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KEEP IT SIMPLE

By John Bussel
December 21, 2010

> "Life is really simple, but we insist on making it complicated." – Confucius
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> "Simplicity is the ultimate sophistication." – Leonardo da Vinci
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> "There seems to be some perverse human characteristic that likes to make easy things difficult." – Warren Buffett

At Hewins Financial Advisors we try to live by these wise words. We counsel our clients that a successful investment program focuses on the long-term goal of growing wealth at a tolerable level of volatility, looks to emphasize solutions that have a consistent history of good relative performance, are cost and tax-efficient, and can be readily converted back into cash, if necessary. We emphasize straightforward, understandable, and transparent solutions.

As we all know, over the last decade the returns of the domestic equity market, especially from the larger companies, have been meager and marked by two bear markets. The Dow Jones first crossed its current level back in 1999. Behavioral finance research tells us that investors tend to extrapolate their most recent experience. For example, when investors were polled about their expectations for returns in 1999, the results show that they thought they would earn a 30% increase in returns on their investment portfolios for the coming year.[1] Recent evidence indicates historically high levels of pessimism about the outlook for equity returns. As of October, over the last 30 months $250 billion had left equity mutual funds, and $550 billion had poured into bond funds.[2] (However, we should note that over the past few weeks, there has been a shift to net outflows from bond funds.)[3] In spite of the relatively poor returns out of the US stock market over the last 10+ years, the overwhelming historical record still suggests that being an owner in a well-diversified way is the path for wealth generation, while being a lender (bond investor) is more the path for wealth preservation. Plus, adhering to strategic asset allocation policies and a strict rebalancing discipline meaningfully hastens recovery from equity bear markets.

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[1] Securities Industry and Financial Markets Association. (2004) *Annual SIA Investor Survey: Attitudes Toward the Securities Industry.* Retrieved from http://www.sifma.org/uploadedFiles/Research/Surveys/2004investorsurvey.pdf

[2] Ron Baron: Stocks Are Cheaper Than Bonds (2010, October 28). *Barron's Magazine Online*. Retrieved from http:/online.barrons.com/video/ron-baron-stocks-are-cheaper-than-bonds/D29CC707-ACC1-4A6A-BCF2-5BD041F8F2CA.html. (2010, December 16).

[3] Gongloff, Mark and Pollock, Lauren. (2010, December 16) Investors Pull Cash Out of Bond Funds. *Wall Street Journal Online.* Retrieved from http://online.wsj.com/article/SB10001424052748704098304576021963439713834.html?mod=WSJ_Markets_LEFTTopNews. (2010, December 17).

But today's Wall Street marketplace does not support our cause. Actually, it is unlikely ever to support our approach. One thing that Wall Street is great at is creating supply to meet demand. Like most industries, Wall Street banks and brokerages need to innovate to ensure good growth in sales and profits. But unlike most industries where innovation is clearly a good thing (e.g., faster computing power, the ability to send huge amounts of voice and data around the world instantaneously, alternative fuels, drugs and devices that can more quickly conquer diseases or injury) financial innovation often does more harm than good for the end-user.

When investors are optimistic, there will be plenty of products to access whatever the "hot" area may be— technology, real estate, emerging markets, etc. In pessimistic times, they will create lots of products to exploit the anxiety and concern that investors feel. A whole class of products that do just that is known as structured products. Structured products are a good example of financial innovation that often begs a very simple question: "Do we (the investing public) really need this stuff?" As you can surmise, we think the answer is usually a very firm "no."

What is structured product? Structured products are financially engineered methods that fulfill what many investors think they need, e.g., offering exposure to the upside of the stock market, but limiting the downside for a specific time. For example, the product may guarantee losses of no more than 10% for two years even if stocks actually fall 20%. Sounds good, right? What's the catch? What you don't hear about from the salesmen is that the upside is capped or impaired, or that there are fees, issuer risk, and illiquidity.

Let's look at a recent example. In May 2010, Dimensional Fund Advisors (DFA) issued a white paper on structured products. In it they cite the following actual product.

