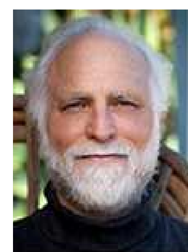
ADVISOR PERSPECTIVES

Comparing Advisors to Jim Cramer: Measuring your Professional Alpha

By Bob Veres
February 5, 2013


Bob Veres

Jim Cramer, Suze Orman and other so-called investment pundits and gurus are constantly telling consumers that they can do a great job of managing their portfolios on their own. Why pay a fee for professional asset management when you can turn on the TV and get Cramer's stock-picking expertise for free?

I've just learned that the Center for Financial Planning and Investment at California State University at Northridge is attempting to quantify the value of professional asset managers compared with nonprofessional do-it-yourselfers. As we wait 18 months for this paper to make its way into academic literature, let's look at what we already know.

Last week, Wade Pfau summarized research that suggested, among other things, that retirees who work with financial planners can get more mileage from their retirement portfolios – approximately 1.82% higher returns during retirement.

Let's look at what the research has to say about the various investment performance benefits that advisors should be able to give their clients during the accumulation phase of their lives– excess returns above what do-it-yourself investors could obtain on their own. I call those excess returns "professional alpha."

The biggest source of professional alpha

Let's start with investor return vs. investment return. Whenever I give presentations or moderate panels on new investment concepts, I start by telling the advisors in the audience that they're taking for granted the most significant tangible value that many of them provide to their clients. By keeping your clients steadily invested and stopping them from chasing hot funds or asset classes and from selling out at the bottom of bear markets, you virtually guarantee that they will beat the only benchmark that really matters: the returns they (and their peers) would achieve on their own.

Do-it-yourselfers often make poor decisions, as during the Tech Wreck bubble. At the recent American Institute of Certified Public Accountants (AICPFA) Personal Financial Planning Conference in Las Vegas, Carl Richards of the Buckingham Family of Financial Services pointed out that prior to the year 2000, the record net inflow into equity mutual

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funds had been $29 billion. That record was broken in January of 2000 ($46 billion in net inflows), and again in February ($54 billion) and March ($39 billion).

The tech bubble burst in March, meaning all those dollars were buying into the market at the best time to sell.

In 2002, a new record was established: It was the first time ever that there were five consecutive monthly outflows from equity mutual funds. The last of those months was October, which saw the market low – meaning all those dollars were flowing out at the best time to buy equities in more than a decade.

The aggregate numbers put actual returns to this anecdotal story. According to a Morningstar article, the average mutual fund gained a meager 3.18% a year during the decade ending Dec. 31, 2009. But the average mutual fund investor posted a gain roughly half as large: 1.68% a year. The discrepancy was especially high between U.S. equity fund performance (1.59% a year on average) and U.S. equity fund investor performance (0.22% a year).

The "aughts," of course, were an extraordinary decade. Looking at longer-term numbers, the Dalbar organization's most recent report showed that, for the 20 years ending Dec. 31, 2011, the S&P 500 averaged 7.81% a year, while the average equity fund investor earned a market return of 3.49%. Over the ten years ending on the same date, investors underperformed by 53 basis points a year; over the latest five years of the study, the difference was 1.96% a year.

Let's be conservative and assign a value of 2% to 4% a year over the long-term, fluctuating over different time periods, to the first source of "professional alpha" – the additional revenue gained when advisors keep their clients properly invested, especially during volatile markets.

The value of systematic rebalancing

Another source of professional alpha comes from systematic rebalancing. Professional advisors understand the importance of returning an investment portfolio to its target asset allocations, and they have the tools to make these changes to the portfolio regularly and sometimes opportunistically. You know how difficult this can be and how much rebalancing software costs. I think it's fair to assume that the person who is trading on Cramer's advice is probably not devoting full attention to rebalancing opportunities.

