

# 10 Questions

## Harold Evensky on ETFs, Reverse Mortgages, and the Most Important Investment in the Coming Decade

by Carly Schulaka



**WHO:** Harold Evensky, CFP®, AIF®

**WHAT:** President of Evensky & Katz Wealth Management with offices in Coral Gables, Florida, and Lubbock, Texas; adjunct graduate professor at Texas Tech University; internationally recognized speaker on investment and financial planning issues; regular columnist for the *Journal*, author of *Wealth Management*, and co-editor of *The Investment Think Tank: Theory, Strategy, and Practice for Advisers*.

**WHAT'S ON HIS MIND:** "I think way too many portfolios today simply don't factor in—to the extent they should—taxes and expenses. At 2.5 percent, if you could save a half of a percent in taxes and expenses, it increases your net-net-net return by 20 percent, and that's pretty impressive."

**PODCAST:** Listen to our podcast with Evensky at [FPAnet.org/Journal/Home/PodcastPage](http://FPAnet.org/Journal/Home/PodcastPage).



**H**arold Evensky is a familiar face to many planning professionals—from newbies to veterans—and his investment expertise is not only appreciated by clients, but also by peers. As president of Evensky & Katz Wealth Management, a firm he founded nearly 30 years ago, he guides clients through his core-and-satellite investment strategy—a technique subsequently adopted by many other planners.

Whether the accolade from various financial services industry media is “influential,” “top wealth manager,” or “mover and shaker,” Evensky has likely earned them all, landing on several “best of” lists in the last decade.

With the topic of “trends in investing” in mind, the *Journal* recently talked with Evensky about changes in his investing strategy, creating real cash flow for clients, and what he’s teaching graduate students in the department of personal financial planning at Texas Tech University.

**1.** *As an expert on investment research, do you think the profession needs more research that is relevant to financial plan-*

*ners, and if so, do you have any thoughts on how we might accomplish that?*

Absolutely. I think we are in desperate need of what I would refer to as applied research. Most of the research that’s out there is what I refer to as generic or policy; women are more conservative than men. As a policy, that might be important, but as an individual practitioner, if I’m sitting with a couple and I assume the woman is more conservative, that might be a disastrous assumption. Or, if I ever start planning for families with 1.7 parents and 2.3 children, then I could use some of that data. So far, I’ve never run into it, so that’s a long-winded way of saying yes, we are desperately in need of applied research.

How to accomplish it? I believe that the answer is going to be the growing universe of newly minted Ph.D.s in personal financial planning. One of the major attractions of my association with the program at Texas Tech is working with some of the doctoral candidates and new Ph.D.s. In doing that, I’m trying to encourage them to focus more on applied research.

**2.** *Has the Great Recession changed your investing philosophy or strategy?*

Not substantively. It certainly did not change our philosophy. I get frustrated when I read these stories about MPT [modern portfolio theory] is dead and doesn't work. My response is that people who say that simply have never read Markowitz. Modern portfolio theory and optimization is not looking backwards and not based on historical returns; it's based on forward-looking returns. It certainly takes into consideration valuation and everything we know and everything we're guessing about the future.

The argument that it didn't work is kind of crazy. The fact of the matter is diversification certainly did work to the extent someone had money in fixed income, they did a whole lot better than if they had all their money in equities.

And I recognize that the suggested alternative is tactical. I love the term. Intellectually, I like the concept. But I don't know anyone that has ever successfully consistently done it. So bottom line: I still believe that diversification's important. I believe that domestic and international's important. There's really nothing that has fundamentally changed.

In terms of strategy, we modified a little bit. We modified quite a few years ago and went to a core-and-satellite [strategy], so that's a change prior to the Great Recession. The biggest change that we made [since the Great Recession] was we added a small allocation category that we call alternative, utilizing some of the mutual fund type of alternative investments to provide a little bit, we hope, of volatility buffer, but that's about the only substantive change.

**3.** *You are widely recognized as the originator of the core-and-satellite strategy for investing. How do you determine the best way to invest the satellite portion?*

The way the core-and-satellite [strategy] came about for us was, seven or eight years ago, when I was looking forward and concluded that I expected real returns for the next number of decades to be lower than they had been historically. And although nothing had changed in our philosophy, we needed to invest very differently than we had in the past—much more cost and tax efficiently. In looking around for a solution, I stumbled across an institutional strategy that had been around, which was core-and-satellite, so I certainly didn't invent it. I simply adopted what had been an institutional strategy.

Our criteria for the satellite is really fairly simple. Conceptually, in lieu of taking extra risks throughout the equity portfolio, the concept is the core is invested simply to capture the market return as cheaply and tax efficiently as possible. So, take no risk beyond the pure market exposure, and take the whole budget for risk that normally is spread throughout the equity portfolio and concentrate that in the satellite, so the satellite investments can be more risky.

We refer to it as a tactical satellite, meaning the core is strategic—our time horizon and economic cycle is roughly five years—the [time horizon for the] satellite is one year. So our criteria is looking for investments—it can be strategies, it can be sectors, it can be styles—where we believe in the forward-looking 12 months, net of expenses and taxes, it will do 2 percent better than the general market, basically the S&P.

