PART I

Evolution of a Wealth Manager: My History, World, Experience, Clients, and Company

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CHAPTER 1

Starting Out

In this chapter, I explain the first origins of the investment philosophy that now guides the way I advise my clients. Since investment philosophy in itself can be not only dry but abstract, I want to breathe life into that philosophy by offering it in the most personal way possible, as the story of my own education as a wealth manager. My story in this chapter and the next one will introduce the main concepts that I spend the rest of this book discussing. I hope that the personal context will make the concepts more easily understandable.

Inflation, Stagflation, and High Interest Rates

Before I begin this discussion, I think it is important for me to provide the briefest macroeconomic context for the period 1978–1982, when this story begins. In 1971, President Richard Nixon slapped wage and price controls on the economy in response to what was termed raging inflation (4.5 percent). That worked well enough in the very short term and backfired massively in the longer term, arguably resulting in both stagflation at the end of the 1970s and the inflationary cycle of the early 1980s. Remember stagflation? It is a macroeconomic term for a period of inflation combined with stagnation or slow economic growth and possibly even recession. Inflation was now really raging in a way it had not been previously—11.2 percent in 1979. Under President Jimmy Carter, the Federal Reserve enacted monetary policies to combat inflation, including raising interest rates significantly. The first effect was more pain, as inflation hit 13.6 percent in 1980. Meanwhile, economic growth had mostly ground to a standstill, and unemployment hit a high of 9.7 percent in 1982. Then the world economic system got a big jolt when OPEC first flexed its economic muscles and raised crude oil prices fourfold in 1973. We experienced some of the worst down markets in recent history in 1973 and 1974, with a mini cycle that ended in 1975.

Interest rates in the bond market tracked the rising inflation rate. The long bond yield hit a high of 15 percent in October 1982. Mortgage rates touched 18 percent in 1981. The housing market came to almost a complete standstill. There was little technology and no technology boom in those days; the Internet and electronic trading were still far in the future. The highest marginal tax rates were 70 percent or more and did not come down until the start of the Reagan administration. Those rates led to many investments that made little economic sense but sheltered income taxes. For affluent individuals, tax planning and investing were driven above all by this high tax bracket and trying to avoid taxes. It was a strange time.

Finding Partners

At the beginning of my career as a financial adviser, I never thought I was smart enough by myself to know how to invest for my clients, and I spent years looking for the Really Smart Guys who were going to teach me how to invest. I learned over time that, in fact, those guys were not really that smart—although they were certainly greedy—and never had the best interests of my clients at heart. They got paid their billions—some of them—and I did not. I don't know what happened to all of them, but I am still here.

I know that lives have turning points. You get up in the morning and have breakfast and walk out the door without knowing that, by the end of the day, the entire direction of your life will have changed. My life changed in that way at a lunch my partner Joe Hudetz and I had with Dave Reedy in 1979. I walked into the restaurant as a young attorney without a real direction, and when I left, I had found one of the individuals I would spend most of my business career in partnership with.

In the Introduction to this book, I mentioned the law business Joe and I had established in 1978. We specialized in networking lunches in our first year in business, as we struggled to get a toehold on enough business to sustain us. Joe knew Dave Reedy from high school and we solicited him and his partner Tom King for business.

The year 1979 was a bad year for us to start out in business; it was a terrible year for real estate businesses like Reedy-King. Stagflation and high interest rates were strangling the real estate market and traditional real estate firms were forced to reconsider how to stay in business. Dave and Tom had decided to branch out.

Dave and Tom asked if we had experience in real estate syndications and tax-deferred exchanges, both of which required a high degree of expertise in securities and income tax law. Dave hired me to write the offering memorandum for the first apartment building that he was going to offer as part of a limited partnership. Of course we assured him that I had the expertise this job required, and then spent weeks learning everything I could about real estate and securities law. The three of us quickly became fast friends.

As it turned out, this new business worked so well for them that they had to diversify beyond selling only their own deals, and this required a fundamental change in their business organization. You can sell your own limited partnerships privately but you have to get a securities license and belong to a broker-dealer to sell deals that you did not originate. In effect, at that point you are selling securities and you have become part of the highly regulated securities industry.

