



Game On!

By Lance Paddock

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The following is in response to Dave Loeper's article, [No Shell Game? Then What Is It?](#), which appeared last week. That article was in response to Roger Schreiner's article, [It's No Shell Game](#), which appeared on March 2, and is part of an ongoing exchange between Mr. Loeper and Mr. Schreiner. The exchange began with Mr. Schreiner's February 16 article, [The \\$100,000 Challenge to Passive Managers](#), and was followed on February 23 by Mr. Loeper's article, [The \\$2 Million Charity Challenge to Active Investors](#).

Dear Editor,

I read with amusement Dave Loeper's response to Mr. Schreiner. Mr. Loeper has written many interesting things over the years, and he may be doing a wonderful job for his clients, but he is being rather tendentious in his argument with Mr. Schreiner, and making some very puzzling assertions.

First, I heartily endorse his points about managing risk to client goals. But, being familiar with Mr. Schreiner as well, I have to ask: Who is he arguing with? Mr. Schreiner's strategies may well underperform in future years, but certainly he has made no statement that implies he feels that building a portfolio of strategies designed to meet client goals is not a good idea. Where in the realm of active management can it be said that it is not possible to manage in accordance with client goals?

He is also being tendentious in characterizing Mr. Schreiner's design of the contest. Mr. Loeper contends that his riskiest portfolio (the Growth portfolio) is not what he would recommend to his clients, and thus his use of it in his challenge would not be the proper choice for comparison. However, Mr. Schreiner has said a challenger like Mr. Loeper can choose the assets that Schreiner invests in. It would be quite possible for Mr. Loeper to propose his conservative portfolio for Mr. Schreiner to compete against, with a stiff requirement that Mr. Schreiner have both higher returns and lower risk. I say game on.

As for his complaint that the deck is stacked in a way that Mr. Schreiner can game, that is also tendentious. Nothing in Mr. Schreiner's approach suggests he would engage in the types of rigging that Mr. Loeper suggests. I also feel the complaint is irrelevant to the goals of the contest. Even if such gamesmanship



were used, it is not true that passive management could not win. Nor would it serve Mr. Schreiner's purpose, since the winning of the bet would be far outweighed by negative publicity, and such easily identified tactics would not demonstrate what he is trying to prove. In fact, they would make Mr. Loeper's point instead.

Such tactics on Mr. Schreiner's part, then, would constitute a win-win for Mr. Loeper should he take up the challenge. If he outperforms, he will certainly be able to crow about the victory. If Mr. Schreiner engages in such tactics and wins, Mr. Loeper can certainly point out that Mr. Schreiner is a disreputable fellow who doesn't have enough confidence in what he does to play straight. Once again, I say game on.

My puzzlement comes from Mr. Loeper's statements about the risk of underperformance. Underperform what? Hasn't Mr. Loeper been arguing that the benchmark is client life goals rather than "the market"? If that is the case, then the question is whether active strategies such as Mr. Schreiner's will be more successful in generating the necessary dollars to fulfill those goals. Obviously if one tracks the market, that manager cannot trail it by any significant amount, but he can trail client goals. The risk of underperforming *those* is exactly what is at issue. One can claim that Mr. Schreiner cannot control when he will "underperform" the market, but Mr. Loeper cannot control when the market underperforms client goals, a far more serious issue.

Managing to client goals is precisely why active management in various flavors may be appropriate. Rather than assuming returns over time, it seeks to add opportunities for return (or at least minimize losses) even when some markets cannot reasonably be expected to do so. Whether it succeeds is another question, but it is obviously also a question whether a passive investor can meet goals when markets are uncooperative.

Mr. Loeper mentions his conservative portfolio. Clients who cannot meet their goals over the long term with such meager returns might wonder about active approaches that have far exceeded those returns over the last ten years. Clients with more aggressive portfolios might really wonder why a passive approach is automatically considered less risky than those that have done far better.

Mr. Loeper, are you accurately (and clearly) exposing the risks of passive investing to your clients? When presenting your process to potential clients, do you say something along the lines of the following?

Mr. & Mrs. Client, my approach to investing your portfolio is about matching the underlying markets, which introduces no opportunity to outperform, but which does allow for the risk of not reaching the goals you



have set. Since your goals are different than other clients' and I'm attempting to manage your portfolio relative to your specific goals, I need to warn you ahead of time that I am at the mercy of the markets. Not only can I not outperform on average, but unfortunate timing of when markets do well or do not could end up reducing your wealth and compromising your goals. The approach I use costs less, has lower trading commissions and bid/ask spreads and will subject you to lower taxes than more active approaches. I do this for several reasons. First, I have no confidence that I add any value beyond designing a portfolio of diversified assets and hoping they perform similar to how they have in the past. Thus, I feel reducing all these other expenses is a way of adding enough to overcome periodic market failures. I'm hopeful that more of my clients will benefit than will be harmed, even though I do not know and cannot control which clients those will be. I hope you are one of the lucky ones. The second reason is that Harvard invests differently. And, despite their incredible performance over the long term and the vastly higher level of wealth you would have achieved if you had taken an appropriate-to-your-circumstances version of their approach, I will avoid mistakes like the one Harvard made with Bernie Madoff (see story in [The Harvard Crimson](#).)

Of course, I have major criticisms of Harvard's approach, and Yale's as well, but ironically, they stem from the passive nature and assumptions of both endowments, which are similar to Mr. Loeper's assumptions when it comes to more traditional sets of passive indexes. Yale and Harvard's mistake was to believe that holding certain assets and strategies in certain proportions could yield predictable long-term returns. They were dismissive of the idea that certain assets and strategies (whether active or passive) could be predictably unlikely to deliver the desired returns. Those with a similar approach to diversification, but a willingness to recognize that the risk premium of many asset classes had disappeared, did not suffer the losses they did in 2008.

Bringing up Madoff is unfair. The problem with Madoff wasn't his active approach, it was the gullibility of Harvard in not doing due diligence. Mr. Schreiner, whatever his skills are or are not, runs separate accounts that are transparent. I suggest Mr. Loeper avoid building straw men and tarring Mr. Schreiner with the likes of Mr. Madoff.

I also suggest Mr. Loeper is adding another layer of uncertainty with his argument about withdrawals and cash flows. The point about managing that issue is valid. Unfortunately, since the timing of underperformance of client objectives is unpredictable (though not nearly to the extent Mr. Loeper claims) regardless of whether one is active or passive, the best way to judge the issue in general is in terms of risk-adjusted returns. Draw-downs at inappropriate times are the problem, not underperformance of the market in general. Thus the



frequency and depth of draw-downs is the right metric, not whether by luck in this particular challenge they happen to fall at an inopportune time because of withdrawals for one approach or the other. Strategies that have fewer of those will outperform for clients who have cash flow needs over various time periods. Of course, if I adopted the tone of Mr. Loeper, I might suggest that adding a bit of randomness to the contest is what all underdogs like. However, I am not sure Mr. Loeper feels he is really the underdog. Whatever the case, risk-adjusted return is the proper metric for this type of analysis.

So, Mr. Loeper, choose the allocation of assets that you wish to compete with, and then let Mr. Schreiner take those same assets and manage them actively, whether it is 20% bonds or 80%, 5% REITS or 20%. Pick the timeframe you feel is most appropriate and have at it.

Game on!

Lance Paddock is CEO of Thompson Creek Wealth Advisors, a Louisiana-based Registered Investment Advisor.

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