Kindred Spirits

The CEOs of Loring Ward and Dimensional Fund Advisors (DFA) share candid comments on robo-advisors, ETFs, lessons learned five years post the Great Recession trough, and much more.

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Context / Setting

While at the semiannual Tiburon CEO Summit in New York City on April 9, 2014, Marie Swift of Impact Communications sat down over lunch at the Ritz Carlton Battery Park with of the two top industry executives in the industry for a candid discussion about financial advisor challenges, how they see the investment landscape and what keeps them up at night. Alex Potts, the president and chief executive officer of Loring Ward, was joined by David Booth, co-CEO and founder of Dimensional Fund Advisors (DFA).

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KINDRED SPIRITS

The CEOs of Loring Ward and Dimensional share candid comments on robo-advisors, ETFs, lessons learned five years post the Great Recession trough, and much more.

By Marie Swift

In addition to sharing a unique investment philosophy, Loring Ward (www.LoringWard.com) and Dimensional Fund Advisors (Dimensional) (www.dimensional.com) have had a long and interesting relationship. I caught up with Loring Ward CEO Alex Potts and DFA co-CEO David Booth while at the Tiburon CEO Summit in New York City in April 2014.

Marie Swift: Where does the Loring Ward / Dimensional story begin? How did you find one another?

David Booth: Loring Ward was one of the first firms we worked with starting in 1989-1990. Our relationship is just as strong, if not stronger, than it was back then. It's really changed in line with the way the industry has changed. In those days, financial advisors would get paid for picking 10-12 mutual funds for clients. Now advisors are working closely with clients to figure out a better investment strategy for their clients. Many also provide wealth management and additional services.

Alex Potts: When we first started, our predecessor company, RWB Advisory (now Loring Ward), had three million dollars under management, ten portfolios, and Dimensional for three funds, Vanguard, Lexington Gold and Janus Venture for the other funds.

Then Iraq invaded Kuwait in August of 1990, and the Janus manager took a 20% cash position. This affected every single one of our portfolios, upending the asset allocations and risk/return parameters we'd so carefully engineered. That was the "ah-ha" moment for us that fundamentally changed the way we saw the world. And of course the manager missed the market completely. After that, we never wanted to have our portfolios held hostage to the idiosyncratic decisions of portfolio managers. That is when we moved all of our assets to Dimensional's asset class funds.

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>
> ~ Alex Potts

Booth: You have hit on something that I've only fully grasped in the last couple of years. Largely, the way we manage money today is the way we did it then. First off, you know we are not going to do anything crazy and unexpected, and second is the benefit of what happens when you have disappointing results. Every manager has a period of time when his results are disappointing but what's interesting is what happens with advisors and their clients up and down the line. The good thing about us is you know why our results are what they are. If you are working with a typical fund manager that made a shift from one kind of stock to another kind of stock – with disappointing results – you don't know what they did and why, which is really frustrating. So, having Dimensional be objective and transparent is a real benefit. Transparency builds trust; it doesn't feel like the rug has been pulled from under you.

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> ~ David Booth

Potts: We are trying to help an advisor help their clients get from point A to point B for the least amount of risk. If we can help them do that without disruption and surprises from money managers, we can engineer a portfolio that makes it easier for the advisor and for the client. The advisor is not wasting time apologizing for the underperformance of a manager – that is a useless conversation. There are so many more important things to discuss.

Booth: When you started working with Dimensional, we only had the US and International small cap funds and the one-year fixed income portfolio so you had to use those other funds because, even if you wanted to use more, we didn't have them. So, basically, we've kind of grown up together. At the end of 1990, Dimensional had about $4 billion under management. Today we are little over $350 billion.

Potts: I think it would have been hard to predict the success both firms have achieved over the years. It was a brand new industry so nobody could predict how big it was going to get.

LESSONS LEARNED 5 YEARS POST-RECESSION

Swift: We just passed the bottom of the market of the great recession; in fact, we are at the 5-year anniversary. What have you learned – and what should *we* have learned?

Booth: We learned that markets go up and markets go down. Buyers and sellers come together, and markets have to clear on prices that make it attractive for buyers to come in. In a voluntary transaction, both sides of the trade feel like they got a good deal. That's such a simple lesson; but is hard to remember when you are in the middle of big decline. We don't think investors are coming in and buying stocks so they can lose money. There are forced sellers but not forced buyers; so without forecasting and making a random guess at the time, I did this video in the fall of 2008 saying my guess was that buyers were getting a great deal. It's also reassuring to clients that, even though the markets dropped a lot, something of this magnitude happens once a generation.

