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The Investment Edge

BetaVest: Investing's Third Dimension

Part One: The Underground

If you were walking through one of the New York City subway tunnels, would you be careful not to touch the third rails? The electric power that moves hundreds of subway trains around the city flows through those third rails, the ones toward the inside that have protective plates a few inches above them. You easily could fit your foot beneath the guard plate; subverting the purpose of the plate and touching the rail itself, however, would burn you to a crisp.

As in the New York subways, investment trains should run on three rails. But until BetaVest, there were only two, representing risk and average return. That's essentially the formula for modern portfolio theory (MPT), which says that each investment runs on a two-rail train without a power rail. Even so, until BetaVest, MPT was the primary way to get investments from one point to another and measure supposed volatility and risk. BetaVest adds the third rail, the one with the power, although unlike subway third rails, it tends to remove danger instead of adding it. It's perfectly safe to touch BetaVest; in fact, you are far more likely to have investments burn to a crisp if you don't touch the power source!

BetaVest removes a lot of the scary stuff about investing by shining new light into the darkness — the nooks, crannies, and deep crevasses of investing.

Flat Files vs. Relative Databases

Imagine working with database files on your computer. You may add various categories — name, birth date, sex, street address, and city, state, and ZIP — but all the items you describe will be contained in one file. Your database file uses a lookup function to find things but can find only items in that one file. It can draw averages and conclusions but not relative to anything else, only to itself. This is called a flat-file database.

MPT is arguably the greatest single investment concept, the basic building block of the financial planning process. But it is similar to that flat-file database because it uses only two dimensions — risk and average investment return.

On the other hand, big government and business databases are relative. Each accesses not only the flat-file information contained in its own data, but other data in other databases as well. And each may draw conclusions and averages from many collections of data. This relativity[1] provides for much more meaningful information.

Enter BetaVest and the Timing of Deposits and Withdrawals

As stated, MPT deals with risk and average rates of return over time. It does not look at the timing of inputs and withdrawals. Like me, you probably have experienced the dismay of seeing Customer A get a certain result after entering a carefully crafted portfolio on, say, Jan. 10, when the market is down, and Customer B getting a much lower result after investing in the same portfolio on Jan. 17 in an up-market. And like me, you've probably said, if only to yourself, "It's because one customer started when the market was down and the other began when it was on the up-tick," and then nodded your head knowingly and gone back to work.

When 9% Isn't 9%

But what about when there are inputs and withdrawals over a l-o-n-g period of time? Do you rely on that foregoing tired, old up-market/down-market statement, even if you are, in terms of genius or insanity (depending on your viewpoint!) only talking to yourself, or do you try to calculate the actual return, paying attention to the timing of each withdrawal and deposit? Given the timing of dividend inputs and the different dates each month of deposits and withdrawals, that's not an impossible task, but it would keep you hunched over your computer for months, manipulating numbers in Excel or Lotus 1-2-3, and that would be unhealthy for your business.

Jeff Manry, the Certified Financial Planner who created BetaVest, proves in a heartbeat that sometimes a 12% return is a 12% return, and sometimes "it taint so, McGee";[2] sometimes what seems to be a 12% return is really a 4% return or worse. Manry, a financial planner based in suburban Atlanta, has ensured that other investment professionals don't have to spend weeks grinding away with spreadsheet software to make that discovery. He and his firm have done all the hard work and produced two wondrous products — an extremely professional video designed to help manage customer expectations, and a software program called the BetaVest CASE Management System. This planning software, which incorporates the BetaVest model of input and withdrawal timing, will be discussed in the next column.

Timing cash flows in and out is not in itself radically new — high-end software programs such as Axys do a great job of accounting for deposits and withdrawals in computing investment performance, for example. Until BetaVest, though, no one bothered to explain to customers why it was so important, and no one actually looked at how withdrawals and deposits could turn estimates of past results topsy-turvy and applied that lesson to future projections. That's where Jeff Manry's genius saves the day. He figured out how to add that third dimension to customer expectations and future projections.

Readers of "The Investment Edge" know how highly I think of Dr. Harry M. Markowitz and his work with MPT, beginning with an article publishedin 1952 that presented MPT's mathematical underpinnings. With BetaVest, Manry has picked up where Markowitz and MPT left off. I like to think of Manry's work in a mathematical/algebraic way as well — take any problem and solve for X. That's pretty straightforward, right? A + B = X. Both sides of the equation are equal. Now, imagine that the wholemodel moves in time. It becomes dimensional, and X is still the same as A and B, but each side of the equation changes every day. It's a different and more realistic way of developing investment averages.

Depletion!

Manry looks at it all in this new BetaVest way. He says that volatility risk tells us nothing about depletion risk. The current methods of measuring volatility are worthless when trying to guard against the risk of running out of money. An adviser without BetaVest might say to his customers, a married couple both age 65: "Here is a low-risk, low-volatility portfolio that is appropriate for you. I have done my due diligence. Let's put it to work." That's all fine, and the portfolio is put to work with a good intent and a clear conscience, but the chances are good that the couple will be broke in 15 years. MPT and the efficient frontier provide risk and average return measurements and produce a supposed expected rate of return with a standard deviation, but cash flow does not enter into the equation, and Manry is right — cash flow is everything! Cash flow is a moving bull's eye, and all of the old targets are static, frozen in two-dimensional time.