So we look for investments that may have done poorly in the last few years that we believe there's reason that we may see regression back to an even more normal kind of return. That's the criteria.

**4.** *What role do ETFs play in your client portfolios?*

Well, a significant role in the equity portion. Eighty percent of our equities

are basically passive, so that's a combination of ETFs and quite a bit of DFA [Dimensional Fund Advisors].

We also use ETFs occasionally in the satellite, if we're looking to, in effect, make a bet on a particular area or style or something of that nature; something where we're just looking for pure exposure, so [ETFs] do play a very significant role.

**5.** *Can you tell us a bit more about the role that alternative investments are playing in your client portfolios?*

We certainly are familiar with alternatives and have looked at them for years, but our conclusion has been for the most part, that what's available in the retail universe—which I define as under about \$100 million—is expensive and third-rate, so we have not utilized traditional alternatives.

But as a result of the Great Recession, a number of managers who we respect and we think are high quality saw a business opportunity and developed mutual fund-type alternative offerings, so we started looking at those. It meets a lot of our criteria: that we think it is first-rate not third-rate, it's not opaque, and it's relatively not expensive.

The catch is it's also those investments that are, for the most part, unleveraged, and what makes alternatives so attractive is the leverage... So in looking at these investments, our conclusion was that the returns would be relatively modest. Our best guess is somewhere between bonds and stocks, but they would be poorly correlated with the broad, other investment markets.

So we took 3 percent from our bond allocation and 3 percent from our stock [allocation], which gave us 6 percent to work with, and then split that by a number of these new alternative funds. The idea being, it shouldn't impact our return expectations, since we took half the money from bonds and stocks and expect

the returns to be half of each. But because of the low correlation, it would give us a little bit of a buffer in a volatile market.

**6.** *Where do you think interest rates are headed in the next year or two, and in five years or so?*

As long as no one holds me to it, I think relatively flat for the next couple of years. It's going to take that long just for economies to finally fire back up, and I believe the Fed when they say that it's their intention of holding rates really low for another year or two.

Five years out I would expect returns to regress to a more historical norm. That's kind of fingers crossed ... but best guess is a fairly significant increase from say the 1, 1.5 percent now to the 5 percent or so range.

**7.** *I have heard you say that people don't need income, they need real cash flow. What do you mean by this, and how is that accomplished for your clients?*

One of my many soap boxes is my frustration with the concept of an income portfolio. That basically means a portfolio that's generating income for a client through dividends, and/or interest payments, or combination thereof. It certainly sounds good and feels good, but it makes no sense in my opinion from a planning standpoint.

First of all, when you design a portfolio like that, the stock/bond balance is completely controlled by whatever dividend and interest rates happen to be at the time you do it. So today, if you needed 5 percent, you'd probably have 100 percent in high-yield bonds or something, because the dividends aren't high enough and interest rates are so low you'd have to have almost all fixed income, which would have no relationship to what's an appropriate long-term portfolio for anybody.

Other problems with it are, if someone

has a portfolio—dividend and interest, and primarily interest—and interest rates go up in a couple of years, their income goes up and they're feeling rich when in fact, the value of their portfolio just went down because interest rates went up, so bond values went down. If interest rates go way down, they're beginning to feel poor because they're getting a lot less cash flow when in fact, the portfolio's worth more. So how they feel and what's happening economically is the opposite.

It's not a consistent income stream. People who had income portfolios designed a couple of years ago, the income they're getting today is nowhere near what they were getting a few years ago, because interest rates are down so much. For all of those reasons it simply makes no sense.

Individuals need real cash flow. When someone says, "I need \$50,000 a year," and inflation's 3 percent, they need \$51,500 next year, not \$50,000. An income portfolio—certainly to the extent that a significant portion is coming from bonds—is a nominal payment, not a real return, so it fails to meet the inflation erosion risk. The way in which I think people need to do it, is design a total return investment portfolio, and then develop a strategy for getting the amount of money in real cash flow they'll need every year.

A simple way would be a reverse dollar cost averaging, but that tends to be an inefficient way of doing it. So the strategy that we developed back in the early '80s we've somewhat modified, but basically, we carve out two years' worth of someone's projected cash flow needs. So if someone had \$1 million and they said, gee, I need \$50,000 a year to supplement retirement, Social Security, whatever, we'd say, okay, you've got a \$900,000 investment portfolio, and \$100,000 we're going to put in what we call the cash flow reserve. (I wished I called it buckets back when I wrote it, but basically it's a two-bucket strategy.)

That \$100,000 we would put in a money market, short-term bonds, and set it up to pay out 1/24th of that into their local checking account like a payroll check, so they know exactly where the money's coming from. And as we manage the investment portfolio, we can decide when something is sold to fill back up that cash flow reserve.

My former graduate assistant, now a professor, and I looked at this in much more detail than I had done when I developed it back in the '80s, and our conclusion is that a one-year cash flow reserve is adequate, so that's the strategy we use and it's been immensely effective.