Dave and Tom also wanted to try financial planning. They believed the new fledgling industry called *financial planning* would become important. We all saw the limitations of focusing solely on real estate, and they wanted to expand their expertise and offer more services. Dave and Tom were already dealing with a wealthy, sophisticated client base that could use these services, although the International Association of Financial Planning (IAFP) had only just come into existence. No one really knew what a financial planning firm was, although I, too, was intrigued by the idea and imagined it could be a great business to meet successful people with vision and drive and be paid for one's expertise.

Founding Terra

For all these reasons, we decided to form a company. Dave and Tom founded Terra in 1981 and I soon joined as partner: Dave, Tom, and I were the original three partners. Dave used his Catholic education to come up with the name of Terra Securities, from the Latin word for earth or ground—a good name for a firm that began with real estate and was transitioning to securities.

At the beginning, we only wanted to find a larger broker-dealer with which to affiliate. Therefore, we attended the second conference of the IAFP held, ironically, in Las Vegas. There would be 20 or 30 brokerage firms at the convention and we thought they would all be interested in talking to us about our financial planning business and real estate partnerships.

Tax Shelter

Put simply, a tax shelter is a method to reduce taxes; taxpayers in general will always have more money left after taxes if they can increase the amount of tax deductions. In investment terms, a tax shelter makes money for the investor more from producing income tax deductions than from producing profit from the deal. If your income tax rate is approximately 35 percent—as it is likely to be at the time I write this book—then $1,000 of tax deductions will put approximately $300 in your pocket. If you look at the highest marginal tax rates at the time we are talking about—the late 1970s and early 1980s—then you can see that $1,000 of tax deductions could put on the order of $700 or more in your pocket (some deals gave $2 of losses for every $1 of investment). Then consider that it might be much easier to structure some investment so it can generate losses rather than profits. Now you have a tax shelter.

At that time, broker-dealers in our channel sold only tax shelters in the form of real estate limited partnerships, which basically consist of at least two persons: a general partner, who has unlimited liability, and a limited partner, whose liability is limited to the amount invested in the company. Limited partnerships are often used as a vehicle for raising capital, due to the limited liability for the limited partner. A real estate limited partnership would of course have been created for the purpose of investing in real estate.

The limited partnerships we saw at this conference went beyond real estate to include wacky tax shelters like gems, Christmas trees, oil, and lithographs. There were oil and gas drilling limited partnerships, movie deals, leasing deals, guns; I remember seeing the racks of guns. They were raising money for anything you could think of and creating big tax losses. It was one great sleazy group of people—way too sleazy for us. There was no way we would be able to join any of those organizations. As it turned out, most of those broker-dealers were eventually driven out of business for all the usual reasons, mostly bankruptcy. Even some of the financial planning on display was like something from an alien universe. No one was thinking about mutual funds or the stock market. There were just a few, barely perceptible signs of the first credible vendors and mutual funds that would play a significant role in building this industry.

It had not yet occurred to us that we should form our own introducing broker-dealer. At that time, you could form an introducing broker-dealer with only $5,000 in capital, but there would then be restrictions on the kind of business you could do. It turns out to have been an extremely fortuitous decision, but in fact we started it only so we could legally get into the financial planning business.

And yet, as we started up with Terra, our small group was captivated by the notion of changing clients' lives in a positive way. We were young; we thought we were smart; and we wanted to establish a good business and embrace the new world of financial planning so that we could help our clients in ways that had not been possible for us before.

As it turned out, founding our own company was exactly the right thing to do, but we did not realize then what a good decision it would turn out to be.

Creating a New Business Model

Acquiring new clients one by one is one way to establish a new business, but you get more leverage when you use centers of influence. From the inception of Terra Securities, Dave Reedy, Tom King and I were aware of the advantages of marketing through centers of influence such as tax professionals and other lawyers. The idea, obviously, is to woo them so they refer business to you. Accountants are preferable even to lawyers because they have a regular client base and are highly respected. Furthermore, they are perfectly placed to see when an individual has cash to invest or has made a bad investment or could use some investment advice. (I use the term *tax professional* rather than *accountant* or *CPA* because not every accountant is a CPA, but I am afraid that when using these terms casually, I—like most people—tend to use them interchangeably.)

