Perspective

The Real Cost of Low Investment Fees or

Is There A Cheap Doctor in the House?

Thomas Schneeweis

March, 2020

Sometimes cheaper is just that cheaper, but cheaper is not always better.

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The Real Cost of Low Investment Fees

Every time I pick up a financial newspaper or look at a financial site on the internet, I cannot help but see a new article advising investors on the benefits of various low fee index investments and the evil of higher fee active management products. Generally this article is sandwiched between other articles which point out that active managers over some historical time period have failed to beat the comparable low fee income product. The authors of these articles criticizing higher fee products must feel particularly bad. Despite their repeated efforts to inform the public, many investors often continue to purchase actively managed products from managers whose fees are often considerably higher than the low fee passive index alternative. How could this be so? Are all investors just stupid? Why pay these managers their pound of flesh?

It is not the purpose of this article, to point out the obvious; that is, perhaps the investor is actually getting something from the active manager that he or she is not getting from the lower fee passive alternative. The obvious case is that a low cost index fund often is not the same as the higher cost alternative just as the lower cost actively managed fund may be fundamentally different in some ways form the higher cost comparative product. For instance, the passive index product may have little ability to change in light of changing economic conditions. Perhaps the inability of the lower cost active manager to dynamically change his style or emphasis is worth a few basis points, even if those opportunities are few and if current regulations restrict him from using his skills to change his strategy without extensive communication with his investors such that by the time he or she is capable of the change the chance for the change has already passed.

Ok what other benefits may a higher cost active manager offer? As I have often said, the principle problem with an index product is that (except in a few cases of index funds with greater active trading alternatives) will run itself into a wall rather than adjusting for the obvious. In some sense the fees you are paying your fund manager is like the fees on an out of the money put. In short a type of insurance payment for the dynamic hedging ability of the active manager (now I realize we could do this ourselves but my wife says I should paint the house instead). Since unexpected events should impact funds which specialize in small cap rather than large cap funds, one would expect that that insurance (and fees) should be higher for small cap funds than large cap funds. Of course one could buy one's own insurance (a real put) but the path-dependent insurance offered by the managers is often less costly than the one time puts and calls purchases by the investor and as pointed out previously I have to paint the house.

One could continue to give numerous other examples, but let us just say that active manager based funds differ from passive index funds in numerous ways including some potential insurance like options of which may have value and one should pay for them.

Few if any of these articles discuss the above points. Instead they focus on something called Alpha. Outside of the fact that almost no one has a clue on how that is defined or determined, let us just say that managers may charge for their services if they can offer net returns which are higher than the net returns of other similar products (e.g., low fee index products). Ok let's get the point out now. I do not care and you should not care how much your manager makes as long as he or she offers you a net return higher that a similar (in all aspects; that is see above discussion on options) than the similar index product or lower cost active manager product. If that manager can earn gross returns higher than the net returns of the similar product then they should have the right to charge up to an amount that equates the two returns. Now if fact, they may charge you less just to keep you with them rather than the lower fee product, but that difference is up to you and him and surely not the writers of various Bloomberg or P&I columns.

But we continue. Does Alpha exist? At the gross level of course. One would expect that a manager who pays for the Bloomberg machine, hordes of reports, analysts, compliance officers, planes, trains ….had access to information that the index or lower fee active manager creator does not, and should make a higher gross return. I expect Goldman Sachs to have more information than I have in a trade. I expect their gross return to be higher than mine. After costs, I expect the difference between us to be smaller (my costs are the costs of coffee at Starbucks and use their internet to trade). The issue is if are the fees offsetting the before cost 'Gross Alpha'?

In addition, he or she may also wish to know if my manager is charging one for the cost of his operations and information and a reasonable return on his personal efforts. I may have little right to demand that he give me a higher net return Alpha by lowering his costs, but I can ask. Let' s get this straight a 1% and 20% hedge fund managers is not making 1% and 20%. Much of that goes into the cost of operations. I dare anyone to manage a high quality equity fund for less than three to five million dollars. Even if one has a $500,000,000 under management, if one goes through a period of low excess performance, one is just covering costs with a little on the side for the managing partners. One can always complain that the actual return to a manager in the best cases are beyond what is reasonable, but who is to decide what that is. Again only net returns matter. One should not begrudge Tom Brady his twenty million as long as you get yours. Forcing a manager (or a Tom Brady) to deflate his fees or reduce operational costs (or the football) may lead to results you will not like.

