Midlands
Business Journal

APRIL 26, 2013 THE WEEKLY BUSINESS PAPER OF GREATER OMAHA, LINCOLN AND COUNCIL BLUFFS VOL. 39 NO. 17

Investors tempted to be proactive as fixed income product expectations evolve

by Michelle Leach

Local professionals indicate most Americans, subconsciously or by design, gravitate more toward the "hares" of the investment world — the active management style — as opposed to the "tortoise" — the passive management or buy and hold approach.

"Hope always springs eternal," said Ross Polking, lead advisor with the Foster Group. "People tend to get anxious when markets are moving downward, and a stay-the-course mentality is mentally and emotionally challenging."

That said, Polking also noted that, with investors being more aware of costs associated with their investment portfolios, the active management world has sustained what he characterized as "somewhat of a black eye."

"Buy-and-hold by nature is a much less costly approach to investing as it does not rely upon human and technical resources behind the scenes constantly trying to figure out what's hot and what's not," he said. "Transactions and the subsequent tally of trading costs are much less, as well, since market timing is not utilized."

Polking also said investors gravitate toward the simplicity afforded by passive management.

"Not having to spend the time researching the market, scouring prospectuses, and playing the gamblers' game is a welcomed relief for most," he said, noting that information moves too fast for one to "consistently take advantage of market inefficiencies and mis-pricings."

"The highest probability of success more often than not falls in the camp of a more passive approach," he added, noting that the S&P 500 has risen on an annual basis 75 percent of the time (with 32 years since 1926 whereby it returned in excess of 20 percent).

Callahan

President and CIO William Callahan of Callahan Financial Planning Co. also noted that American investors continue to elect active management over passive investment funds.

"Even with the substantial growth of exchange traded funds in recent years, actively managed mutual funds are still more than 5 times larger by total assets," he said. "When adjusted for the amount invested in each equity mutual fund, the average investor pays nearly 1 percent per year still just for the mutual fund, excluding other investment costs. This compares to an average expense of just .14 percent for their passive (or buy and hold) fund counterparts."

Callahan cited the likes of joint university research coming out of UC-Davis, University of Virginia and Virginia Tech to note that most of the additional cost is not worth it, and is actually made worse, he said, by an average annual trading cost of 1.44 percent.

"This cost, while not eliminated, should decline in direct proportion relative to how active a mutual fund is traded by its managers," he said.

He urges investors to "keep it simple."

"Focus on investment funds that keep both their expense ratio lower, but also their trading costs low," Callahan said. "Doing this, along with the right diversification, is all that is needed. Everything else is just busywork under the guise of 'finding investment opportunities.'"

Andrew Hunt, president of Guide Rock Capital Management, said in the past retirees could invest a large portion of their nest egg in fixed income products and generate income of 4 to 5 percent — an unrealistic expectation today.

"With bond yields near record lows and a pressing need for a regular income stream, we are seeing retirees take on more risk than they have in the past — and they may not even realize it," he said. "The risk of investing in bonds is heightened when maturities are long and interest rates are low, so when an investor purchases a long-term bond they may find a little better yield but they are taking on a significant amount of risk."

For example, Hunt referenced "renewed interest" in blue chip stocks and preferred stock, which carry an attractive income stream — as well as more risk than a "traditional" fixed product.

That said, even cash carries some sort of risk.

"We need to educate ourselves on the possible outcomes and walk into any new investment fully understanding what the risk vs. reward is," he said. "We may have to go farther down the risk spectrum to find the required return but that does not mean we should go blindly."