Potts: I was surprised, from our perspective, that we were net positive in assets. That was an interesting testament to our investment approach. We'd spent many years helping clients understand why they are actually invested and how markets work. That's not to say that it wasn't painful. We had a lot of upcoming advisors and clients who were nervous at that time. We joke now that if an investor actually slept through the last 10 years, they'd have a decent rate of return, without all of the drama that actually occurred.

Booth: It's important to have an investment philosophy just like it's important to have your own personal philosophy -- one you can stick with through thick and thin. People who got out after the market dropped 50% needed 100% returns to regain ground. If you were out of the market and missed the up rally, it could take a long time to get back to even.

Potts: In early March of 2009, we were rebalancing portfolios as part of a normal rebalancing schedule—it wasn't a market-timing thing. Some advisors said: "Are you rebalancing again?" We said: "Absolutely, we are keeping to the investment policy guidelines." We were essentially selling fixed income and buying equities to ensure that portfolios were brought back in alignment with the risk factors clients had signed up to take. And we really saw the value of advisors who helped keep their clients invested with a longer-term focus. Around the same time we did a series of conference calls for advisors and their clients to provide perspective. And that was actually another "ah-ha" moment. We were sitting in our offices watching people stream in and out of Starbucks. Life went on as usual. And I realized that the power of markets is really all about these individual companies and their ability to make money in all kinds of markets. And if they can continue to make money, odds are that investors will also continue to make money. It really was a profound experience. Just everyday people walking in and grabbing their lattes, and knowing that Starbucks and all its suppliers were making a profit on each $2.00 cup of coffee they sold. And, this was in the throes of the 2009 bottom of the market. It reminded me just how powerful markets are, how powerful companies are.

> "The great advisor is not a sales person. He or she is providing comprehensive advice that is grounded in what is best for the client."
>
> ~ Alex Potts

THE ADVISOR'S ROLE

Swift: Alex, you mentioned earlier that Loring Ward has continued to grow and add assets, even during down markets. Could you elaborate?

Potts: We spend a lot of time educating advisors upfront, talking about why we do what we do, how we believe markets actually work, and how to think through helping clients. A great advisor is not a product sales person. He or she is providing comprehensive advice that is grounded in what is best for the client. It's a lot easier to do that when you have an investment belief that you are not apologizing for. When advisors "get that" they never look for another investment methodology again and they spend more time working with clients, helping them solve all the financial issues that really matter. This is a profound change because, all of a sudden, advisors are not placing their value on the markets – they are placing value on themselves. That was a formative change for us. But I give credit to Dimensional for having the idea of spending some time teaching advisors why you do what you do.

Booth: It's easy to say; the tough part is executing and sticking to the discipline.

THE PROBLEM WITH ETF'S

Swift: Let's talk a little bit about ETFs. Do either of you see a problem with ETFs?

Booth: It's not so much that there's a problem, but ETF's are a different type of mutual fund. Many investors may not understand what or how they're paying for an ETF. When you buy an open-end mutual fund, you get to go in at the net asset value at the end of the day; that's the fair price -- you go in at what it's worth. You are not paying a commission or a dealer spread. When you buy an ETF you are buying it from a dealer, and it shouldn't come as a shock that the dealer is doing this to make money. You don't know how much they are making -- but you're paying something for that privilege. If you want to sell your ETF shares and that dealer isn't making market that day, you are out of luck. The spread may be very wide; they may be charging a lot that day to get out. Whereas if you are getting out of a mutual fund, you will get out at net asset value. What can be better than that?

Potts: Whether you own a mutual fund or an ETF, it's like owning a house, which should be a long-term investment. Imagine having the price of your house on the garage door. If you kept seeing that price every minute of the day, versus once a day (and even then, that's still a lot), it can become detrimental to your thinking. If you are not intending to sell, are you are really worried about the price of your house? Probably not. I love Warren Buffet's analogy of the market: Picture the farmer out there working away and doing what farmers do, but some crazy neighbor keeps yelling an offer to buy the farm every day. The wise farmer will just ignore or say no to that crazy guy.

> "If you are not intending to sell, are you really worried about the price of your house? Probably not."
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IN-HOUSE OR OUTSOURCED MONEY MANAGEMENT

Swift: Do you think it's a good idea for advisors to manage their clients' money in-house? Or is there something to be said for outsourcing it to professionals who are not emotionally involved with the end-client?

