Low-Cost Investing:
The “Costly” Approach?

Laurie S. Stegenga, CPA, CFP®, PFS, AIF®
President, Foresight Capital Management Advisors, Inc.

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Content Research: Mark Forgiel, Trent Strang, Corey Boller, and Justin Littleton

Warning and Disclaimer

This book is intended to provide general information regarding Low-Cost Mutual Funds and comparison information for how these funds have compared to Foresight's moderate mutual fund model portfolio. It is not intended as a substitute for the investor's own research, or for the advice of a qualified financial specialist. The author shall have neither liability nor responsibility to any person or entity with respect to any loss or damage caused, or alleged to be caused, directly or indirectly by the information contained in this book.

About the Author

Laurie Stegenga is President and founder of Foresight Capital Management Advisors, Inc., a fee-only Registered Investment Advisory firm. Her past financial work experience has spanned 32 years of managing and accounting for billions of dollars in investments. In 1983, Laurie began her career in big eight accounting, auditing large publicly traded corporations and performing audits and taxes for small entrepreneurial businesses. Five years later she joined Midwest Microwave, Inc. a defense manufacturing company as Chief Financial Officer and Human Resource Director. In 1993, Laurie joined Alexander Hamilton Life Insurance Company as Manager of Investment Valuation and Statutory Reporting for their $7.3 billion portfolio. Several years later Laurie became a Divisional Director of Accounting and an international finance consultant for Thomson Publishing, Inc.

Laurie then joined Tisch Investment Advisory, Inc., a regional mid-west Registered Investment Advisory firm in 1998, to form and develop their retirement plan division. During her nine years, as Vice President, with the firm she assisted in growing the retirement plan division to a $140 million portfolio, which represented about forty percent of the assets under management for the firm. Laurie's expertise is in retirement plan services, providing on-site education and one-on-one personal financial planning for the employees, fiduciary consulting, and all aspects of personal wealth planning for the individual and family office.

In 2008, she ventured out on her own and established Foresight Capital Management Advisors, Inc. and as of 2016 the firm is managing over $130 million in assets. She has been featured in an article on the Financial Advisor IQ website, a division of the Financial Times, named a Five Star Top Advisor in the 2016 Hour Magazine, interviewed at the National AIF and NAPFA Conferences, created an on-line video regarding Foresight's investment process for portfolio selection and rebalancing, featured in Forbes Magazine-Michigan Financial, and is a Fiduciary Consultant for the State of Michigan education facilities. Mrs. Stegenga is a Cum-Laude graduate of Eastern Michigan University.

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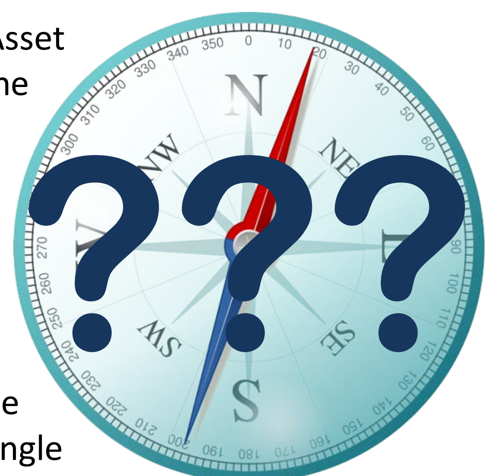
The topic of Low-Cost Investing has been debated for many years and with so many opinions, who is to believe? In order to fully understand and form an opinion from the numerous philosophies and debates over low cost investing, investors must first understand what exactly is being debated.

What is NAV?