The Consumer Video

The 20-minute BetaVest video presentation is a terrific piece of work. If you take a customer through it, he or she will, for the first time, understand all three dimensions of investing. (It's not just customers who need to watch the video. Because investment professionals, myself included, have a built-in bias to accept the familiar and reject the new, it might take us two or three viewings to clear away the grimy cobwebs of two-dimensional investing and arrive at an epiphany. At that moment, inside your brain, high-voltage light bulbs will switch on and illuminate everything, synapses will fire, and you'll say: "Wow. Holy smoke!" and maybe even more.)

The consumer-oriented video presentation is at http://www.betavest.com/; any professional who subscribes to BetaVest may use it for his or her customers. It quickly removes from the customer's mind any preconception that the adviser has an axe (or axes) to grind because it provides unblemished education through facts that are as pure as the driven snow. (If you're still skeptical, you may view the presentation for free by telephoning BetaVest toll-free at (866) 972-5680. Tell whomever you speak with that Richard Hoe asked you to phone, and you will be given a temporary password.)

The Big Kahuna

At first it's difficult to grasp the enormity of Jeff Manry's accomplishment. When you visit the BetaVest site, you'll find the following quote from *Bull's Eye Investing* by John Mauldin: "Over the next few years, we are going to see a new type of competition among investment firms and analysts. Investors are going to start ignoring overly optimistic analysts and begin looking for some accuracy. This won't happen all at once, as there is still a demand for analysts who will tell investors what they want to hear. But as the secular bear market wears on and the patience of investors begins to wear thin, you will see projections become more in line with reality. It will take four or five years at least for this to become standard, but the S&P announcement of a core earnings standard is the beginning of what will become a trend. Just as you tell your friends you have a conservative attorney, investors will start to look for conservative analysts. Optimists will come to be seen for what they are: dangerous to the health of your portfolio. Realistic and on-target forecasts will become the style to which we all aspire." (See my review of Mauldin's book later in this column.)

Mauldin might have written that before he knew about BetaVest, which has been around since the turn of this new century. Even so, his words seem tailor-made to describe this concept. The rest you can get by checking out the video presentation.

The gains you'll realize from using BetaVest include: a way to manage customer expectations, more referrals, a far more accurate way to allocate assets, better customer retention, and a remarkably consistent sales/investment approach.

What Manry & company are selling is far more than software; it's a pathway toward becoming a distribution expert. BetaVest might be the best way to tap into the needs of baby boomers and help them develop plans for producing sorely needed retirement income. Using the BetaVest power rail — showing investors how deposit and withdrawal timing affects results — provides each investor with a higher probability of success and, of equal importance, with reasonable expectations for the future.

I will discuss the second part of BetaVest — the planning software — in the next "Investment Edge."

Broker's Bookcase

Bull's Eye Investing — Targeting Real Returns in a Smoke and Mirrors Market, by John Mauldin (John Wiley & Sons, 2004). Mauldin is the president of Millennium Wave Advisors, LLC, and has a different, out-of-the-mainstream way of looking at investments. This makes for an interesting and worthwhile read. He divides his book into two parts, targeted to individual investors: (1) How to fish, and (2) Where to fish.

In the introduction, Mr. Mauldin writes, "The folks on Wall Street are in the business of selling stocks (and stocks packaged in mutual funds) ... their advice — buy what they sell — has been wrong about half the time." Mauldin imagines Wall Street constantly asking everyone to wait out a bear or sideways market, saying, in essence, "... have patience, and please give us more of your money."

He's not totally wrong in throwing out some of the axioms. For example, the idea that modern portfolio theory deals with risk over the short term is not accurate; MPT deals with decades of time, some periods lasting 30 years or longer. (As an aside, it's interesting that Warren Buffett, arguably the world's greatest investor, thinks in 25-year or longer slices of time.) Mauldin actually visited with Harry Markowitz and asked him about the buy-and-hold theories espoused by many investment companies and advisers. Markowitz replied, "It all depends on what assumptions and future returns you use."

I learned a lot from this book. Mauldin isn't perfect — he moans at one point about the jobless recovery, but that was 2004 pop political psychology, and we now know that there were and are jobs in our economy — but with *Bull's Eye Investing* he has produced a doggone good book.

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Footnotes:

1. There is a simplistic analogy here with Einstein's Theory of Relativityor, more succinctly — as jazzmen Les McCann and Eddie Harris put it — with one of the top jazz songs of all time, the appropriately titled"Compared to What?"

2. With due credit to Marian Jordan, who played Molly to her husbandJim's Fibber in "Fibber McGee and Molly," for about 25 years during the golden age of radio.