So at first, Dave took referrals from accountants but he did not have a way to pay them aside from an annual bottle of J&B every Christmas. The securities laws made it illegal to pay them (because you had to be securities licensed to share in the commission), so it was not a lucrative arrangement for an accountant.

The governing body for accountants is the American Institute of Certified Public Accountants (AICPA). When Terra was first formed, the AICPA had a rule that its members could not be in the financial services business. Fortunately for us, just at the time we were getting started with that idea of working with accountants, the Federal Trade Commission (FTC) sued the AICPA and the latter had to change its rule. This was a transformative change.

Finally it occurred to us that we would still do the sale but the accountants we worked with should acquire the necessary licenses so they could get paid a portion of the commission or fee from securities transactions completed with their clients. It was not a matter of getting accountants to try to sell securities themselves; the central issue was our being able to share commissions legally with them. We thought we had really discovered a new business model! It was a novel idea to have them get licensed so that they could not only provide advice but also get paid if *we* provided the advice.

Building the Business Model

While we were figuring out the business model that was to carry us forward, my friend Brian Savage joined us in 1984. Brian was a CPA with a practice based mostly on tax preparation. We bought his business by making him a co-owner/partner of Terra Securities and moved him into the office with us. Since Terra had a value of basically zero, it was a good buy for us to trade part of our practice for his.

Like many accountants and tax professionals, Brian's tax business required him to work from 8:00 A.M. to 8:00 P.M. during tax time, and people just rolled through his office. Brian would finish his tax appointment, then walk that client into an adjoining office and say, "Talk to Dave." Dave would try to sell the client a mutual fund for an IRA or something. It was the easiest way to get new clients that we had ever experienced. Our epiphany was the realization that by affiliating more closely with more tax professionals, we could revolutionize the whole way we prospected and did business.

Although at the time tax professionals saw commissions as a huge conflict of interest, in1984 we brought in the very first outside accountant that we did not make a partner in the business. Our idea was so revolutionary that we then stopped looking for new clients and started looking for tax professionals who had 300 to 400 clients so that we could leverage their business. I could spend all my time building a book of business with my own 300 to 400 clients, or I could find one individual who already had those 300 to 400 clients and work with him on the securities business and split everything with him. That was the basic concept.

We realized that we had discovered a great business model because accountants were already in a position of trust with their clients and wanted to broaden and diversify those relationships. As time went on, we developed ways of talking to, educating, and serving our customer base.

Accountants are both risk-averse and analytical, which fit extremely well with our risk-averse, asset-allocation approach. The greatest risk an accountant faces is losing his or her clients. We found accountants to be a tough constituency: they wanted the right product at the right price for their clients, and that became a driving force in how we looked at money and investments.

Accountants are just not motivated by money: Their client is their most important asset, so they will not do anything to abuse that trust. Furthermore, an accountant already has a way of earning a living and generally will not push product sales to clients just to get some income.

Evolution of the Business Model

Working with a few of the pioneers was one thing. At some point, we realized that our doing the presentations for every accountant was not creating a scalable model for our business. It was just impossible for us to visit every accountant for every $2,000 IRA investment.

We decided that instead of trying to send out Terra principals for every sale, we would develop very robust marketing, training, and compliance so these accountants could do it on their own; that was what the model eventually evolved to. Here was our value proposition to accountants: *You* be the adviser, and we will give you everything you need to advise your clients about investments; we will give you the entire support structure. We will provide you with asset allocation models; we will do the due diligence; we will provide you with all the training and the compliance. *You* maintain the client relationship and provide your clients with investment recommendations that are truly in their best interests. We thus had two clients, both the accountant and the clients of the accountant.

Marcus Heinrich joined the firm as we were beginning to develop this business model and took the lead in recruiting accountants much more systematically than we had in the past, and then developing the Terra program to support and teach our accountants how to be registered representatives (meaning they were licensed to sell securities). Marcus immersed himself full-time in the business and brought an incredible energy to his recruiting and training efforts; he built out the company to the next level.