Potts: I believe most advisors should outsource the non-client facing tasks. There is the cost of establishing all of the advisory services: from establishing portfolios, trading, you have to be your client's technology officer, you need a staff, a manager that manages that staff, etc. All of those tasks take the advisor away from their clients. That is an opportunity cost that an advisor needs to weigh; if that works for them, then that's great. But there are a lot of firms, such as Loring Ward, that are happy to help. We exist because of advisors understanding they can leverage our services to better serve their clients. Those are the advisors with whom we look to work. Advisors who manage client's money in house may tend to complicate their practices and not spend as much time with their clients as they would ultimately like.

ROBO-ADVISORS A REAL THREAT?

Swift: There is a lot of talk about robo-advisors. Will the automated advice model ever really replace the more traditional client-advisory experience?

Booth: At Dimensional, we talk all the time about the technology needed to help financial advisory firms be as efficient as they can be. I think that, long-term, the advisor is going to meet less frequently with clients. The idea that you need to sit down quarterly with your client and talk to them, well I think it's boring to the client. I think the use of technology to aid communication with clients will be a big plus. Advisors will use tech-messaging tools more than in-person meetings. I wouldn't put that in the area of robo-advisor; I just think it's doing what they do now but doing it more efficiently.

Potts: I agree with that. But I worry about a lot of do-it-yourself investors. They are at a disadvantage because they may not understand how to really do things right. One, they may not set up good goals or a viable plan. The value of an advisor is not just setting up the client's portfolio, but helping clients implement the plan, avoid pitfalls and stay invested when things get bad. Think about doing your taxes. Turbo Tax makes it easy, but I would much rather be sitting in front of a CPA who knows what I might have missed. There will certainly be room for robo-services serving do-it-yourselfers, but anecdotal research suggest that once an investor has a portfolio worth more than $250,000, he or she is likely to turn to a human advisor for guidance. Even with robo-advisors, managing your financial life yourself is hard. And mistakes can have major long-term consequences.

Booth: As technology improves and costs go down, advisors will be able to serve smaller and smaller clients. Hopefully one of the benefits of this improvement will be more people will have access to advisors.

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> ~ David Booth

Potts: And cheaper access to things. Technology will make it more efficient for advisors and firms like Loring Ward who serve advisors. It will be a win for all of us.

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David Booth
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David Booth was a founder of Dimensional Fund Advisors in 1981 and is Chairman and Co-CEO. Booth has written numerous articles including "Diversification Returns and Asset Management" with Eugene F. Fama, which won a Graham and Dodd Award of Excellence from the Financial Analysts Journal in 1992. The University of Chicago Booth School of Business was named in his honor, where he also serves as a lifetime member of the school's business advisory council. Booth is a member of the board of trustees of the University of Chicago, the University of Kansas Endowment Association, and he is on the board of directors of Georgetown University. He is also on the board of overseers for the Becker Friedman Institute. In 2010, Investment News named David as one of "The Power 20" in the financial services industry, and MutualFundWire ranked him 12th in its list of the 100 Most Influential People in mutual funds. Booth received his MBA from the University of Chicago in 1971. He also holds an MS and a BA from the University of Kansas.

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Alex Potts is the President and CEO of Loring Ward Group Inc. as well as President and CEO of the SA Funds – Investment Trust. Previously, he was the Chief Operating Officer of LWI Financial Inc. He has also served as Chief Executive Officer of RNP Advisory Services, Inc., a registered investment advisory firm. Potts started the SA Funds – Investment Trust. He also founded Loring Ward Securities Inc. (formerly Assante Capital Management Inc.). In addition, he served as Executive Vice President and General Manager of LWI Financial Inc. (formerly Assante Asset Management, Inc.). Potts earned a Bachelor of Science Degree in Economics from Santa Clara University. He also holds General Securities (Series 7), State Law (Series 63) and General Securities Principal (Series 24) licenses.

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Marie Swift is a nationally recognized consultant who has for over twenty years worked exclusively with some of the industry's top financial institutions, training organizations, investment advisory and financial planning firms. A top rated speaker at dozens of industry events, Marie is dedicated to elevating the conversation in the industry. Marie is also a prolific writer and contributes to many of the industry's leading publications, including Financial Planning magazine. A thought leader for thought leaders, she is known for bringing some of the industry's best and brightest voices together for dialog and debate. Her Executive Insights series is just one example of how Marie generates interesting conversations with movers and shakers in the financial services industry.

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