It also has very significant behavioral attributes, because when the market is falling apart, our clients may not be happy, but they're not panicked, because they know where their grocery money is coming from; it's basically sitting in cash. They can see it, touch it; they know they don't have to worry; they know they don't have to sell anything right then. So it makes it a lot easier to step back and take a little longer-term view than if all your money is invested and you've got to take \$50,000 out, then it's, "This is terrible."

We were doing this before the '87 crash, the tech bust, and the Great Recession, and it worked extremely well through all those periods.

**8.** *What do you think will be the most important investment product over the next decade?*

One that I still find hard to say that I believe, but I do believe it's going to be [important], is immediate annuities and longevity insurance. A few years ago, I famously, and some friends remind me, was quoted as saying I'd rinse my mouth with soap [if I ever said "annuities."]

The products have changed so that now there are products out there where the insurance companies aren't taking all the mortality return off the table for profits.

It's been very hard to keep up with the product innovation and all of the terms of variable annuities, but immediate annuities are a lot simpler, certainly immediate fixed, because all you have to do is look at a number. Longevity insurance is a little more complex, but basically it's a pretty simple product. Both of them are much simpler than a deferred variable [annuity]. You start talking about immediate variables, then now you're getting somewhat more complicated, but it's still a reasonably straightforward concept.

The good news is it's not something I think anyone needs to implement yet because they're so dependent on current interest rates and [current interest rates] are so low. I believe there's very little risk in delaying the decision to use them until interest rates regress to a more historical norm. And they really don't come into play until your clients are maybe 70 or so.

**9.** *You co-wrote a paper with Shaun Pfeiffer and John Salter that the Journal published last year on using a reverse mortgage as a risk management tool. How you are using reverses mortgages with your clients?*

Up until very recently, pretty much like every other practitioner, I wouldn't touch [reverse mortgages] with a 10-foot pole. What changed that was a year or so ago when a new product came out called the [HECM] Saver, which is very analogous to a home equity loan, a HELOC. The difference is, with HELOCs, as we learned the hard way, there's nothing guaranteed. So during the Great Recession when clients looked to tap into that for the short term, banks shut them down, so [HELOCs] weren't there when people wanted them or needed them. This Saver is a reverse mortgage that can be established at relatively modest costs, and you don't have to borrow on it, so it's like a standby home equity loan.

The way that we see the use of it, and what our study did, was say, okay, the

risk of investing in the market is having to sell at the wrong time. So let's suppose you establish this, so in effect, it's sitting on the sideline, and you have a cash flow reserve, but it's such a bad period that you blow through your reserve and you don't want to sell anything because interest rates are up, so bonds lost money, stocks lost money. Then you turn and you borrow against this home equity loan. When markets recover and get better you pay it off again, so it's not designed to be a leverage investment strategy; it's not designed as a credit strategy. We see it simply as risk management, "insurance" against a volatile market allowing investors to remain invested through those volatile times.

And our conclusion was, anyone who qualified for it should consider doing it. And there's a high probability, based on our simulations, that most investors would never have occasion to draw on it, but as I said, we see it as an insurance policy.

Some other strategies or other uses we've been looking at is management of Social Security. I know there's been a lot written about how in many cases, it makes sense for at least one spouse, if not both, to delay Social Security until [age] 70. In some cases, that may be problematical because people may not, in the normal course of events, be able to do that. Well, reverse mortgages may provide the resources to enable someone to delay that Social Security, and then as they get the bigger payments, pay back down that loan.

**10.** *One of your research interests is portfolio design in a low-return environment. In your role as an adjunct professor at Texas Tech, what are you teaching students about this?*

I teach one graduate class on advanced investment which certainly covers this. Basically, what I'm teaching the students is that they need to develop

their own professional philosophies and beliefs. And one of those is going to be what are the forward-looking returns, what do they think market returns are going to be in the future?

And then I help walk them through a simple little process, which is basically, okay, you think the return's going to be this, and what do you think a traditional balanced portfolio—say 40 bonds, 60 stocks—what's that return going to be? And then subtract from that a reasonable number for the cost of managing that portfolio, just the rebalancing and the transaction costs. And then subtract what you believe is a reasonable number for taxes. But then, subtract out their expectations for inflation.

What is left, based on our forward-looking expectations, is not very much; it is about 2.5 percent. That, for me, was a huge wake-up call. That's depressing to put it mildly. I realized we have no control over returns, but certainly we have some control over taxes and expenses, and that's where the importance of that mushroomed in my mind. And it was that simple little calculation that led us to move to core-and-satellite. I think that any practitioner should be doing that, and hopefully my students, when they get out in practice, will be doing that. And if they do, that will substantially change the way in which they implement a portfolio.

I think way too many portfolios today simply don't factor in—to the extent they should—taxes and expenses. At 2.5 percent, if you could save a half of a percent in taxes and expenses, it increases your net-net-net return by 20 percent, and that's pretty impressive. ■

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