Brian Savage was both a CPA and a former IRS agent. Brian knew how accountants thought and he spoke the same language they did, thereby facilitating communication. Because of his IRS background, he was instrumental in helping Terra set up financial controls and became a leader in the compliance area; he really understood the regulatory environment. Small broker-dealers are notorious for getting into compliance trouble accidentally, but we never did, thanks to Brian. He was our financial principal—which was a big deal—and ensured that we kept a clean record: That was a credit to our products and our representatives, but above all a credit to Brian.

Howard Kite brought insurance knowledge and training skills. He had years of experience in the insurance industry; his special expertise in training came from his background as a business teacher and sales manager. We were babes in the woods in terms of insurance. Insurance products tend to be both extremely complex and arcane, but when we really needed to understand how a product worked, Howard would take it apart for us. He brought us to a new level in our ability to deal with insurance products.

Terry Gallagher brought banking and trust experience. He had had early exposure to the fee-based business through his trust background and he understood how the trust side worked—and could explain it to us.

Creating a New Value Proposition for Independent Broker-Dealers

We were also at the beginning of the development of the independent broker-dealer. Up until that time, most advisers or brokers or registered representatives were employees of the large wirehouse firms like Merrill Lynch or Smith Barney, which would dictate how they had to present products to clients and what they had to sell. (In case you are not familiar with the term *wirehouse*, it is an old name for these large, Wall-Street-type firms; it stems from the way the communication systems in that pre-electronic era linked the various branches and trading floors and enabled the sharing of financial information and prices.) The independent broker-dealer was not obligated to sell the products of a parent company, so the advisers who worked in this new kind of company were beholden first of all to their clients.

The regulatory authorities were used to the idea of wirehouse registered representatives who were all contained in one place. If we were going to have part-time representatives who were not even our employees, then we would have to demonstrate that they could function legally and ethically without a supervisor physically looking over their shoulder. Accountants were the perfect kind of person for this kind of independent existence.

I believe that the emergence of the independent broker-dealer was in the client's best interests. Beyond that, not only were our advisers independent, they had well-developed technical knowledge because they were accountants. They understood numbers and they really understood their clients; what they lacked was infrastructure. Our job was to provide the infrastructure they needed to be able to offer their clients investment solutions that were right for them. This was something new: truly doing the right thing for the client.

We started doing trade shows and other things to recruit. Our representatives joined us for different reasons. They could broaden and diversify their relationships with their clients while also diversifying their sources of revenue. In general, tax professionals are devoted to their clients, and most of them had seen some egregiously bad examples of financial service abuses. After the fact, the only thing the tax professional can do is report the loss on the tax return and say, "That was a really bad investment. I wish you had discussed it with me before you went into it." You hear that over and over when you talk to accountants: "I wish I could have helped but by the time I got involved it was too late."

Learning the Lessons of Tax Shelters and Limited Partnerships

In the first years of Terra, we were still heavily involved with limited partnerships and tax shelters. This experience in the early years of my career was a bitter lesson for me and transformed my understanding of risk. I began to understand that managing wealth means managing risk.

In my first years as an adviser, tax shelters (which took the form of limited partnerships) were a main focus of our business. Tax shelters are not even used anymore, but they were popular at that time because the tax structure was so different from the way it is now, and many investments were driven above all by the idea of saving on taxes. The extremely high tax rates meant that the potential tax deductions available from a limited partnership were worth far more in dollar terms than has ever been the case since, and the marketplace was filled with bogus opportunities. Clients primarily wanted to generate deductions; if along the way they also made money on the investment, that was a bonus.

We worked hard to find the deals with some underlying economic sense and stressed the value of the underlying real estate investment rather than the tax shield. I would sell and my clients would buy real estate and leasing partnerships that would save them one or two tax dollars for every dollar they invested. With the highest marginal tax rate at 70 percent, that seemed to be reasonable.

I believed the promoters of these deals, who claimed that they still made sense despite egregiously high fees charged to investors. I wanted to believe this was in the best interests of my clients. After all, my clients wanted to save on taxes, and if I did not sell them these products, I figured they would just go buy them elsewhere.