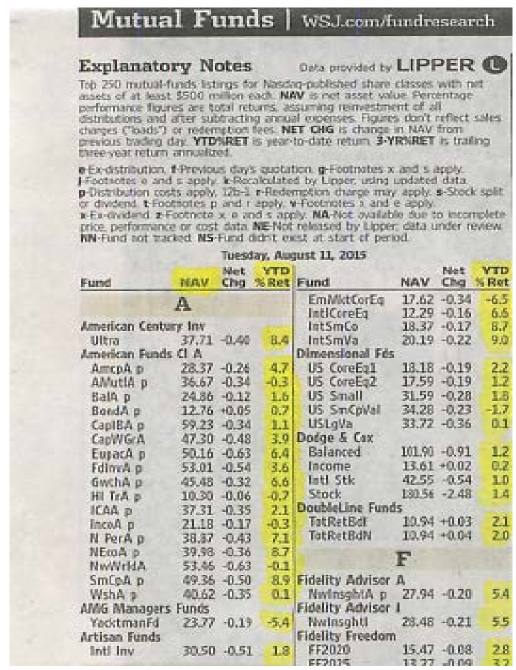
Before we venture into the details of NAV, or Net Asset Value, it is important that we first review the fundamentals of mutual funds. Starting with the basics, a mutual fund is an investment vehicle composed of many investors' funds for the purpose of investing in a broad range of stocks, bonds, and other assets. From an investment perspective, these funds are attractive because they provide the opportunity to invest in a wide spectrum of securities through the purchase of a single fund. The holdings within mutual funds are chosen by the money manager that operates the fund, with the overall goal of returning capital gains to the investors.

Unlike common stocks, mutual funds do not trade instantaneously throughout the day. Instead, they are required to report their Net Asset Value after market closing (4:00 p.m. EST) each day. The NAV is a mutual funds price per share, which must be reported and then released to the public every trading day. NAV is computed by taking the market value of all securities held by the fund, including cash or cash equivalents, subtracting the fund's liabilities, (this includes money manager fees, trading fees, and operating expenses) then dividing this number by the total number of shares outstanding, arriving at the NAV.

Formula:

$$\text{NAV} = \frac{\text{(Market Value of All Securities Held by the Fund + Cash and Equivalent Holdings - Fund Liabilities)}}{\text{Total Fund Shares Outstanding}}$$

A basic understanding of NAV is essential for mutual fund investors because it determines the price at which an investor is able to purchase and/or sell mutual fund shares. Unfortunately many investors misunderstand how mutual funds are valued and find themselves misled by the rate of return, unaware that the expenses which make up the Net Expense Ratio are already factored out of the Mutual Fund's reported return. <u>*A mutual fund's reported investment returns are always calculated net of expenses.*</u> Since mutual funds are required to report NAV, the reported prices have already taken into account the fund's money manager fees and operating expenses. <u>**Therefore when comparing mutual fund returns, the funds can be compared apples to apples based on their performance, regardless of their net expense ratio**</u>.



Mutual Funds | WSJ.com/fundresearch

Explanatory Notes Data provided by **LIPPER**

Top 250 mutual-funds listings for Nasdaq-published share classes with net assets of at least $500 million each. **NAV** is net asset value. Percentage performance figures are total returns, assuming reinvestment of all distributions and after subtracting annual expenses. Figures don't reflect sales charges ("loads") or redemption fees. **NET CHG** is change in NAV from previous trading day. **YTD%RET** is year-to-date return. **3-YR%RET** is trailing three-year return annualized.

e-Ex-distribution. **f**-Previous day's quotation. **g**-Footnotes x and s apply. **j**-Footnotes e and s apply. **k**-Recalculated by Lipper, using updated data. **p**-Distribution costs apply, 12b-1. **r**-Redemption charge may apply. **s**-Stock split or dividend. **t**-Footnotes p and r apply. **v**-Footnotes x and e apply. **x**-Ex-dividend. **z**-Footnote x, e and s apply. **NA**-Not available due to incomplete price, performance or cost data. **NE**-Not released by Lipper; data under review. **NN**-Fund not tracked. **NS**-Fund didn't exist at start of period.