I presume one could pass laws which encourage investors to place their money with the lowest price alternative (sorry I forgot that in regard to 401 K that is what we are trying to do). Just beware that not all alternatives are equal. I never seen a person walk into a hospital and ask for the lowest cost doctor (Oh I forgot that is what the government wants us to do). The simple truth is sometimes better doctors, better academics, better managers simply cost more because they do more and after considering all the costs they are simply worth it. I often wonder if the publications or authors which or who are so concerned with my net returns have ever done a test to see if the cost of their publication or services (with news that is often, at best, 6-12 hours dated) has a positive net return to me the investor or if they suddenly did find a real continuous source of valued information would not increase their price to capture that value. I think I know the answer. Sometimes cheaper is just that cheaper, but cheaper is not always better.

Perspective

The Importance of Education (And the CAIA) in the New Financial World

Thomas Schneeweis

June 2020

If anything is obvious from the recent economic events, are those words – Change, Knowledge, Retool…" are now going to be the focal point of this and the next generation. If the World is Flat how to I make sure that I stand a little taller than the rest. If I cannot forecast a 'Black Swan' how to I take advantage of the market suddenly coming aware of its existence.

In class (yes at times I still teach) – I try to get two primary points across to all of my students – First of all it is knowing about the process of education that is as important of education itself – Look at your textbooks, 2008 copyright (8th edition) – written in 2006 based on academic articles published in 2004 which were written in 2002 based on data ending in 2000. In short, textbook knowledge is almost ten years out of date by the time you read it. Second, what you learn today may not be of direct importance in your current world, but could be in many "of the parallel universes". What you want from education is as many 'relatively costless' options in your backpack; ready to be taken out when needed. Survival in the long run is based on knowledge and chance – But chance opportunities without knowledge provide no basis for taking advantage of the optionality in chance.

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The Importance of Education (And the CAIA) in the New Financial World

For many, recent events have refocused us on the importance of alternative investments and their impact on financial markets in particular and the economy at large. Both in the public press, industry reports, and academic research, questions are being raised as to the fundamental basis for a wide range of alternative investments and their place in the modern investor's portfolio. Often one reads or hears that many alternative investments (hedge fund, commodity investments, private equity….) are simply too risky or too complicated for either the individual or institutional investor.

As a co-founder of The Chartered Alternative Investment Association, it may seem a bit self serving to provide my summary observations on the importance of alternative investments or on the role of education in understanding better the role of alternative investments in today's financial world. One could of course, simply roll out many of the 'time worn' clichés' as to the importance of understanding better those areas that are vital to one's personal education or job training. Many of us have stalled in traffic behind the sticker – If you think knowledge is expensive try ignorance. Ok I get it. Now Move On. Well we all did. What we did not do was take the time nor the opportunity of reading the other bumper sticker – The Only Constant is Change.

When I graduated from college (along with Thomas Jefferson, Benjamin Franklin and the gang) one of my cohorts sat with me, thanking the heavens that he would not have to read another book or article the rest of his life. Several years later I had him in my MBA class as he attempted to retool himself.

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If anything is obvious from the recent economic events, are those words – Change, Knowledge, Retool…" are now going to be the focal point of this and the next generation. If the World is Flat how to I make sure that I stand a little taller than the rest. If I cannot forecast a 'Black Swan' how to I take advantage of the market suddenly becoming aware of its existence. In class (yes at times I still teach) – I try to get two primary points across to all of my students – First of all it is knowing about the process of education that is as important of education itself – Look at your textbooks 2008 copyright (8^{th} edition) – written in 2006 based on academic articles published in 2004 which were written in 2002 based on data ending in 2000. In short, textbook knowledge is almost ten years out of date by the time you read it. Second, what you learn today may not be of direct importance in your current world, but could be in many "of the parallel universes". What you want from education is as many 'relatively costless' options in your backpack; ready to be taken out when needed. Survival in the long run is based on knowledge and chance – But chance opportunities without knowledge provide no basis for taking advantage of the optionality in chance.

As for those who know me, it has taken a long time to get to the point; that is, the importance of education in the Alternative Investments and the role that CAIA in obtaining that knowledge.

