THOUGHTS FROM THE FRONTLINE

The Real Cost of Low-Fee Fund

By John Mauldin | October 19, 2018

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Today, rather than tackle some big macroeconomic issue, we'll go back to this letter's roots and look at market timing and portfolio construction issues. I expect this will get both enthusiastic support and at the same time, make a number of readers uncomfortable—if not annoyed.

Why? Because I am going to take on a number of shibboleths many hold sacred and dear. But after a great deal of thought over the last few years, I've come to realize that all too often, and this includes myself, investment advisors and investors tend to "talk their book." We bring prejudices and biases into our portfolio construction, and then if it doesn't work, we just call it "bad luck." Let's jump in.

The Real Cost of Low-Fee Funds

I wrestled with the title for this letter because I could've substituted the word high or true or hidden for the word "real" in the headline and just as easily have described my thesis. Low-fee funds, used the way that they are generally used, have hidden costs investment advisors don't want to discuss and investors ignore.

Other things being equal, lower fee funds are better than higher fee funds which do the same thing. That is obvious. The total returns of lower fee funds over time are mathematically precise on this.

Yogi Berra, although he may not have been the first to say something similar, popularized the quote, "In theory, there is no difference between theory and practice. But in practice, there is." That also applies to low-fee funds.

If you are using an investment advisor, you pay advisory fees plus fund and custodial fees. If you are an individual investor running your own account, you are paying the fund fees plus the custodian or platform fees. It makes sense to pay as little as you can for those services.

If you use those low-fee index funds (like ETFs) as trading vehicles, that is particularly good advice. But that is not the way the vast majority of low-fee funds are used.

You Must Include Risk When Calculating Total Cost

Most low-fee funds are part of a "buy-and-hold" management strategy. Investment advisers say we are "investing for the long run," and diversify among low-fee funds in various asset classes and indexes. They trot out studies showing that over the long run, investors will average 8% or whatever.

And those are true statements, but most investors don't have the 40 or 50 years those studies were designed for and so have to experience the bear markets along with the bull markets. The studies can be misleading, too, depending on when they start. They generally don't tell you that the market can be in a bear cycle for 20 years before recovering.

That is all well and good in a bull market, but in a bear market, you are simply diversifying your losses. While it may be tax efficient, in a bear market, you simply end up with tax efficient losses.

We are now in one of the longest running bull markets in history. However, it is not clear if this bull market will continue for a few more years, roll over into a much larger correction, or maybe churn sideways for an extended time. No one knows the future.

But I do know this: We are eventually going to have a recession and the accompanying bear market will be brutal, as all bear markets are during recessions. I don't think there has been, at least that I can find, a serious bear market that doesn't accompany a recession. You can find corrections like 1987 or 1998 that weren't associated with recessions, but as we will see below, those should perhaps be treated differently.

I think the next recession will likely see a bear market loss of at least 40% if not 50%.

As I've demonstrated elsewhere, high total US debt means the recovery will be even slower this time. If you are over 55 or 60 years old, your "investing for the long run" could end up seriously impacting your retirement income. Or push your retirement off for years as you try to make up by saving what you lost in the bear market.

And the investment advisor or strategist who told you to use a buy-and-hold strategy will simply shrug it off and say something like, "I am sorry. But we can't predict the markets. It's just bad luck we had a recession and bear market."

That's because they did not disclose the true cost of your buy-and-hold strategy, and the hidden cost of your low-fee funds.

Sir John Templeton and a number of others teach us to remember that bear markets always follow bull markets and bull markets always follow bear markets. You should be anticipating the change and deciding what you'll do in advance.

Let's say you're down 50% after a 10-year bull run. The actual cost of that low-fee fund was 5% a year for the risk you took. Nowhere in the disclosures you will be reading is there any indication you should be budgeting for risk as part of the fees and true cost of that strategy.

If you add in 5% total cost to your low-fee system, all of a sudden, the costs seem pretty high. You would have never bought it knowing that you would pay 6% or more. But that is essentially what you did. Whether you are paying those fees incrementally or all at one time during the bear market, the results are the same. But the investment advisor will say the markets will come back and you will be okay. That may be reasonable advice if you are 30 years old, but not if you're 60 or 65.