Tuesday, August 11, 2015

Fund	NAV	Net Chg	YTD %Ret
A			
American Century Inv			
Ultra	37.71	-0.40	8.4
American Funds Cl A			
AmcpA p	28.37	-0.26	4.7
AMutlA p	36.67	-0.34	-0.3
BalA p	24.86	-0.12	1.6
BondA p	12.76	+0.05	0.7
CapIBA p	59.23	-0.34	1.1
CapWGrA	47.30	-0.48	3.9
EupacA p	50.16	-0.63	6.4
FdInvA p	53.01	-0.54	3.6
GwthA p	45.48	-0.32	6.6
HI TrA p	10.30	-0.06	-0.7
ICAA p	37.31	-0.35	2.1
IncoA p	21.18	-0.17	-0.3
N PerA p	38.37	-0.43	7.1
NEcoA p	39.98	-0.36	8.7
NwWrldA	53.46	-0.63	-0.1
SmCpA p	49.36	-0.50	8.9
WshA p	40.62	-0.35	0.1
AMG Managers Funds			
YacktmanFd	23.77	-0.19	-5.4
Artisan Funds			
Intl Inv	30.50	-0.51	1.8

Fund	NAV	Net Chg	YTD %Ret
EmMktCorEq	17.62	-0.34	-6.5
IntlCoreEq	12.29	-0.16	6.6
IntSmCo	18.37	-0.17	8.7
IntSmVa	20.19	-0.22	9.0
Dimensional Fds			
US CoreEq1	18.18	-0.19	2.2
US CoreEq2	17.59	-0.19	1.2
US Small	31.59	-0.28	1.8
US SmCpVal	34.28	-0.23	-1.7
USLgVa	33.72	-0.36	0.1
Dodge & Cox			
Balanced	101.90	-0.91	1.2
Income	13.61	+0.02	0.2
Intl Stk	42.55	-0.54	1.0
Stock	180.56	-2.48	1.4
DoubleLine Funds			
TotRetBdI	10.94	+0.03	2.1
TotRetBdN	10.94	+0.04	2.0
F			
Fidelity Advisor A			
NwInsghtA p	27.94	-0.20	5.4
Fidelity Advisor I			
NwInsghtI	28.48	-0.21	5.5
Fidelity Freedom			
FF2020	15.47	-0.08	2.8
FF2015	13.27	-0.09	3.2

Wall Street Journal Section Mutual Funds, WSJ/Fund Research August 11, 2015

To illustrate this concept, suppose you own two mutual funds, each having a reported return of 10%. However one of the funds has a 2.50% net expense ratio and the other only has a 0.50% net expense ratio, so which fund had the higher return?

The funds both returned 10%, so a $100 investment in either one of these funds would have received a $10 return, regardless of whether one is considered "low-cost" or not. The net expense ratio did not affect the $10 return for either one of the funds because the net expense ratio is already factored in when they calculate the reported 10% return. However, the fund with the 2.50% net expense ratio actually did earn a higher gross return, but net of expenses they are equal to each other both earning 10%.

	Fund A	Fund B
Beginning NAV	$100.00	$100.00
Gross 1 Year Return	12.50%	10.50%
Net Expense Ratio	**2.50%**	**0.50%**
1 Year Return Net of Fees	10.00%	10.00%
Reported NAV (Net of Fees)	**$110.00**	**$110.00**

The Tunnel Vision Investor

Since the average investor doesn't know how mutual funds are valued, there are many who believe that Low-Cost mutual funds (mutual funds with a low net expense ratio) will provide a higher return. This is a common misconception and the terminology of "low-cost" does not help the situation. Many investors have the misbelief that low cost funds are the top mutual funds to invest in. They are convinced that the less you pay for a mutual fund, the less comes out of the total return, therefore the more money in the investor's pocket. The Analysts at Foresight Capital Management encounter this misunderstanding on a regular basis and actively seek new ways to educate investors on this topic.

Foresight Capital Management recently performed and analyzed a series of studies to determine what the best approach to investing is when considering mutual funds expenses. Foresight determined investing with tunnel vision and using misguided logic in seeking only low-cost funds is anything but "low-cost", when referring to untapped potential returns.

When investing in the market, the cost of a mutual fund (in this case low-cost mutual funds) isn't what allows a portfolio to appreciate in value, rate of return is the lone factor that makes investors' money. We have found that investors who suffer from this *tunnel vision* may actually see lower returns because they only invest in low-cost mutual funds.