First: The CAIA was created to offer a means by which 'a body of knowledge' could be reviewed by both academic and practitioners and made available in a consistent and timely fashion. The CAIA is a non-profit educational enterprise. It has no – I repeat no- direct corporate funding. The CAIA was in part the outgrowth of the realization that academic investment textbooks fail to fundamentally offer current and timely knowledge as to the

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underlying characteristics of alternative investments and their role in the modern financial world – In most investment books – alternatives are considered primarily gold, silver and your mother's antiques. Second, that practitioners also failed in their role as educators. As long as ten years ago, I and others wrote in the Journal of Alternative Investments that hedge funds were not 'absolute return vehicles' and were impacted by the same market factors as traditional stocks and bonds. In addition - many hedge funds do not hedge – many hedge funds hold little or no leverage – that historical private equity returns are often 'accounting' rather than market based - hedge funds are more of a "legal structure' than a single strategy – that our current measures of 'Alpha" are totally misunderstood. Many current measures of alpha are merely measures of 'excess returns' and are not necessarily evidence of skill but the ability to provide expected returns not easily available in other forms of investment. In short, the knowledge is there, the CAIA provides the avenue for that knowledge.

Second: The CAIA was created to reduce the perception that many alternative investment strategies are simply too complex to be understood by even the most educated investors – That is; alternative investments are black boxes. Lack of understanding is more of a lack of desire to educate oneself as the basics of an investment strategy than the inability to do so. Moreover, if knowledge is the lock that must be broken, then the CAIA provides the key. To the less informed, I am sure that alternatives seem like magic. As one who performs the show every day, I can assure you that it is not. I can also assure you that no CAIA graduate does not know what is happening behind the curtain - that historical data is just that historical – that 'Simple' VAR is for 'Simple'tons – that in times of crisis (especially credit crises) all assets may fall together -

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that the ratings that ratings agencies give are often poor if not worthless as measures of market or price sensitivity.

Lastly, The CAIA is not the fount of all wisdom. The CAIA emphasizes a limited but important part of the investment world; that is, alternative investments. Other professional organizations (CFA, IAFE) offer additional avenues for education in traditional asset markets as well as risk management. As CAIA does not provide detailed background on traditional asset management or risk management, those organizations cannot and do not provide detailed information on alternative investment management. What these organizations have in common with CAIA is their long term commitment to knowledge and education. Many other 'for profit' educational ventures (online or otherwise) offer the teacher of the week – or the just fired executive to provide the educational experience. While these courses have their place, they do not and cannot provide the overall perspective, consistency or honesty required by a professional certification. The goal of education is to change when change is required and to remain steadfast in our adherence to always asking ourselves if we are providing the 'state of the art' as to our current understanding of the markets. The CAIA has been, is and will continue to be the standard by which our level of understanding of alternative markets can be judged. With the understanding that this is an every changing standard – I look forward to having all potential members join me in this quest – I hate to remind myself that just as – Ignorance of the Law is NO Excuse – When working with investors, lack of knowledge of the basic truths of alternatives is NOT either.

Here it is looking forward to you being continually educated and reeducated in an ever changing world. Remember if it were simple, they could just hire a monkey and feed it bananas.

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Perspective

Figures Don't Lie Especially A Really "Good Looking" Figure

Thomas Schneeweis

September 2020

Many individuals with less often feel abused or taken advantage of. In short, why should they have so much when I have so little. Here we discuss who should pay and what they should pay.

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Figures Don't Lie Especially A Really "Good Looking" Figure

In recent months the question of the benefits of increased income and wealth transfer has seen renewed interest. Some government officials have proposed a 70% tax on incomes over $1,000,000 while others have supported an increased wealth taxes on individuals with a net worth of over $10,000.000. Here is the issue. As has been said "Talk is easy but actions cost money". More importantly, there exists a large segment of Americans who feel they are not in line for or have been excluded from the American Dream.

Why not $250,00 for a household and $1,000,000 in net Worth. If it is right for the upper 2% why not they upper 20% and if 70% of income or 50% of net worth is not enough why not 100%. Now to be honest since above the plans target individuals that do not cover most individuals. Now I have retired. So since I am or will soon be in the getting more faction I am benefited by income and wealth transfer. But I understand the problem. So I adhere to the Story of Socialism when an individual is asked if they supported anyone with 20 goats to give half of them to those with no goats, he said yes. Did he support sharing 10 goats, he said "Yes". Did he support sharing 2 goats? He said "No". "Why?" he was asked. "Because I have 2 goats", he answered. Any rational person would like to get more than they give, as long as there is no major cost or impact to society or in fact themselves.

