Asset Protection For Dentists

BY RON MILLER, DDS

While studying financial planning and asset management, it became apparent to me that more rapid change is going on in financial services than in dentistry. Fortunately, most of the changes in the industry are favorable, so even the do-it-yourself investor has a better chance of creating a successful investment portfolio.

Speculation utilizes hindsight and intuition in an attempt to predict future results. Investing employs foresight and assessment of risk to generate a predictable outcome. The anonymous quotation, "What a wise man does at the beginning, the fool does at the end," differentiates investors from speculators.

I have retired from dentistry and consider myself a successful investor. I have been asked to share my opinions regarding the protection of investment assets for this issue of the *Journal* so members may benefit from my knowledge and experience.

COSTS MATTER

When investing, "you get what you don't pay for." Management fees for many financial products are dropping. You can now purchase many Exchange Traded Funds (ETFs, they are like mutual funds but trade like stocks) with an annual management fee of as little as 7 basis points (0.07 percent). As of April 2005, there were over 170 ETFs available covering most sectors of the financial markets. In 2004, most ETFs were purchased for self-directed accounts, and by then the majority of fee-only advisors were recommending them. Vanguard, Fidelity and many other excellent no-load mutual fund companies are also lowering their management fees on many of their traditional mutual funds.

Today most of your investment diversification needs can be met with ETFs and no-load (no sales commission) funds that have annual management fees of 7 to 50 basis points. On-line brokerage commissions are also dropping. In May of this year, Wells Fargo on-line brokerage began offering 50 free trades annually if you kept the required minimum in your account.

Compare this with load (commission) mutual funds that are sold to you. First-year commissions and management fees can be up to 700 basis points (7 percent). With high management fees and other charges, it can cost you up to 200 basis points every year thereafter. With a time horizon of 10 to 30 years for your retirement funds, the similar quality lower-fee products will make a huge positive difference in your long-term portfolio performance. Check what you are paying annually for the mutual funds you have. Many of the fees are not very transparent, but they are easy to check on.

A PERSONAL INVESTMENT POLICY STATEMENT IS ESSENTIAL

Details of this topic were covered in a previous article. (July 2000, HDA *Journal*) The most important element of an investment policy is to determine your risk tolerance and put in writing the relative percentage of fixed (bonds) and equity (stock) assets you decide is best for your portfolio. A written investment policy will help ensure you will not change that allocation when you get euphoric or depressed about market conditions.

DIVERSIFICATION & ASSET ALLOCATION

In 1952 a 25-year-old graduate student at the University of Chicago named **Harry Markowitz** wrote an article titled, "Portfolio Selection." When you hear the term "Modern Portfolio Theory" that is what they are talking about. He ended up winning the Nobel Prize in economics based on the information in that article. His main idea demonstrated that a portfolio of different securities acts entirely different than the holdings considered individually. This concept has come a long way since 1952, especially over the last decade.

Most people would define risk in the stock market as the possibility of sudden, unpredictable downward swings in your portfolio value that can occur from month-to-month or year-to-year. We all know that different sectors of the financial markets are constantly changing in regard to their performance when compared to each other. What is very difficult to determine is what sectors of the market are going to do well or poorly and when. The more the parts of a portfolio do not correlate with each other in regard to annual returns and different sectors of the financial markets, the less volatile the downward swings of the portfolio will be compared to a concentrated portfolio.

As a stand-alone investment, commodities can have extremely violent swings in value. However, because commodities will usually perform best when the stock market is doing poorly, it makes them a good diversifier in a balanced portfolio. Consider including at least some of the following investments in your portfolio: commodities, convertible and inflation bonds, domestic and foreign bond funds, senior income trusts, along with REITs, micro cap stocks, small and large cap domestic and foreign value stocks, and growth stock funds are all reasonable alternatives.

With the proper asset allocation an investor can create a portfolio with less risk and greater return. The new ETFs and excellent low-cost mutual funds that concentrate on different sectors of the markets make this process much easier. Both the young dentist just starting to fund retirement, willing to take on extra risk for greater return, and the dentist transitioning into retirement, needing to be more conservative, would be better able to reach their objectives with customized portfolios that have diversified investments in these various categories.

For those who reject the idea of the importance of diversification in their investment portfolio, I highly recommend *American Sucker* by **David Denby**. If the title doesn't persuade you to agree with me, the content of the book most certainly will.

ACTIVE VS. PASSIVE PORTFOLIO MANAGEMENT

Certainly **Peter Lynch** and **John Neff** proved that there are some active asset managers that consistently beat their market index. The difficulty is figuring out who these managers are ahead of time. Ever more of a concern is the damage you can inflict on your investment portfolio in the pursuit of these superstars. Some respected financial experts, like **Jeremy Siegel** and **William Bernstein, M.D.**, have stated that passively managed stock and bond funds are just as successful over the long term as the vast majority of funds that are actively managed by professionals. Why? Again it comes down to the higher trading costs and management fees of the actively managed funds. It is simply too big of a hurdle for most active managers to overcome when comparing their net returns to passively managed index funds.