Due to the low-cost blinders put on by investing with a *tunnel vision* mind set, investors are not even considering a large number of mutual funds which could likely generate higher returns for their portfolios. Investors who purchase low cost funds will typically be paying a lower amount of fund expenditures; however this cost savings may not be enough to compensate them for the potentially greater rate of return they sacrificed. Even though low-cost investors are paying fund managers the least amount, they are losing out on overall earnings by not selecting the top returning funds net of all fees.

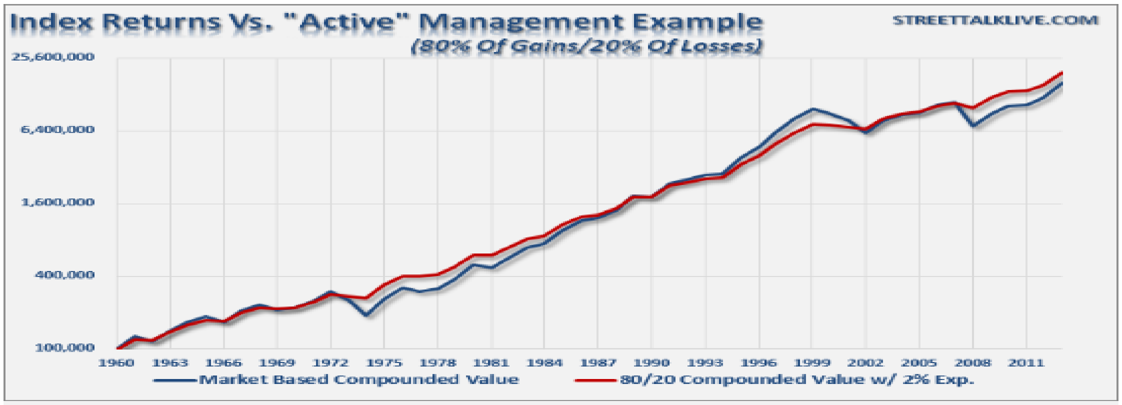
Below is a comparison between two large cap growth mutual funds. VIGAX would be classified as a low cost mutual fund with an expense ratio of 0.09%. GTLLX would not be classified as low cost with an expense ratio of 0.87%. When comparing the two funds GTLLX has outperformed VIGAX over the past 5 years by 1.71% net of all mutual fund fees. Both mutual funds also have very similar risk levels as seen in the standard deviation.

Ticker	Fund Name	Prospectus Objective	Tot Ret % YTD	Tot Ret Annlzd % 3 Yr	Tot Ret Annlzd % 5 Yr	Std Dev % 3 Yr	% Rank 1 Yr	3 Yr	Sharpe Ratio	Alpha % 3 Yr	Net Expense Ratio	Mstar Risk 3 Yr	Fund Incept Date
LARGE CAP GROWTH													
Description: Large-growth portfolios invest in big U.S. companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large-cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly													
GTLLX	Glenmede Large Cap Growth	Growth	1.51	16.21	13.81	12.11	15	1	1.30	3.67	0.87	Average	2/27/2004
VIGAX	Vanguard Growth Index Adm	Growth	0.34	12.57	12.10	12.34	24	27	1.02	0.11	0.09	Average	11/13/2000
	Large Cap Growth Category (Average of 1,744 Funds)		-2.45	11.07	9.88	12.71			0.89	-0.92	1.19		

The Tale of Two Investors

Analysts at Foresight Capital Management Advisors, Inc. (FCMA) recently conducted a study where they imitated the investment strategy of low-cost investors. The study revealed that low-cost funds consistently ranked near the 50th percentile of their respective fund categories. In order to keep the funds cost low, fund managers of low cost mutual funds are following the indexes similar to an index fund, which is migrating their returns to the mean. Index funds attempt to replicate the movement of specific indexes such as the S&P 500, which buys proportionate shares of five hundred large companies based on market capitalization. Another example of an index fund is the Russell 2000, which buys proportionate shares of two thousand small cap companies. Many low-cost mutual funds keep their costs low by simply mirroring these indexes, also known as “indexing”. Indexing allows mutual funds to almost manage themselves, requiring very little, if any active management. They are able to keep the costs low because this form of passive management takes all of the time and effort out of allocating the fund’s portfolio. In short, by mirroring the indexes, investors will likely see the same returns that the market is giving; however they will never beat the market returns.

