



More Discipline, Less Drama.
Indexed ETF portfolios can protect against needless pitfalls

Index investing is boring. For many, buying and holding a diversified portfolio of low-cost, tax-efficient ETFs will never be as satisfying as picking specific stocks, money managers or hedge funds. It just doesn't have enough moving parts to make it interesting. There's no intrigue, no thrill. That's one view. But I couldn't disagree more. If 2008 taught us anything, it is that drama is overrated. Owning an index portfolio does not eliminate investment risk, but it can protect investors from many of the worst possible scenarios.

In a troubling market environment where protecting capital is now priority number one for many, indexing can be an investor's best friend. Of course indexing doesn't eliminate risk. And thankfully so. Investors welcome some kinds of risk. We *need* it. For the opportunity to earn positive returns, we accept risks related to interest rates, inflation, exchange rates and the specific economies and companies in which we invest. We acknowledge that we may suffer real pain and anxiety due to bursting bubbles, long recessions and plain bad luck. But risk is the price we pay for the opportunity to earn returns greater than Treasury bills.

So indexing can't eliminate all risks. But holding an index portfolio that is intentionally diverse – debt and equity, large and small, domestic and international, value and growth – can provide protection from a range of risks that most investors are not willing to endure:

Single-stock nightmares: Pick a toxic ticker symbol – LEH, AIG, C, BSC, FNM, WB, or GM – any one of the 2008 crisis stocks will do. Investors with material stakes in any of these bankrupt, bought-out or bailed-out companies took a stern beating in 2008. As these are, or were, large and widely held stocks, many index investors likely held stakes in some or all of these stocks. However, in a diversified ETF portfolio the exposure to any single stock's collapse would be relatively small. With indexing, diversification is built in; overall return is never driven by any single stock. And careful asset allocation across ETFs composed of diverse security types, industries and geographies further limits exposure to single-stock calamities.

Rogues: One brand of risk that few investors are willing to accept is the chance that a trusted broker, money manager, advisor or custodian will abandon fiduciary, regulatory and ethical standards for his or her own nefarious gain. Nonetheless, these risks exist, as we learned when the dreaded term "Ponzi scheme" poisoned the financial headlines last month.



Some commentators are asking how Bernard Madoff's longtime Ponzi charade went undiscovered by regulators. I think this is the wrong question. I'd like to know how investors saw fit to invest with Madoff without asking enough questions to, at minimum, uncover areas for concern. And how could funds of fund operators, paid strictly to find the most desirable investments for their shareholders, ignore the absence of standard review and oversight procedures in Madoff's operation? The only plausible answer seems to be blind trust.

Ronald Reagan often used the phrase "Trust, but verify" in reference to the Soviet Union. Madoff Investment Securities, it appears, was all about trust, without any verification.

Trust is easy. But verification takes work. In investing, verification begins with fundamental checks and balances. Madoff administered the fund, handled the money and kept the books, with no apparent oversight, no scrutiny from an independent board of directors. Unchallenged by basic governance processes, Madoff presided over his scheme like a monarch, constrained only by his limited conscience. His investors were indeed victims, but their trust without verification was inexplicable.

Index ETFs fall at the other end of the oversight spectrum, with numerous built-in checks and balances to protect investors. Consider, for instance, the Dow Jones US Index Fund (IYY), an iShares ETF from Barclays.

- IYY seeks to replicate the performance of the largest 95% of publicly traded US companies. The fund's managers succeed by matching the performance of the published Dow Jones index, not by earning shareholders an excess return. This eliminates much of the motivation for the manager to "experiment" with inappropriate or needlessly risky investment models.
- The infrastructure of the fund is highly segmented by function, fostering continuous review and transparency. The fund managers control the composition of the portfolio, not the content of shareholder accounts. They never touch the money. Most interestingly to me, Barclays contracts with State Street Bank, one of its chief competitors, to serve as administrator, custodian and transfer agent. Barclays receives a 20 basis point management fee.
- Further, each iShares fund operates as a trust, governed by an independent board of trustees, and examined by outside auditors. Oversight, rules and standards are built in at every phase of the operation.