According to a Cambridge Associates report, over a 10-year period, 98 percent of the top-ranked managers performed poorly for a few years during the decade. Since portfolio managers tend to focus on a certain segment of the entire market, the "modern portfolio theory" stated it is inevitable these top managers will have periods of underperformance. It is wise to keep this fact in mind when you become discouraged and consider chasing the next superstar fund manager.

Another study by the Vanguard Group followed all 355 actively managed large cap funds in existence in January 1970 up to September 2001. By 2001, only 158 of the original funds were still in existence. Good performing funds are seldom liquidated, but highly successful funds may close to new investors to minimize the in-flows of assets. Of the 158 funds that survived during the Vanguard study, 39 beat the S&P 500 Index. Of those 39 funds, 23 of them beat it by more than 1 percent, and two of the managers beat the S&P 500 by 3 percent. To find an actively managed fund early on that outperforms its appropriate index long term is almost like finding a porcelain inlay in a white shag rug.

On the other hand, passive portfolio management is more like finding the rug. By constructing a low-cost portfolio that closely matches the index of various segments of the market, an investor is all but assured of getting market performance from the segments of the market in which the portfolio participates. Historically, that is all you will need. Compared to the long-term performance of the majority of active money managers, you are very likely to have your portfolio do better on a long-term basis. A wise investor should consider having the majority of his/her investment portfolio passively managed in a variety of indexed type funds. A new book by **Jeremy J. Siegel**, *The Future for Investors: Why the Tried and True Triumphs over the Bold and New*, provides an excellent review of this topic.

BE WARY OF HEDGE FUNDS

In June 2005, there were more than 8,000 hedge funds with total assets over a trillion dollars. The idea behind hedge funds is that they exploit market inefficiencies and diversify an investment portfolio. Is their popularity justified? Imagine you are at a party and mention that your ETF or no-load mutual fund averaged 10 percent over the last few years. Your friend says that's not so good, my hedge fund did 20 percent. How desirable would that 20 percent return be if you then found out that the hedge fund took three times the risk you took to achieve that 20 percent return?

Hedge funds (actually they are limited liability partnerships) are noted for their high fees and lack of transparency. Annual management fees of 150 to 200 basis points plus 20 percent of profits are not unusual. Because of their limited liability structure they are relatively unregulated compared to ETFs and mutual funds. Hedge funds also use leverage that can greatly increase the risk and the reward. Short sales and all kinds of hedging strategies are the norm. Most hedge funds are highly concentrated in a specific sector or market.

A study by **Burton Malkiel** showed that, between 1994 and 2003, 10 percent to 18 percent of all hedge funds were liquidated and closed down each year. Like mutual funds, hedge funds that perform well rarely liquidate their assets. Those funds that close down are not used in the calculation of average hedge fund performance. Many of the funds are secretive about their strategies because they say it would reveal the market inefficiencies they are exploiting. That makes it easy for them to mask the actual risk they are taking. Also be aware that hedge fund performance claims are not audited like mutual funds. Certainly the financial markets may have a few inefficiencies in them for a period of time, but with 8,000 fund managers looking to exploit those few inefficiencies, it's prudent to ask yourself how many hedge funds will actually be successful looking forward?

TRADING SOFTWARE

This is being mentioned because many do-it-yourself investors have considered, or will be considering, using some equity trading software in the future. Other than testimonials, I am not aware of any documented evidence that proprietary trading software will protect an investment portfolio from losses or enhance returns.

A few thoughts on the topic: 1) Avoid the latest fad or trend. In the late '90s, short-term trading appealed to many "day-trading" investors. Some over-confident traders even quit their day jobs to actively trade their portfolios using margin or leverage. The trend ended tragically for most day traders. 2) Continue giving priority to the scientifically proven principles of investing for the long-term. Do not succumb to the unsubstantiated hype of trading software promoters and let that distract you from your investment plan. 3) Paper (pretend) trade for several months before putting any portfolio assets at risk in an active trading program. Even the trading software vendors strongly recommend this because there is a learning curve. Most of the current trading software have paper trading platforms built into them. 4) Be aware of the tax consequences of short-term stock trading. Because this activity is not tax friendly, only trade in a tax deferred account such as a self directed IRA. 5) Decide on a prudent amount you are willing to put at risk in your actively traded portfolio and transfer it into a separate trading account at a low fee broker. 6) Keep track of the percentage increase or decease in the trading account and compare it with your passively managed portfolio. You will soon know if the current trading software may be a useful tool in your hands.

No one knows for sure what the future of the financial markets will be in the next month or the next year. However, by watching costs, having a personal investment policy statement in place, properly diversifying, having the majority of your portfolio in passively managed funds and being cautious with hedge funds and trading software, dentists can greatly improve their chances of investment success in almost any market environment over the long term. ■

Ron Miller recently founded Resource Management LLC, the only hourly as-needed, fee-only financial planning firm in Hawaii. Ron was recently appointed to the investment committee of HDS, which is responsible for more than $44,000,000 of HDS reserve funds.