O.F.O. Partners

Skepticism
Fall, 2020

Earlier this year, we wrote about how simplicity improves your family's financial defenses. This fall let's play offense. Let's attack weak ideas and uncover good ones with the help of skepticism.

It's an important time to be on the alert for baloney. I am startled to see our institutions leaning toward wishful thinking and inept planning. The U.S. election and our coronavirus failures come to mind. Financial systems have also tilted. Extremely low interest rates, high leverage, and the stock market's narrow gains are real dangers. What's at stake is the success of your hard-fought plans.

What's the good news? Confidence and skepticism are great filters of B.S. At O.F.O., we practice something called **open skepticism**: a mix of experience, curiosity, and incentives that improves the choices that families make with their wealth. Best of all, there's plenty of planning and investment strategies out there that work really well, even if truth feels in short supply.

Part One: A Framework

Open Skepticism = Experience + Curiosity – Incentives

Experience

The first element of open skepticism is experience. We've gathered it across two wars, the Great Recession, the internet boom and bust, and four presidential administrations. Along the way we have seen investment ideas packaged in every type of wrapper, but no new ingredients. The basics of a healthy financial strategy are timeless, so why engage in futile or hazardous experiments? Keep costs low, care about taxes, manage risks, avoid unforced losses, and engage your kids. This is a simple recipe in which experience rises above hype.

"The only important financial innovation I have seen in the last 20 years is the Automatic Teller Machine".   - Paul Volcker

A little gray hair allows us to support clients during times of stress. When people are unsure how to safeguard their wealth, they become susceptible to unproven claims. The explosion of interest in Bitcoin, SPACS, and Robinhood-style trading platforms are living examples in 2020. These are the hydroxychloroquine of our economic times - promising, but unapproved for general use.

A recent advertisement from Robinhood proves the triumph of hope over experience.

Having lived a little, our experience affords the opportunity to steer away from bad strategies. But if we always play it safe, then where's the risk? And where's the reward? Curiosity and incentives help us to answer those questions.

Curiosity

Curiosity makes the skeptic productive. You need to care about a topic enough to show up intellectually, and to bring your attention and energy to bear. If you are willing to challenge your current beliefs, the results can be electrifying. Einstein transformed Isaac Newton's law of gravitation with the simple idea that time is not a constant. That leap upended more than two centuries of "proven" experience.

"A mind that opens to a new idea never comes back to its original size".   - Albert Einstein ***

In wealth management, big puzzles demand an open mind as well. In 2020, we scratch our heads about the divergence between corporate earnings, which are down about 15 percent year-over-year, and the stock market, which has risen nearly 13 percent in the same period. Pundits rationalize the schism by pointing to rescues by the Federal Reserve or (someday) Congress. We remain doubtful that the equation balances with those variables. So we keep digging for other evidence; we are curious, and skeptical.

Not knowing all the answers always brings us to the same helpful place – asking great questions. What is possible? What has changed? Where is our understanding limited? What information do we need? We seek information without judgment, and we listen for understanding rather than agreement with our old ideas. This process produces better answers and provides better outcomes for clients.

Incentives

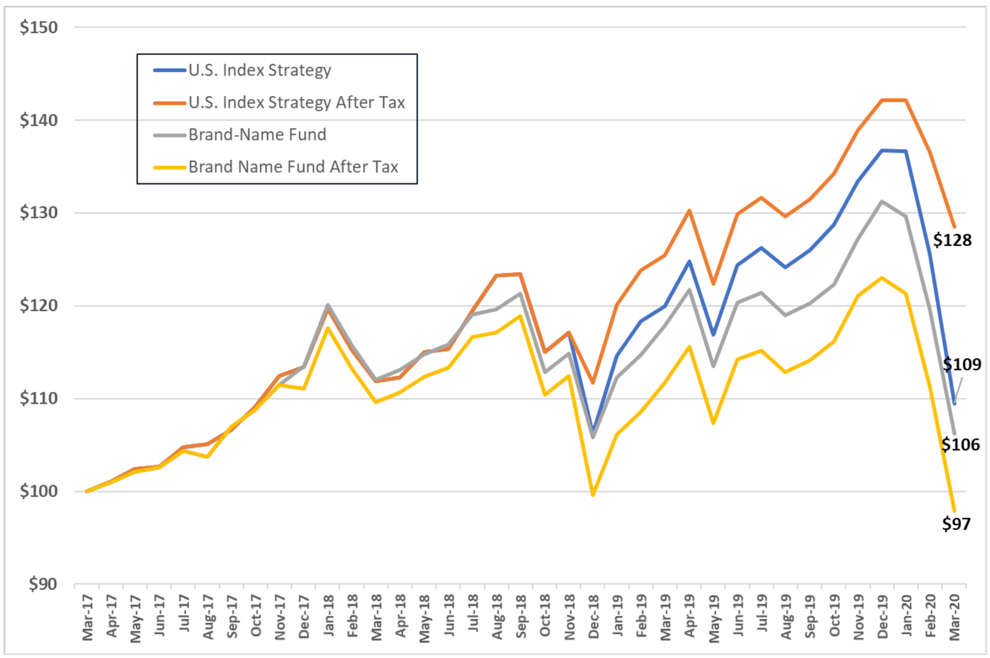
Incentives are enticing. If there is money to be made, then people want to participate. But too often, the alignment between investors and Wall Street is out of whack. There is considerable friction