OK, no one cares for any of the above. Many individuals with less stuff feel abused or taken advantage of. In short, "Why should they have so much when I have so little". Ok away with the Rights and Wrongs of Wealth differentials, if we proceed with income and wealth redistribution that really affect Americans (100% of all household income above $250,000 for a household) and 100% of all net worth above $1,000,000 for a household).

1. From Wikipedia, Annual U.S. budget (Approximately 5 Trillion).

2. From Wikipedia: the number of households with an income over $250,000 is 3757 (in thousands) with a mean income of $400,000. In short if one had a 100% tax on all households

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with more than $250,000 one would only receive $1.5 Trillion or less than three months of the budget and would only cover this year's deficit which is expected to rise (1 trillion). millionaires would only fund government for less than ½ a year. The current annual U.S. budget is near 4 trillion a year. In short, taking all the money would not offer new services to others unless one were willing to keep the deficient at current and future levels.

3. Wealth transfer: Okay if taking all the money from individuals with greater than $250,000 does not do it what if we take all the money from individuals with a Net worth of more than Let us Say $10,000,000 (That is everything, house, land, savings, jewelry …). There are approximately 15,000,000 households or one would get almost $15 trillion. But that is a one time gain and would only cover three years of the current budget and less than seven years of the future deficit. Even worse if one passed this law the net worth of the above $1,000,000 would collapses as individuals had to sell all or transfer it to the U.S. Who would it sell it to and no one would ever act to have a net worth above $10,00000 in the future. (The money that the U.S. gains form a 100% wealth tax decline dramatically as one raises the level).

4. In short, the lower income households deserve basic levels – but who are the poor (e.g., less than 25,000 with kids or without), what services (free college or just trade school – how much and where and what if colleges or trade schools increase tuition since someone else (government thus the taxpayer) pay for it – by the way this happens – costs go up if the government provides it). even if one did the above please read Wikipedia – certain states get more while certain states loose more so if certain individuals in certain states want current levels of services state income taxes would have to rise to meet current needs (by the way: Minnesota is one of them – Sorry).

Ok there we have it, 100% of all income above $250,000 for a household, 100% of all net worth above $1,000,000) has little impact on paying for long term U.S. budget or budget deficit. Even if one believes there is no impact on U.S. Growth or Asset Values. U.S. citizens deserve

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better plans (grow real income by education, efficiency). Plans have impacts, show me the numbers not just the word of mouth. In short, full transparency required.

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Perspective

The Life and Times of Upper-Class White Males in a Politically Correct Society

Thomas Schneeweis

December, 2020

This article is not only an opportunity to reflect on a world in which many individuals are not born into but to put those on notice that those who are given this opportunity do not give it up easily. Again, the white male preppie is well trained and if one wishes to enter their world one must, at the least, be both aware of this training and if necessary to become skilled in the very traits that enable those born there not be disposed of their "fortunate standing".

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The Preppie Perspective

An introduction to a book that in today's politically correct atmosphere would regard as totally offensive is by itself an indication of how little most individuals understand of the place or the importance of Upper-Class White males in today's society or how they have reached this position. This book is written without prejudice to race, religion, belief structure or any other ism's that one may wish to create out of thin air. How can this be so? Simply put, as one of my students who on the phone said I was obviously prejudice to which I responded that could be true if I knew or cared who you were (I never attempted to know any of my students names, sex or race or being able to associate any of the aforementioned with who in fact they were). If one has enough resources to braced oneself from the slings and arrows of both outrageous misfortunate fortune as well as those which are purposely aimed at you then one is able to live a life in which one's interaction with individuals is not clouded by personal misgivings but hopefully would reflect an honest appraisal of that individual's worth (unfortunately that worth may be less associated with the actual character of that individual but more on how that individual fits into one's ability to insure ones current and future position in society).

The reason for this previous paragraph is that it reflects the central story of "growing up Upper Class White Male" that is, one is from a very young age focused on the simple fact that being on top of the pyramid is better than finding oneself at the bottom. The rest of one's life is a series of actions that ensure that the position that you were born into does not shift. In short do

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not screw it up. This is not as easy as it sounds or reads. There are a myriad ways to screw it up and insuring that one creates a set of skills to reduce the “screw up factor” is a central focus of the Upper-Class White Male.

This article is not only an opportunity to reflect on a world in which many individuals are not born into but to put those on notice that those who are given this opportunity do not give it up easily. Again, the white male preppie is well trained and if one wishes to enter their world one must, at the least, be both aware of this training and if necessary to become skilled in the very traits that enable those born there not be disposed of their “fortunate standing”.

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