The people who sold these limited partnerships appeared to be smart, savvy, and sophisticated. Unlike many of the other broker-dealers at the time, we spent many hours doing our own due diligence[1] on the real estate partnerships we sold, visiting the actual real estate property and kicking the bricks, so to speak. By 1984, program sponsors were becoming increasingly shady and less competent and we found ourselves rejecting most deals. I learned the hard way that the promoter, meaning the general partner, always made money, whether clients did or not. This took me many years to realize. Even at the time, some of the people we wanted to do business with gave us a bad feeling. I remember going to California to meet the general partners of one of the leading syndicators doing historic rehabs. This kind of deal was in big demand because of its investment tax credits, and the deals sold out in days. Since the person I was supposed to meet with was an hour late, I had time to walk around the office by myself and talk to people. Although I admired the pretty pictures of their deals hanging on the office walls, I discovered that no one had been there longer than six months and no one knew much of anything about real estate. They did, however, produce some of the best marketing materials I had ever seen. We decided not to sell their deals, and within a year or so they were bankrupt, along with all their partnerships.

It was becoming glaringly obvious to us that there were too many syndicators who would buy property at any price, with all the profit front-end loaded[2] as fees, and we stopped selling real estate tax shelters in 1984. That decision was difficult because the commissions were large and investors wanted to buy them. However, it turned out to have been one of our best calls. In 1986, Congress changed the law on the passive losses[3] that generated the income tax deductions that made these deals profitable—and made the change retroactive. In the end, the vast majority of syndicators and limited partnerships, along with the independent broker-dealers working with those deals, went broke.

By contrast, we were well on our way by 1986 with mutual funds, insurance, and financial planning. We made plenty of mistakes along the way but we had dodged a big bullet, partly by putting our clients' interests ahead of our own. I still believe that most brokers and broker-dealers knew the deals they were selling were not in their clients' best interests, but they were making so much money they sold them anyway. This was not the finest hour of the financial services industry.

Many of these deals failed and some of my clients lost money, despite the thorough due diligence I thought I had done, as well as my good intentions. I was devastated. I lost clients and harmed my reputation. I should have tried to talk my clients out of buying those products. If they had insisted, I should have sent them elsewhere. It was a terribly hard lesson to learn because, for that client, you will never regain credibility. We had believed these were appropriate investments, but they weren't.

As a result, I promised myself that I would never fall into this trap again, that I would never sell products unless they were transparent. Apparently not everyone took this bitter lesson to heart the way I did.

But let me be clear on this: When I say we dodged that bullet, it was the bullet of business failure and bankruptcy. We stayed in business; we did not get sued; we did not get client complaints lodged against us with the regulatory authorities. We survived despite our naïveté about these deals.

But to this day, I am extremely wary of any so-called deal that does not have a sound, understandable economic basis. We realized relatively early on that if an investment is not liquid and transparent, it probably has some inherent problems. I am still wary when told that so-and-so is very smart and knows what he is doing and therefore I should just trust him.

In 2008, we saw not only the frauds and swindles—Bernie Madoff above all—but we also saw the results when individuals were sold investments that were fundamentally flawed. Unqualified people got mortgages; investors were sold derivatives and other securities that fell apart; high-flying hedge funds went out of business, taking their investors with them. I avoided all of it, both for myself and for my clients, because I had learned the hard way to invest only in transparent products that made fundamental economic sense.

Lesson 1

Avoid any investment you do not understand. If it is not liquid and transparent, walk away.

During the time that I have been writing this book, 2008 and 2009, I have congratulated myself a hundred times over that I learned this lesson so early on. It apparently was not possible to learn this essential lesson on Wall Street itself, where the Really Smart Guys were so busy spinning tales about the value and importance of the derivatives they were hawking that they apparently came to believe their own stories.

Evolution of Our Products

We set up our financial planning business model along the same lines we saw others using. A planner would charge $2,500 to write a financial plan for an individual. This seems counterintuitive to me now, but at that time the brand-new financial planning industry thought clients wanted such plans. We were not forging a new path; we were jumping on a bandwagon. That this kind of financial planning was not a brand-new idea could be seen by the amount of software that had already been created.