*** For readers who are sharp-eyed skeptics: The image above is not Einstein, but Mississippi bluesman T-Model Ford. Albert's head is photoshopped. Einstein played violin and piano, with tastes that leaned more toward Mozart than Metallica.

between uncertain profits for customers and the high revenue at banks and brokerages. Fees and taxes have an outsized impact on the money that customers ultimately make.

We recently reviewed several large mutual fund complexes to evaluate their stated returns versus the results that clients received after paying fund-related taxes. Then, we compared these returns to an alternative strategy that included low cost indexing, plus the benefit of loss harvesting – capturing tax benefits during market pullbacks. The results below are from a well-known fund with $100 billion of investor assets.

The growth of $100 initial investment: Brand name mutual fund versus index strategy, before and after tax

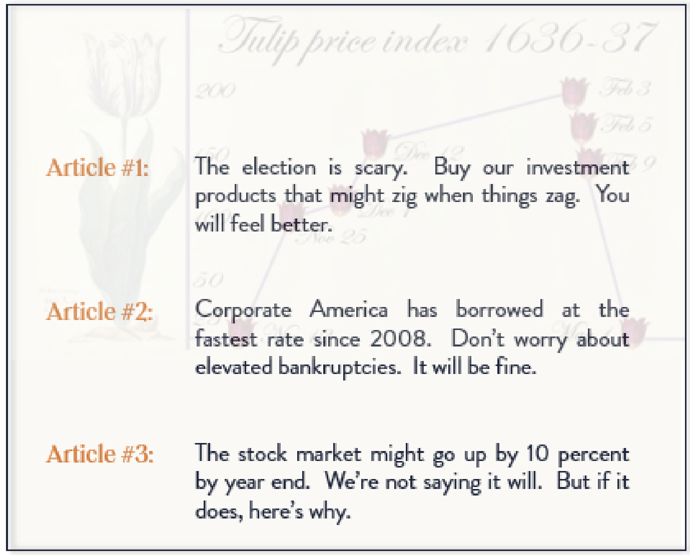


Over three years, the difference from minding taxes and fees represents $310,000 on a million-dollar investment, or a 31 percent difference. Many private banks, brokerages, and money management firms are not aligned with their clients on these measures. And there are other cases in which the managers themselves are not even invested in their own products. It's rather common for wealthy families to overlook these fundamentals.

The percent of managers who have little to nothing invested in their own strategies is high.
Source: Morningstar

	Manager has $0 Invested	Manager has <$100K Invested
Domestic Stock	47%	65%
Foreign Stock	61%	76%
Balanced	71%	82%
Municipal Bonds	80%	95%

Industry incentives can harm clients in other ways as well. Every morning my inbox is flooded with market research. At first glance, there's a lot that glitters. But the real draw is for the vendors, not for clients. When they pitch their products, risk is a straw man. In the examples shown on the right, the extraordinary policy interventions supporting markets are barely discussed. Longer-term risks are not addressed either.



A shortened, unpolished summary of three research articles I received last week.

Abundance

In 2018, I said goodbye to a Global 500 investment company to launch O.F.O. Partners. Our approach opened up a world of capabilities for clients. We use new planning tools, reporting technology, and investment resources that are unreachable at bigger firms. A challenge is to narrow the choices wisely. We've developed practices to sort out the good from the bad. Open skepticism is at the center of that process.