On the next page is a chart from investing.com which compared active management to passive management over a 50+ year period. In this article they pointed out that passive investing (low cost investing) provides no downside protection from the indexes while active management can help prevent downside risk. By actively managing you can reduce the volatility of a portfolio to avoid losses, but still participate in a majority of the upside.



Actively Managed Funds vs. Index Funds

The most crucial point to understand is that the **MAJOR contributing factor** to winning the long term investment game is **NOT LOSING value when the markets decline**. As shown above, even when including a 2% annual drag on portfolio returns over the extended investment period, not losing capital during market reversions led to a larger ending portfolio value than indexing alone.

http://www.investing.com/analysis/active-vs.-passive-asset-management:-which-is-best-213470

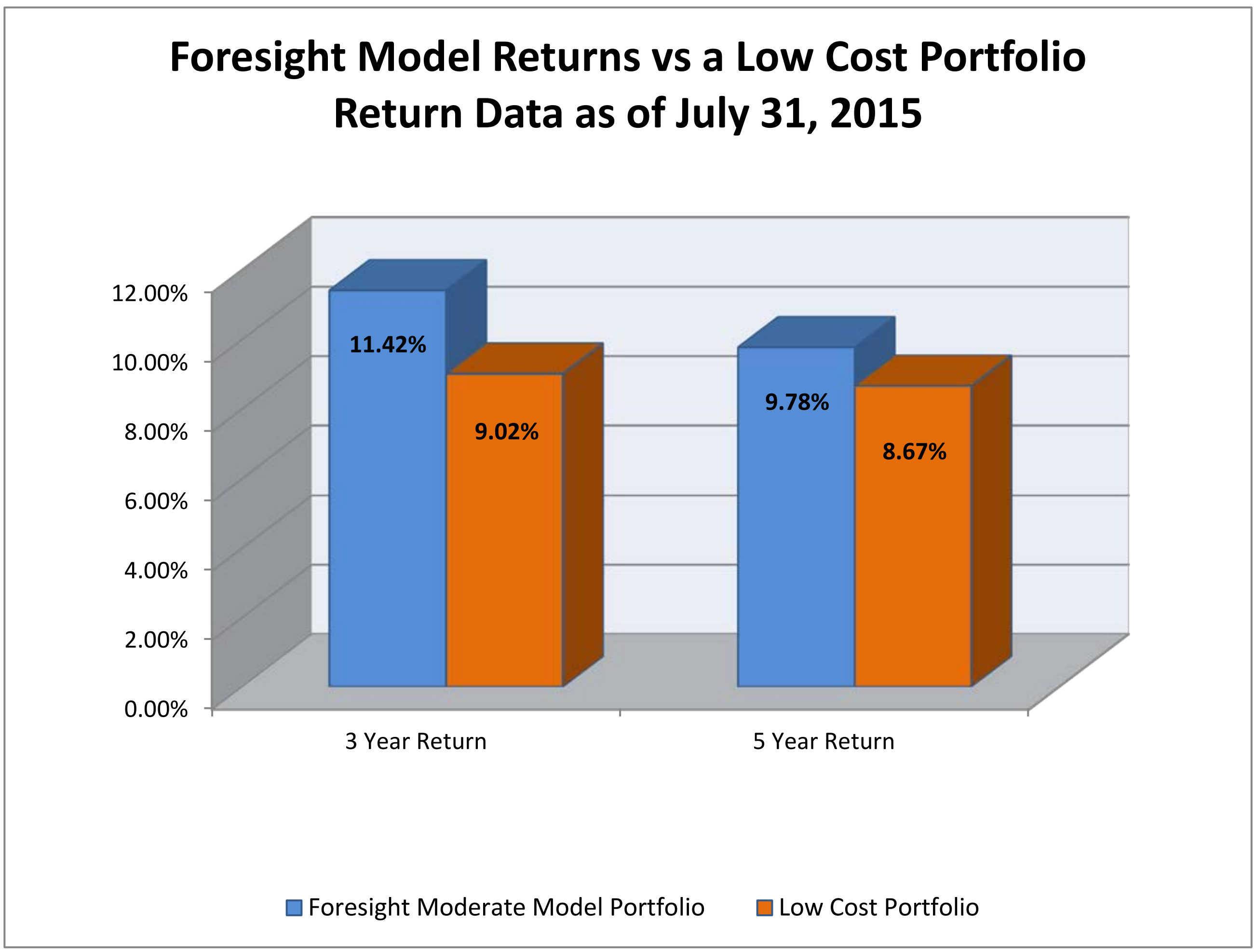
The next part of the study was to test the performance of this passive investment style over the course of three and five year time periods. The Analysts at FCMA simulated passive low-cost investor thinking for a comprehensive study which began with an analysis of the entire market of 30,999 mutual funds in the United States.