Although there were a number of different software packages to choose from, the software was primitive, and the output was voluminous and mostly boilerplate. Clients were required to supply large amounts of personal data about every aspect of their financial lives—data few individuals have at their fingertips. The plan with 80 or 90 pages was clumsy in the way it treated risk and did not really allow clients to interface with their advisers in the way they wanted. The client would turn pale at the sight of this massive document and say, "Just tell me what it says." Clients did not want to read the plan and absolutely did not want to pay $2,500.

Lesson 2

Clients want a prescription, like what they would get from a doctor. Assign them one task at a time

We realized very quickly that clients were not going to pay for that kind of advice and detail, and time has proven us right. What they wanted was a one-page summary. If you give a client six things to do, he will do nothing. You have to start by assigning only the first task. As we were to learn, clients want one-on-one communication, concise written plans, and access to an adviser when they need one. Clients also want wisdom, which means having the life experience to offer advice along with wide enough client experience to have seen what works and what doesn't.

Terra Introduces Mutual Funds

We also decided to start selling mutual funds. I cannot take credit for this decision but it was prescient. An interesting side note to this decision was the now-famous cover story *BusinessWeek* ran in 1981 proclaiming the death of equities after 20 years of dismal returns. This was one of my earliest experiences in seeing the disconnect between what the financial media trumpeted and what was really happening in the markets. This declaration was made at the very beginning of the greatest bull market the United States has ever seen. I was starting to understand that when the financial press declares which investments you should avoid, it is probably a good time to buy them. It also worked the other way: When the press tells you what to buy, run the other way.

Lesson 3

Take the advice of the financial press at your own risk.

Selling mutual funds was the new frontier. There was no Morningstar or any other popular or comprehensive place to go to do in-depth research on mutual funds, and not many mutual funds to choose from. In 1980, there were about 500 mutual funds in existence.[4] The Dow Jones Industrial Average broke through 1,000 in 1982 as the bull market began, and by 1983 there were 1,000 mutual funds.[5] Investors today will be surprised to learn that doing a mutual fund presentation at that time required first explaining what a stock was, then what a bond was and how it was different from a stock, and then what a mutual fund was.

At that time, you expected your client to buy one or two funds. The fund companies put out lackluster marketing materials that did not really help my clients understand what a mutual fund was nor why they should buy a mutual fund at all, or one rather than another. Today we would not recognize the mutual fund names used then, such as equity income, capital appreciation, large-blend, and growth and income. We looked for funds with long track records, and there were not many of those. Almost all mutual funds came with front-end sales loads; one of the most recognizable names was Templeton, which started in the 1950s and was well-known among brokers for its 8 percent load.[6]

The way we sold mutual funds was different then because clients had little access to current, in-depth information about investments in this pre-Internet world. We would say to our clients, "Buy this particular fund and don't worry about it for four or five years." Clients had little choice but to go along with that, since they did not want to change investments and have to pay another load. This proved to be relatively successful, since clients could not look on the Internet every night to determine if they were going to eat dog food or could go on vacation due to the change in value of their investment portfolio. In retrospect, I have realized that having too much information does not necessarily lead to being able to make better investment decisions.

Lesson 4

Unlimited information leads to analysis paralysis and emotional decision-making.

My goal for my clients was to grow their money as fast as possible. While we did not see ourselves as stockbrokers, especially the kind of stockbrokers who would call clients every week with a new investment idea, we assumed that the greatest value we brought to our clients was the return we could help them earn on their investments. Our challenging mission at that time was to get people to invest in mutual fund equities versus bank CDs. We were competing with the Wall Street wirehouses like Merrill Lynch and Smith Barney who said they were smarter and better than anyone else and were thus best positioned to make money for their clients. How could we compete with that? We were independent, but of course we wanted to make money for our clients. We wanted to pick good mutual funds and get a good return. We came to understand later that this was a misplaced value proposition because it did not account for the notion of risk, but that is what we believed in the early 1980s. Our value proposition as a company was searching for the smart people who would help our clients earn a high return on their investments.