Last year, we evaluated more than 85 firms and strategies on behalf of O.F.O. clients. Many of them fell away because of our skeptical approach to money managers. We believe that the ones that remain are likely to protect and grow capital predictably and efficiently. They will also bring peace of mind to the planning path of your family. In a year like 2020, a reasonable skepticism, informed by experience, curiosity, and the right incentives, goes a long way toward regaining sanity.

We look forward to seeing you soon,
Ezra Levine, Doug Moon, Matt Murray & Karen Sugar

Part Two: Reality Check?

Since markets bottomed on March 23rd, risk assets have staged a historic comeback. The third quarter began as lockdowns eased and investors doubled down on the stock market's second quarter momentum. As September passed, market participants became aware of several risks that may lie ahead: a second wave of COVID cases, a fiscal cliff without congressional support, a contested presidential election, and the long-term effects of de-globalization.

Market recap

The U.S. stock market managed to post the best third-quarter return since 2010, finishing up 9 percent. This achievement occurred despite a rough month of September, when volatility returned, and the S&P 500 declined by 3.8 percent. The rationale for continued equity strength suggests that investors have been pushed far out onto the risk spectrum to meet their return objectives. For the quarter, cash was flat, long-term treasury bonds were up 0.2 percent, and investment-grade corporate bonds returned 1.7 percent, not much above the rate of inflation (1.4 percent) . Gold rose 6.5 percent over the quarter, and remains the best-performing asset class of the year. Investors seem to believe that ongoing stimulus and coronavirus rescues will bring with them both inflation and U.S. dollar weakness.

Coming soon: The death of the 60/40 portfolio?

As uncertainty looms over the market, one may retreat to the foundation of their asset allocation. Historically, investors have looked to the staple 60/40 portfolio, comprising 60 percent stocks and 40 percent fixed income. The relationship between bond and stock returns represents a building block of modern portfolio construction and has served investors well for the last 30 years. Typically, as equities fall in value, investors can depend on bonds and cash to "hide out" from volatility. The negative correlation between these asset classes has demonstrated in practice that simple diversification works.

In the current environment, this relationship may have changed. U.S. Treasuries offer no yield after accounting for inflation. The bond "hedge" may be unavailable to counter bouts of equity volatility. With limited protection, family-office clients may want to re-think their current portfolio construction. Low rates may continue to dominate the market outlook.

In a coming white paper, we will explore this issue in more detail. We will address the magnitude of the challenge and provide potential solutions to twist the traditional 60/40 portfolio toward the benefit of family clients.

Part Three: Now Hear This

Here are a few articles and sounds tied to the questions we've pondered this summer.

How to Decide: Simple tools for making better choices

Annie Duke is a cognitive psychologist and former professional poker player. She has written several books about decision-making and cognitive bias.

Recommended Playlist: Songs about Disbelief

Motörhead, Gary Numan, the White Stripes and a Tamil film classic make this curated theme playlist about disbelief of all types.

▲ White Stripes make the list with Girl, You Have No Faith in Medicine. Photograph: Stephen Lovekin/WireImage

Trustworthiness in the Financial Industry

Andrej Gill's academic paper suggests that during college, students who want to start their career in the financial industry are less trustworthy than other cohorts. Worse, the financial industry does a poor job of screening out less trustworthy candidates.

The Rhetoric of Reaction: Perversity, Futility, Jeopardy

Albert Hirschman's 1991 book maps the rhetorical contraptions that politicians use to make public policy discussions intractable. His taxonomy of skepticism is applicable to investment claims as well.

Skepticism: A Primary Weapon in the Fight Against Fraud

Crowe Horwath's Jonathan Marks describes audit-related policies and practices to support healthy institutional skepticism.

Important Information

This material is copyright 2020 by O.F.O. Partners. The information provided is for educational and informational purposes only and does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not consider any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your attorney or tax advisor. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability, or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. O.F.O. Partners, LLC ("OFO Partners") is a registered investment advisor. Advisory services are only offered to clients or prospective clients where OFO Partners and its representatives are properly licensed or exempt from licensure.
For additional information, please visit our website at www.ofopartners.com.
For current OFO Partners information, please visit www.adviserinfo.sec.gov by searching with OFO Partners' CRD #297424.