The low-cost funds were identified by their ability to meet the defined criteria for a low-cost mutual fund. For the purpose of this study, that defined criteria was a net expense ratio of less than 0.50% (making it a low cost mutual fund). This study also took into account the funds minimum initial investment amount, (the minimum amount that you must invest into the fund) and only included those less than five million dollars. This left around 1800 low cost mutual funds. The study included all sectors of the market equally weighted, however excluded aggressive, moderate, and conservative allocation funds, because these are made up of the funds from other sectors we analyzed.

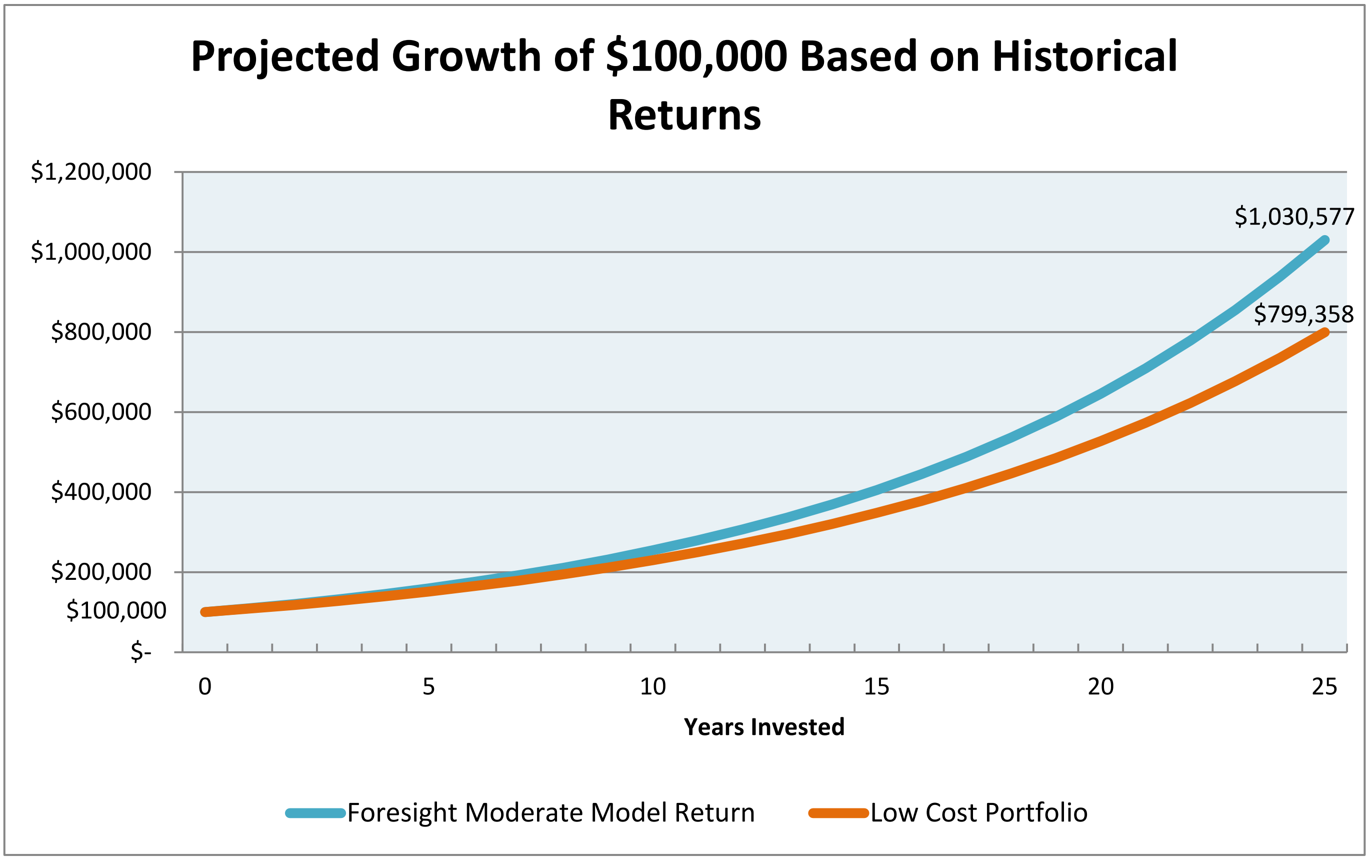
This portfolio was then compared to Foresight's moderate mutual fund portfolio. The Foresight moderate model is constructed by taking all 30,999 mutual funds and screening based on inception date, manager tenure, composition, style, expense ratio, alpha, sharpe, standard deviation, and 1, 3, 5 year returns.

