this magnitude can make a huge difference in your wealth over time. Who is managing your portfolio makes a difference.

Bottom Line

Anyone can build their own portfolio. But, as we have seen, there's more to it than meets the eye. Just because it's easy to buy the component parts doesn't mean it's easy to buy the right parts, combine them properly, or manage them efficiently and effectively through time.

Professional investment managers can add tremendous value in these areas. And if the manager has sufficient expertise, the resulting portfolio can be simple, transparent, and low cost. Whether da Vinci said it or not, we believe that simplicity is the ultimate sophistication.