Palm Beach syndrome: It has been reported that Madoff's impressive, though fabricated, results were the talk of Palm Beach Country Club. Everyone wanted in. The enthusiastic personal recommendations of existing clients replaced responsible due diligence. Madoff apparently turned away many potential clients who hoped they would be deemed worthy of this special opportunity. He stimulated demand by creating a mirage of scarcity. Index ETFs, on the other hand, are completely democratic, available to all, and transparently priced by the marketplace.



Mixed motivations: In times of market turmoil and poor performance by financial institutions, it is particularly important to understand how and when your wealth management professionals make money. Registered Investment Advisors (including Osbon Capital Management) are bound by an absolute fiduciary standard, a legal requirement to act in the best interest of clients. In short, RIAs must earn a living while putting their clients' interests first. In contrast, this strict standard does not apply to broker-dealers. Brokers are free to make trades or recommendations that meet only a "suitability" standard, not a fiduciary one. For instance, some broker-dealers make commissions by selling recommended or proprietary investments that may not be well-understood by the client or, worse still, by the recommending broker. Commissions can be a powerful motivator, sometimes driving broker actions and advice that may be of little benefit to clients. This is a risk investors should understand as they decide how their assets are managed.

The OCM Difference

Osbon Capital Management is a fee-only SEC-registered investment advisor. As an index boutique, we create diversified, low-cost, tax-efficient portfolios utilizing index ETFs for individual investors. We hold transparency and personal service as essential elements of our value proposition.

Unknown unknowns: This mysterious category of risk, made famous by Donald Rumsfeld, may be the greatest threat of all. The uncertainty of the global economy and every financial market has taught us that just about any bad thing can happen, and happen too quickly for individual investors to get out of the way. Purposefully diversified index ETF portfolios can't prevent unknown unknowns from happening, but they can limit exposure to unforeseen events in individual companies, commodities, currencies or countries.

Reality checks

A few more thoughts on the Madoff mess. In retrospect, the Madoff operation had more red flags flying than Communist Russia. While we have seen that even experienced pros missed those warnings, or chose to ignore them, the same need not happen to individuals who follow a basic money manager due diligence checklist.

For starters:

- *Avoid self-custody* – A money manager who also has self custody of assets is like a rabbit guarding the lettuce patch. Any reputable manager either uses an independent custodian, or would feel comfortable using an independent custodian at your request. Madoff self-custodied.
- *Follow the money* – Understanding exactly how your investment managers are compensated reveals to what degree their interests are aligned, or conflicted, with yours. The standard compensation model for Registered Investment Advisers (RIA) is fee-only, based on assets managed. The standard for broker-dealers is commissions. Any mix of those two raises creates the potential for conflict of interest. Madoff posed as a money manager, but earned all his money by collecting commissions, which is unheard of in the RIA field.



- *Demand independent verification* – Identify your money manager’s auditor and tax advisor and talk to them. Following this simple step would have revealed the now infamous and impossibly small “14 by 18 foot room” that housed Madoff’s so-called auditor.
- *Check the references* – Ask for them and call them. While this wouldn’t have exposed Madoff’s scam, it might have revealed how little due diligence earlier investors had performed.
- *Drop by for a chat* – Any reputable firm would welcome a visit from an existing or potential client as a chance to demonstrate its transparency and professionalism. Madoff clients were apparently unwelcome on-site.

The beauty of boring

Yes, indexing is boring. You can see right through it. It lacks the enticement of exclusivity. It eliminates the need for bold predictions and clever bets. It fails to deliver the anticipatory thrill of the next big thing. But in a world where most investors are hunkered down and rightly wondering what’s next, boring can be beautiful.

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