From this screen we determine the best performing funds in each sector based on these criteria. The model is then made up of funds from each sector and assigned a weighting based on current economic conditions and outlooks. Through the Foresight screening process we will naturally have some low cost mutual funds if they are the top performing fund in the sector based on the 11 criteria mentioned above.

The results are as follows: The three year return of the low-cost mutual fund portfolio was 9.02% and the five year return of the low cost mutual fund portfolio was 8.67%. Although these are returns are reasonable, they still fall short when compared to Foresight's moderate model portfolio which returned 11.42% in the three year and 9.78% in the five year.



Although the difference in return may appear minimal, this difference equates to hundreds of thousands of dollars over the course of a working life. In fact, a person who invested $100,000 with no additional contributions in the low-cost portfolio for 25 years would have accumulated $799,358 (based on an 8.67% annualized return as calculated in the 5 year low cost model average return). If that same person would have invested in the Foresight Moderate Portfolio rather than the low-cost portfolio, they would have earned $1,030,577 in the same amount of time (Based on an annualized return of 9.78% as seen in Foresight's 5 year average return). That is a difference of $231,219 at retirement!



An Actual Comparison: Low-Cost vs Blended Portfolios

The low-cost approach to mutual fund investing may not always be the most effective when it comes to overall rate-of-return. On paper, a cheaper mutual fund with good returns may seem more appealing to investors than a more expensive mutual fund with better returns. However, once our analysts took a deeper look into the true 'cost' of the low-cost mutual funds, it was discovered that cheaper is not always better. How did we do this? Foresight's analysts compared their existing traditional blended model portfolios (aggressive, moderate, and conservative) with the low-cost model portfolio alternatives. Mutual fund categories and allocation weightings are identical in both types of models. However the low-cost models contain funds that have a lower net-expense ratio. A mathematical comparison between the low-cost models and the traditional blended models was done for the aggressive, moderate, and conservative models. First, all mutual fund categories that did not have a 3, 5, or 10-year return history were removed from the models for both the low-cost and blended. By doing this, our analysts were working only with funds that showed returns for all time periods and could produce an accurate mathematical result. After narrowing down the mutual funds and taking the difference between the net-expense ratios for each model, then adding that difference back into the rate-of-return for the same model, our analysts found that the traditional blended model portfolios continued to outperform the low-cost model portfolios in all three models. Please see below for an example of how this calculation was performed and how our analysts arrived at this conclusion.