The most comprehensive report on the value of rebalancing can be found in the January 2008 issue of the *Journal of Financial Planning*. Gobind Daryanani, president of Digiqual, Inc. in New Jersey, looked at two important variables: the advisor's "tolerance band" (Do I

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rebalance whenever an asset moves more than 5% outside my target allocation? 10%? 20%?), and the advisor's "look interval" (Do I check if client portfolios have exceeded these tolerance bands every 60 trading days? 30? 10?). Altogether, he looked at 49 different rebalancing algorithms, with tolerances ranging from 0% to 100% and look intervals ranging from 250 trading days to daily.

The result? As you might expect, daily looks and 0% tolerances was not an ideal mixture when you factor in trading costs. In general, 0% tolerance was a bad idea. The sweet spot, interestingly, was relatively frequent look intervals combined with relatively wide tolerance bands, resulting in a lot of looks but not a lot of trades.

Based on market returns from 1992 through 2004, advisors who looked every 5 to 10 days and used rebalance bands of 20% or 25% generated what might be called a "rebalance alpha" of between .37% and .45% a year. Advisors who rebalanced every six months were able to add 30 to 36 basis points a year to client portfolios.

Quantifying the value of diversification

A third component of tangible value provided by professional investors comes from diversification. This is not an easy concept to standardize; to calculate the professional alpha, you have to know the client's current portfolio and how far it is from the efficient frontier.

But we can get a useful look at how much lay investors might be missing from an article by William Bernstein, who evaluated the "permanent portfolio" that was promoted by the late Harry Browne. The permanent portfolio was not complicated: funds were equally allocated to four asset classes: gold, stocks, long bonds and Treasury bills. This allocation puts clients in what many of us might describe as a defensive or fearful investment posture – which actually reflects the mood of the moment among those investors who are still looking over their shoulders for a repeat of 2008.

Using data from 1964 through 2009, Bernstein graphed the return of an idealized permanent portfolio using indices as proxies for each asset. Then he drew an efficient frontier, using the returns and standard deviations of large-market capitalization stocks, Treasury bills and long bonds. He found that the four-asset-class model provided lower returns by almost exactly 1% a year compared to the returns of a portfolio on the efficient frontier with the same standard deviation.

It is fair to add two additional components of advisor alpha to this part of the analysis. First, a professional advisor will help clients accept a less fearful portfolio mix, with a larger stock allocation and less gold, and help the client understand that the world is not and never has been in imminent danger of collapse. Taking on a very small amount of

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additional portfolio volatility could get the professionally advised investor at least 2% more return per year.

In addition, there is obvious room for improvement over the naive four-asset-class portfolio that Bernstein constructed for comparison purposes. Adding five or six more asset classes to the mix – which a professional investor would certainly do – probably would have resulted in an efficient frontier curve offering better long-term returns for similar risk, conservatively adding 25 to 50 basis points a year.

Somewhere between 1% and 2.5% a year, on average over time, is added to professional alpha through diversification. But the actual value for individual clients will vary greatly.

The biggest imponderable

Finally, let's see if we can tame the biggest imponderable of all the professional alpha calculations: the value of tax-aware investing. This has to be broken down into several components.

Tax-aware advisors will typically offset gains with losses in some systematic way, avoiding short-term gains and deferring capital gains as long as possible. The benefit will depend on the client's tax rate, and Congress doesn't make these calculations any easier when it changes the marginal and capital gains rates on a regular basis.

To date, I know of only one advisory firm that has carefully studied the tangible benefit of its tax management over time. Gary Miller, at Frontier Asset Management in Wyoming, has estimated that the difference between his tax-managed portfolios and the returns he would have achieved if he had ignored the tax consequences of his trades comes to between 50 and 100 basis points a year.

This is not a complete picture, however. Miller's firm does portfolio management for advisory firms, as an outsource provider, and therefore he doesn't make decisions on the location of different asset classes in taxable or tax-deferred portfolios. How much value can you squeeze out of deciding whether stocks, bonds, real estate and other assets will be placed in the client's taxable or tax-deferred accounts?