As I mentioned in the Introduction, I was a Certified Financial Planner (CFP) and a Personal Financial Specialist (PFS). One of the ironies about being a financial adviser in the United States is that, legally, a securities license is all you need to provide investment advice to the public. Having a securities license means only that a person understands the most basic elements of financial products and regulation; it certainly does not mean that an individual is really and truly competent to offer investment advice. Given my growing interest in helping my clients and advising them in their financial and legal affairs, I always felt it was extremely important to gain all the real education, qualifications, and credentials possible. My personal value proposition was my commitment to obtain the knowledge and credentials necessary to be able to offer my clients the best advice available.

Introducing Asset Allocation

In 1984, I attended another IAFP conference. There were fewer weirdo tax shelters, a few more mutual fund representatives, and something that was really a new and unfamiliar idea at that time, both in the marketplace and to me: a presentation on asset allocation. As soon as you stopped to think about it, the idea of asset allocation made inherent, intuitive sense—it was as simple as not putting all your eggs in one basket, in case something happened to that one basket. For the first time, I was thinking about more than just the investment *return*. I was also thinking about how to protect that return and manage its *risk*. I thought that one way to do that was to divide the investment into several amounts that could be invested separately. That would be the equivalent of taking a dozen eggs and putting them into four or more different baskets, in order to protect the overall investment from risk. From an investment perspective, of course, there was much more involved.

Using asset allocation to manage risk is one of the overriding themes of my investment career. Later in this book, especially Chapters 5 and 6, I take up that topic at length. What follows here is the short explanation, for the sake of this narrative.

Using *asset allocation* means investing your money in different asset classes. An asset class is composed of a number of different securities that have the same risk/reward characteristics in the marketplace. Investing your money in several different securities that in fact belong to the same asset class—such as buying several different 10-year bonds, or several different large-cap stocks—does not accomplish the diversification you are seeking when you decide to use asset allocation.

There seemed to be a real science about it, and I was determined to use the new software to create the best allocations possible—to find the optimal way to combine assets to get the highest overall performance for the lowest risk. I was enthusiastic about the idea of asset allocation and diversification, but I had to figure out for myself how to implement these complex ideas. I bought one of the earliest asset allocation optimization programs and got started with an IBM PC 286, the one with the glowing green screen. The idea of asset allocation optimization, of course, is to find the *optimal* asset allocation.

The Importance of Risk

I was gradually starting to understand that the concept of risk is essential to any discussion about asset allocation, and that money management is concerned with risk as much as return. The commonsense understanding that it is risky to invest in only one or two securities, or even in only one or two asset classes, leads to the question of how many different kinds of investments should be combined together to create less risk for the client. What constitutes a different kind of investment? Does that mean two different stocks or two different mutual funds? We will come back to these questions.

I wanted to understand these issues so I could answer this kind of question for myself and for my clients. Each asset class has a set of characteristics as well as a history of performance. Performance is defined both by the potential increase in value, or *return*, and by the *risk* of the asset class. Defining market risk is one of those questions that has occupied market participants and academics alike for a long time. There are plenty of different kinds of risk that I can imagine but not quantify. The marketplace has come to define risk as *volatility*, because using a measure that is not totally satisfactory is better than not having any measure at all. Volatility in turn is measured by *standard deviation*, which is a statistical measure.

When I look back now at what I was trying to do, I marvel that I accomplished anything at all. In the rarefied air of the financial world, asset allocation is a very sophisticated concept. There are several generations of difference between the kind of analysis that can be run now and what I was doing with primitive software and a ridiculously underpowered IBM 286 to run it. But for us, it was pure revelation. It gave us a starting point for making an intelligent decision about asset allocation. We felt ourselves to be on the cutting edge of the financial world.

There was no training; I learned through trial and error how to make the asset allocation program run. Using my IBM 286, I had to plug in my own data manually. Each asset class required three all-important pieces of information: *historical return* (how the asset class had performed in the past), *expected return* (how I expected it to perform in the future), and *standard deviation* (as defined above, standard deviation represents the volatility of the asset class in the marketplace, and that volatility provides a measure of risk). I could get the historical return and standard deviation from industry data. Then the software asked me to provide the *expected return* of the asset class, the return that I thought the mutual fund or index would provide in the future. Asking me to predict the future return for the asset class was like asking me to look into a crystal ball; if I could predict future performance, I would spend my time investing my own money and making a fortune, not trying to manage other people's money. I ended up using historical return for expected return. It made sense to me that a particular asset class would continue to perform in the future in a way that was similar to how it had performed in the past, although you have all seen the warnings the regulatory authorities require on any prospectus or any discussion about a security: "Past performance is no guarantee of future results." But it can be a starting point or a proxy.