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Comparative Performance Summary
Low cost vs. Blended Models

	* Low cost Moderate Portfolio	* Blended Moderate Portfolio	Difference	* Low cost Aggressive Portfolio	* Blended Aggressive Portfolio	Difference	* Low cost Conservative Portfolio	* Blended Conservative Portfolio	Difference
3 Yr Return	5.56%	5.73%	0.17% x3 years = 0.51%	6.60%	6.65%	0.5% x3 years = 0.15%	5.28%	5.61%	0.33% x3 years = 0.99%
5 Yr Return	5.47%	5.69%	0.22% x5 years = 0.66%	6.34%	6.54%	0.20% x5 years = 1.00%	5.60%	6.17%	0.95% x5 years = 2.85%
10 Yr Return	4.90%	5.27%	0.37% x10 years = 3.70%	5.41%	5.83%	0.42% x10 years = 4.20%	5.40%	5.97%	0.57% x10 years = 5.70%
Net Expense Ratio	0.44	0.74	0.30	0.45	0.78	0.33	0.42	0.73	0.31

*All data is from Morningstar 3/31/2016.

The low cost and blended portfolios represent identical allocations of mutual funds in the Foresight aggressive, moderate, and conservative models. These portfolio strategies are offered to our individual and retirement clients and are updated each quarter with mutual funds that are top performing in their peer group. The low-cost portfolios look at mutual funds that have an average net expense ratio < .50, thus limiting the number of funds that are available for the model portfolios. The blended portfolios look at the entire global universe of all US mutual funds availalble (31,000+), regardless of the net expense ratio, and are comprised of a more blended group of higher performing mutual funds that may have a net expense ratio >1.0. However, their returns net of expenses are top performing in the peer group. Therefore, the blended portfolios are comprised of a more diverse group of mutual funds and offer a more blended investment approach.

Comparison Conclusion: Foresight's aggressive, moderate, and conservative blended models beat the low-cost portfolios net of all fees in the 3, 5, and 10 year returns. Even though the net expense ratio is more expensive in the blended models compared to the low-cost models, it is clear that the excess difference of higher returns concludes the blended portfolio, which utilizes a broader screening of all mutual funds, outperforms the low-cost portfolio. The blended portfolio, which uses a broader selection approach to investing, is the best overall approach to maximizing return over time while maintaining an appropriate strategy.

So how do you reap the benefits of the excess market returns? Seek professional help from an advisor who utilizes asset allocation to invest in the best market sectors and the best funds available using investment research and rebalancing throughout the year to keep a leading edge on the indexes. This entails looking at all available mutual funds not only the low cost funds. If you only look at the low cost mutual funds you are excluding about 90% of available mutual funds! By only looking at 10% of the mutual funds available to an investor it makes it much more difficult to find a top performing fund.

The Foresight Way!

At Foresight, we use a rigorous screening process that is executed quarterly through a rebalance to keep a leading edge on the forever changing global market. This screening allows Foresight to utilize the leading sectors of the economy, while still delivering a well-diversified portfolio. By rebalancing each quarter and properly weighting the best performing sectors of the market, we are able to then screen and hand pick the best two to three performing funds in each sector. This quickly narrow's the over 30,000+ mutual funds available, down to the best 50 mutual funds in the market. Our screening process has helped lead to our impressive 7+ year track record of returns. Low cost mutual funds will be in Foresight's portfolios, but only if they earn their spot by being the top performing mutual fund in that category net of all expenses. The long term conclusion is a mix of low cost and actively managed mutual funds should provide the best returns over time. Please contact us if you wish to discuss our investment strategies or our findings regarding the misconception of total low cost investing.

Laurie S. Stegenga, CPA, CFP®, PFS, AIF®
President, Foresight Capital Management Advisors, Inc.
1705 Woodland Drive, Suite 204
Saline, MI 48176
Phone 734-429-4680