You Must Have a Quantifiable Hedging Strategy

Bluntly, and this is going to anger a few people, in today's times and with our particular sophistication available to almost any investor, a buy-and-hold strategy without an appropriate hedging strategy is lazy. The next bear market is going to devastate pensions and retirement accounts for the vast majority of investors and pensioners in this country. And it can be avoided.

I argue that you should hedge by having a diversification of trading strategies. But that is just one of a half dozen different ways to hedge your portfolio. I was on a TV set with my friend David Tice (formerly of the Prudent Bear Fund), and his favorite way to hedge is simply buying put options for your portfolio. I know one manager running multiple billions of dollars that has been doing that for almost 20 years, and his total performance through a cycle simply outperforms any buy-and-hold strategy I've seen. He also underperforms during a bull market, as hedging costs real money. But when he makes money during a bear market, the real "cost" of his strategy is soon revealed.

If you are a smaller investor and can't get an investment advisor who can hedge for you, then simply use the 200-day moving average. When your funds drop below their 200-day moving average, exit to cash. If it's a real bear market, you will be in cash for the rest of the drop and then you will be able to buy back in closer to the bottom, and as their recovery begins (and there is always a recovery), you will be closer to your original capital position and able to continue to grow your portfolio.

But the important thing to do is to plan your hedging strategy in advance. It must be automatic and quantifiable. I know some people who only want to use the 200-day moving average after market close on the weekends because they don't want to be looking at their portfolio every day. I can't argue with that. Just do something to avoid the worst ravages of a bear market.

And recognize that you must have a risk budget. Risks and the losses that accompany them are part of the total cost of investing and managing money. I have my own preferred strategy that I use for client money, and regulators don't allow me to use the word "guarantee" very often, but I can guarantee you that my system will lose money at a minimum during the early stages of a true bear market. You can't participate in the market to whatever extent and not expect to take some losses. But we have quantifiable systems that know what to do and when to exit. Hopefully, we will avoid the worst ravages of a true bear market. Our philosophy is more of a "participate and protect" strategy.

But again, there are lots of ways to hedge a portfolio. If your investment advisor is not hedging you in some way, if you don't have a quantifiable strategy to protect against a serious downside move that is accompanied by recessions, then you need to get a new investment advisor. If you are managing your own money, you need to either get an investment advisor who can hedge your portfolio, or you need to have your own strategy. If you don't, then I predict you will not be happy with the results.

Risk is a cost to your portfolio that is not disclosed in the documents you get talking about the total fees you pay. The regulatory authorities are properly focused on having advisors and brokers disclose the total costs of their management to their clients. But nobody calculates the cost of risk. First off, it is unknowable. Will a bull market last for four years or eight years or 10 years or 12 years? No one knows. How deep will the bear market be? No one knows. So, it's very difficult to actually estimate a cost upon future facts that no one knows today.

That being said, I can tell you there is going to be a recession a bear market in the future. And it is going to exact tremendous cost upon your equity portfolios. Telling you exactly what that cost will be? I don't have a true clue except looking back in history, and that tells me losses of 40–50% (or more) are quite possible. Ugh.

This weekend, if you don't have one, at least begin to figure out what your hedging strategy for the future will be. There will come a day when you will be happy you did.

Where Is the Market Going?

I'm getting more questions at my speeches and in my inbox about whether I think we are entering into a bear market? The honest answer is I don't know. My particular management system doesn't really care as we have triggers that will move us out of the market or back into a market based upon various indicators that my underlying managers use. I trust their systems and I sleep at night, not worried about what my portfolio or the portfolio of my clients are doing.

But the question is still reasonable. And it allows a teaching moment. First, looking back in history, there are essentially two types of bear markets: those that happen in a recession and those that don't. Bear markets that happen accompanied by a recession generally are deeper and the recovery is much longer. Those that happen simply because the market had gone "too far, too fast" and seemingly needed a correction tend to be "V" shaped recoveries. Think 1987 or 1998.

Looking at the economy today, and absent a trigger from Italy/Europe or China (or worse, shooting ourselves in the foot with our China tariff policy) or some Black Swan, there is no true reason for a long-term bear market. The economy is in relatively good shape, and I don't see a reason for a recession to begin anytime soon, absent some trigger event.

That means if we did have a bear market correction, I would actually expect it to be "V" shaped and a very tradable exercise.