At that time, I had four or five different asset classes: U.S. large-capitalization stocks (U.S. large-cap), small-capitalization stocks (small-cap), bonds, a dash of international stocks, and some REITS.[7] I entered all my data, told the software to run, stared at the screen, and then realized it was going to take a really long time to produce an answer. I would go to lunch, go shopping, run some errands. At some point the program would stop and recommend an allocation or a series of allocations, each one depending on the amount of risk the investor wanted to take.

Implementing Asset Allocation

Meanwhile, while I was trying to develop asset allocation methodology, we at Terra were constantly searching for the best mutual funds for our clients. It was the same then as it is now. We would visit the fund companies and listen to the fund managers tell us why they thought they had a *model* (meaning a model investment strategy by which to manage investors' money) that would provide our clients with a good investment experience. We listened to some very smart people, but sometimes the actual investments just did not work out.

For example, take one of our early experiences with the managers of bond funds. In the early 1980s, the extraordinarily high level of interest rates resulted in unprecedentedly high bond returns. The bond managers assured us that the high interest rates on bonds meant that a retiree should be invested in almost all bonds. In general, the low volatility of shorter-term bonds can help reduce the overall volatility of most portfolios. But longer-term bonds, like 20- or 30-year bonds, in fact do have significant volatility, especially in that interest rate environment. The bond managers kept insisting that they knew how to manage volatility and tried to tell us that it was almost a free ride. They would say, "I can get you high yield on a long bond but don't worry about the volatility."

But I have real-life clients. How could I recommend a highly volatile investment to a retired person, despite the high yield that seemed attractive? I did not want to go with bonds only, and yet stocks are supposed to be even more volatile than bonds. How do you balance the risk of highly volatile long-term bonds with the normal risk of equities in a way that makes sense? I had been in the business for only a few years and I had no other reference point. This is where the software program came in, because I needed something analytical to provide some justification for the allocations we recommended. Working with a software program seemed like a very reasonable approach.

But now I had the opium of believing that if I just put everything into this black box—which is how I thought about the asset allocation software in my IBM 286, or maybe I was up to a 386 by now—it would give me the ultimate right answer about which mutual funds to buy to get my clients the best return and manage investment risk besides. I heard the word *optimize* and thought it must be idiot-proof, although I already knew that the software had flaws. You put in the correct data and got the correct allocation—presuming, of course, that there was such a thing as correct data and a correct allocation. To enter correct data meant to provide an *expected* return for each asset class—expected in the *future*. As I already mentioned, that meant I had to have an opinion about the asset class's future performance. I found that if I changed the expected return by even half of a percentage point, the resulting asset allocation would be totally different. In other words, expected return is only a guess, and changing a guess by a small amount seemed to skew the asset allocation significantly. We had to use mutual fund data to represent asset classes, because only mutual funds had data on past performance, both returns and standard deviation. Besides, what else could we use? The idea of an index fund was far in the future, and this asset allocation would certainly not work with individual stocks and bonds.

Once again, I was just going along with the mainstream, and it was better than nothing: I can see that I was dealing with the right issues and asking the right questions. Nevertheless, we were already seeing that there were flaws. I attended an Ibbotson conference in the late 1980s and learned that you had to use asset classes, not mutual funds, for this kind of asset allocation. (Roger Ibbotson founded Ibbotson Associates; he was one of the earliest proponents of asset allocation.) Normal mutual funds were *not* asset classes because they almost always combined more than one asset class.

Talk about an "aha!" moment for me! I realized that a balanced fund would hold both stocks and bonds. A large-cap manager would also buy mid-caps. An equity-income fund would buy stocks of any size as long as they paid dividends, and so on. What asset class did an equity income fund represent? You had to start with indexes such as the S&P 500 or international equities to figure out how much you needed of each asset class. Once you figured that out, then you had to figure out which mutual fund best represented that index or asset class.