The best research I was able to find was conducted by Daryanani and Christopher Cordero of RegentAtlantic Capital in New Jersey. The study was quite elegant; it ranked 13 asset classes according to their long-term tax efficiency and created alternative rankings based on various marginal tax rates and capital gains rates. The least-efficient, highest-return asset classes (real estate, actively managed U.S. stock portfolios, absolute return funds and commodities) were prioritized as the first to be used to fill the client's IRA

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or other tax-deferred retirement vehicles. Meanwhile, individual stocks with long holding periods were prioritized for the taxable portfolio.

Daryanani and Cordero found that optimizing the asset locations had the potential to add approximately 20 basis points a year, after taxes, over a strategy where the advisor uses the same asset classes in taxable and IRA/tax deferred accounts.

Add the two, and professional attention to these tax details might be able to give the investor an average of between 70 and 170 additional basis points of return a year.

Can you beat Jim Cramer?

If we add up each of these components of professional alpha, using the most conservative assumptions in each case, they sum up to a remarkable 4% a year. Summing the higher figures, which may be more accurate for many *Advisor Perspectives* readers, gives you a figure north of 8% a year. And of course this assumes that you're getting market returns; it doesn't include any return improvement over the broad market indices that you might be providing.

But it also doesn't account for something that Pfau reported on last week: the chances that clients save more and plan more efficiently for their retirement when they work with a financial planner. Pfau cited a study by Terrance Martin and Michael Finke at Texas Tech University that strongly suggests that investors with plans set aside more of their income – which, of course, would raise the terminal value of their retirement portfolios.

We should use these figures with caution, since the actual professional alpha will depend on a client's actual returns and the actual returns of the advisor, plus individualized tax situations and risk profiles. But Pfau suggests a methodology that advisors can use internally to begin to quantify their value to their clients – in addition, of course, to any advice they provide about the client's financial life.

There are other possible ways to make these comparisons. One of the simplest is compare the performance of a professional investment advisor to that of an avid CNBC viewer who is busy scribbling down the recommendations that Jim screams every trading day. Cramer famously called the Great Recession market low in mid-July 2008 and advocated that viewers buy back into the markets – about two months before the worst stock market debacle since the Great Depression. Cramer recommended that viewers buy Bear Stearns at $118.20 per share on Aug. 17, 2007; the company no longer exists. He described Lehman Brothers as "a screaming buy" on Sept. 5, 2008, when the company was selling at $16 per share; the company filed for bankruptcy the same month. He also hyped Facebook before its initial public offering.

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Mark Hulbert has compared the overall performance of Cramer's Action Alerts with the Wilshire 5000 index for the calendar years 2009, 2010 and 2011. (You can find the chart here). Hulbert found that over the three-year period, Cramer's recommendations would have delivered an investment performance of roughly 9.9% a year – and this did *not* account for trading costs or tax obligations that accumulate when you're buying and selling 10 or 11 times a day. During the same time period, the Wilshire 5,000 index delivered an average annual return of 14.9%.

Here's the kicker. CX Advisory Group, which tallies the performance of 68 different investment "gurus," estimated that Cramer's stock recommendations have been right 47.4% of the time – he was slightly more often wrong than right. And if you look at the overall scores (you can find them here), Cramer came in at about the middle of the pack; in other words, he's representative of the group as a whole.

The most comprehensive analysis of Cramer's track record was done by a couple of finance professors at Northeastern University and was reported in an *Advisor Perspectives* article a few years ago. Using techniques that properly adjusted for the riskiness of Cramer's stock picks, they found that he was "harmless" – if you follow Cramer's advice, your performance would equal that of the market on a risk-adjusted basis.

Cramer and his cohorts offer their hyped-up stock picks ostensibly for free. Investing for retirement based on their advice, however, can be very costly. No evidence exists that they add value, while academic studies show that advisors indeed add professional alpha to retirement portfolios. When comparing professional management to the do-it-yourself investor who listens to the cable TV gurus, the excess returns north of 5% a year point you to the right answer.

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