The market itself is showing signs of weakness. My friend Dave Wright points out that even during the large upward movement on Monday, the stocks on the NYSE made more new lows than it made new highs. That is not a healthy market. Dennis Gartman gives us this following graph:

Source: Dennis Gartman

Again, this is not the sign of a healthy market. All that being said, much of the correction came in the tech sector, especially the S&P. I'm not going to show a chart here, but if you had taken the technology stocks out of the S&P 500, we would've been in a downward market for quite some time. Technology clearly led the way in recent times.

It is very possible that we get into a "sector rotation" market and that we churn sideways for quite some time. It is just as possible that we see what normally bearish David Tice thinks will happen: That we are actually in danger of a market melt-up, which can happen for all manner of reasons. Let me give you a potential. Right now, the market and most commentators believe that Democrats will take the House in the midterm elections a few weeks from now. What happens if they don't? Could we see the same type of bullishness in the markets and sentiment that developed after Trump was elected?

I know my Democratic friends want to ignore it, but so many sentiment indicators are at all-time highs, and they've been getting that way since Trump was elected. Don't ask me to tell you the reason or discuss politics with you, I'm simply looking at the facts. And I think we all agree that sentiment does drive markets. But we need to remember that sentiment can turn on a dime.

Mastering the Market Cycle

Now let me give you some really good advice, one that I am confident will make you a better investor. One of the greatest investors of our times is Howard Marks of Oaktree Capital. He manages $122 billion and his quarterly letters are must-read. They are full of wisdom and insight. He is one of my investment and thought heroes. (He has graciously agreed to come to my conference in May next year.)

He has written a brilliant and extremely readable book called *Mastering the Market Cycle: Getting the Odds on Your Side*.

In interviews and other places, he basically says he thinks that 2018 is much like 2006. As he says, "Where we are in the market cycle shapes the probability distribution of returns that you face, and so it's worth trying to figure out where we are." This is from a man who wrote his famous memo, "Race to the Bottom" in 2007.

Whether you are a professional investment advisor or an individual investor, you really should get the book. It may very well be the most important thing you do for your investment portfolios this year. I can't say it any stronger than that. Other than to say, I wish I had written the book.

What Should You Do Now?

Okay, after you buy Howard's book and begin to create your own hedging system if you don't already have one, what should you do? Let me offer a brief personal advertisement.

Quickly, I advise on money for a variety of investors and professional investment advisors. The strategies I prefer are available in both a mutual fund and in managed accounts. Full disclosure, I have recently closed my own personal investment advisory firm down and moved my registration to my longtime friend Steve Blumenthal of CMG. As a personal strategy, he has all the infrastructure and team to support me, and it really does allow me to spend more time researching and reading and writing.

We have done a report called "Investing During the Great Reset," which explains our strategy and rationale. If nothing else, it will show you how I want to deal with the risk of a coming potential bear market and give you ideas for doing it yourself or in your own firm. Of course, I hope that some of you will become clients. But I am perfectly willing to help you whether you do or not. I want as many people as possible to get from where we are today to the other side of The Great Reset.

I should note, for investors who have a net worth of more than $1 million, there are additional opportunities to diversify your portfolio that we can talk about. I will be talking more about those in the future, but whether you are worth $25,000 or $250 million, I think this report will give you something to think about.

Puerto Rico, Frankfurt, and Here and There

Shane and I will go to Puerto Rico next week, then come back to Dallas for a few days before I catch a plane to Frankfurt where I will speak to a large group of institutional investors. I know I have a few other trips that aren't scheduled as yet, but they are clearly going to be in my future. And sometime in late December, Shane and I will end up in Cleveland for a long overdue full-day medical checkup. I understand Cleveland is wonderful to visit in December. I may be ready to go back to Puerto Rico after that trip just to warm up.

Winter and rain showed up in Texas beginning last Sunday. We had a norther come down bringing an enormous amount of rain along with it and drop temperatures into the uncomfortable area. Shane was complaining about it being cold before Halloween, which is not normally the case. David Tice and I were talking about how perfect the weather normally is prior to Halloween, and he remembers particularly in the last two years because he had to pay for two weddings which were outdoors.

I will be writing from Puerto Rico next week, or at least finishing up the letter. And with that, I will hit the send button. You have a great week. And think about how your portfolio is positioned for an uncertain future.

Your wanting to help you get to the other side of The Great Reset analyst,

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