> On May 20, 2009, JPMorgan Chase filed a term sheet with the Securities and Exchange Commission (SEC) for the "Buffered Return Notes Linked to iShares® MSCI Emerging Markets Index Fund" (the notes), which mature on June 25, 2010. According to the document, the commission/fee of the note is 1.25%, and the notes will pay 1.5 times the price return (not including the dividend income) of the iShares® MSCI Emerging Markets Index Fund (the fund), an exchange-traded fund (ETF) traded on the NYSE. The notes will pay this specified return between the issuing date and June 22, 2010 if the return is positive, with a maximum total return of 25.85%. If the fund earns a negative return up to -10%, the notes will pay the principal amount of $1,000. However, when the funds return is lower than -10%, investors will start to lose and receive a return equal to the fund price return, plus 10%. For example, if the fund return is -15%, investors will earn -5%, a return that is 10% higher than the fund return.[4]

Imagine the bank salesman touting an upside of 1.5 times and limiting the downside, as cited above. But what is he not likely to emphasize?

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[4] Lee, Inmoo & Repetto, Eduardo (2010 May). Structured Products. 5-6. Retrieved from https://my.dimensional.com/media/articles/papers_library/2010/06/structur/structured_products.pdf (2010, December 16.)

1) The upside is capped at 25.85%. That sounds pretty generous for a one-year period, but remember, this note is based on emerging markets, which have the most volatility, but also the most potential upside of the entire global equity universe. Furthermore, these notes were issued to capitalize on investor fear soon after a 60%+ drop in emerging markets, when a large upside bounce might not be all that unlikely. In fact, iShares® Emerging Markets Index Fund returned 25.32% from May 20, 2009 to June 25, 2010 with dividends reinvested. In this particular case, the 1.5 times upside carrot was not even applicable as the ETF returned approximately the same as the cap.

2) The product is designed to protect well against moderate losses but not severe losses. In the event that emerging markets collapsed in the period and fell 60%, the investors in this note would have still lost 50%.

3) The fees of 1.25% are 74% higher than the emerging market ETF itself, which costs 0.72%.

4) Investors are essentially locked into the note for the full year because structured notes trade only occasionally and investors would have to accept a deep discount if they had to sell before maturity.

5) The investor in the note is a creditor of JPMorgan Chase. The investors in Lehman Brothers structured products learned the consequences of the issuer risk the hard way.

6) It is not that difficult for individual investors to replicate the various potential outcomes of this note by themselves using a combination of options (both puts and calls) on the underlying emerging markets ETF. The issuer is putting on these same option positions and then charging a spread over the cost of implementation, therefore guaranteeing a profit on the note.

The beauty of equities is that the upside is theoretically unlimited. But the bulk of the upside, whether over the course of a year, 10 years or 20 years, tends to occur in relatively short bursts. Predicting when those bursts may occur is essentially impossible. So capping the upside over some random period of time (that is determined by an investment bank) could potentially have a negative impact on long-term goals of wealth generation. It is hard to think of a case where an individual with long-term goals can claim that he “needs” to invest in structured products.

Why invest in a product that is costly, complex, and illiquid when simple adjustments to asset allocation policy can typically solve the issue at hand? When a broker or banker calls and pitches the wonders of a product that can limit your downside and ease your concerns about losses, keep in mind that by simply lowering your equity exposure the same results can be achieved. In most cases, structured products may offer some psychological relief, but from an investment and economic perspective, there is just not much beyond that to warrant their use.

Our advice is to keep it simple, stay disciplined and avoid the “feel good” financial products out there. Structured products are like fast food— they may taste good going down but they can really damage your long-term financial health. As DFA concluded in its white paper, “Investors should not

equate complexity with higher expected returns or other enhanced features…structured products offer neither a free lunch nor magic solution to any investor's future performance objective."[5]

Now if we could only get all that financial engineering talent sitting in the investment banks to actually engineer real world innovations to make the world a better place….

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A copy of Hewins' current written disclosure statement discussing advisory services and fees continues to remain available for your review upon request. We remind our current clients to please contact us if there are any changes in your personal/financial situation or investment objectives.

[5] Lee, Inmoo & Repetto, Eduardo (2010 May). Structured Products. 12-13.