Interview:
Chuck Jaffe

Investments & Wealth Monitor recently spoke with Chuck Jaffe, senior columnist for MarketWatch, where he writes the popular column “Your Funds” about mutual fund investing in the United States. He also created the “Stupid Investment of the Week” column, which highlights mistakes that lead to bad investments. He is the author of two books, The Right Way to Hire Investment Help and Chuck Jaffe’s Lifetime Guide to Mutual Funds. The following is an excerpt from the September 2007 interview.

Monitor: How do you see the evolution of instruments for personal investors, in particular the use of exchange traded funds versus mutual funds?

Chuck Jaffe: This depends on what the instrument is and what they’re using it for. In the old days everybody wanted to come up with the next idea. You’d get things like the Tombstone Fund, which was a death-services sector fund. On the one hand it sounded like a good idea and on the other hand there are nine companies in that industry, most of them small, and they couldn’t support an index. Today the same people would not create a mutual fund, they’d create an ETF. For the typical person ETFs are a fine vehicle if they know what they’re buying.

Monitor: What about in the context of asset allocation and implementation solutions?

Chuck Jaffe: The question is: Can you ride the rollercoaster? When you buy an ETF or any type of index vehicle, you’re stepping onto the rollercoaster. The financial advisor’s job is to provide emotional discipline. A financial advisor needs to know his or her customer well enough to know when to turn a customer away. If you don’t know your client well enough to know they can’t ride the rollercoaster and you strap them onto it, you deserve what happens.

Asset allocation only works in certain situations. John Bogle has been overly critical of ETFs because he believes that if you build a trading vehicle for somebody, people are going to trade it. His numbers would back him up, although the numbers are skewed by the fact that ETFs are built to be trading vehicles; in some cases they’re traded, in some cases they’re held. Redemptions have come way down not because people are redeeming less than the average investor, but because the small percentage of people who were abusively trading are gone so they don’t count in the statistics anymore.

I don’t necessarily believe that people are going to trade the vehicle, especially if they’re buying it through a financial advisor—again because the advisor’s role is to provide emotional discipline.

Monitor: Please give us your thoughts on the debate about life-cycle funds.

Chuck Jaffe: As a default choice life-cycle funds are a lot better than anything else out there. But I feel no differently about them than I do about balanced funds. If someone wants to find a great mutual fund for their first mutual fund, I might suggest they get a balanced fund—stocks and bonds, a little exposure, professional management, low cost, diversification. That’s great until the client wants to take charge of the asset allocation. Life-cycle funds make a tremendous amount of sense as a default choice if we’re going to enroll employees in their 401(k) plans and they’re not going to actively participate.

I don’t think they’ll play out for people who take a more active role. If you’re working with a financial advisor and this is part of your 401(k) plan, you’re going to be advised to pick that asset but go to a spot where we can control it, we understand what it does, and we’ll give you the emotional discipline to stick with it. It’s not the panacea it’s intended to be, and I don’t know that it ever can be.

Monitor: On the institutional side, what do you see as the extent of structured products that may be unknown or unidentified in mutual funds? Is this an issue that people should think about?

Chuck Jaffe: There’s no question that you can have these issues. But these days most funds have taken care of this by changing their prospectus language. They’re allowed to have them and if you don’t recognize that they have them, then shame on you. The Piper case, if I recall correctly, was
more about money market funds that have interest-only and principle-only mortgages that nobody understood. Then people got to the point where they said interest-only mortgages are bad. Well how many interest-only mortgages are they issuing in California right now? The fact that you’re taking a derivative on your house doesn’t seem terrifying; the fact that somebody else is taking a derivative product does.

I’m much more accepting of not just alternative strategies, but I’ll take for granted that everything out there works for somebody. I may not take for granted that it works for everybody and frequently, because I write “Stupid Investment of the Week,” I will tell you that it doesn’t work for most people.

Monitor: Are investors getting smarter?

Chuck Jaffe: That depends on how you want to measure intelligence. People are a lot smarter with regard to not chasing performance, but I also think some of that is circumstantial. Who in their right mind would chase performance? It’s almost impossible for a general fund to get to the top of the performance charts. There’s much less performance surfing, although you still see 97 percent of all money going into mutual funds going into the four- and five-star funds, which is its own form of performance surfing.

Monitor: You’ve written about the size of the funds, the so-called emerging managers phenomenon. Do you see the persistence in investing today?

Chuck Jaffe: Yes and no. We all want to meet and get to know the next great manager. But I’ve met five or 10 next great managers who became next great flops. Equate this to financial advisors. A recent Rydex Advisor Benchmarking study talked about the average registered investment advisor who has a minimum and how that minimum has gone up significantly, now upwards of $400,000.¹ Plenty of people tell me they don’t have enough money to get a financial advisor because every good advisor has a million-dollar minimum. A minimum has nothing to do with whether or not you’re a good advisor, it has to do with how someone values their time. Every good advisor I know who has a minimum started out not having a minimum. Some percentage of those people looking for an advisor today are going to get the next great advisor and some percentage of the people who are not with that guy today are going to wind up disappointed.

In an ETF-driven world you don’t need to find the next great global-macro manager or the next great any-kind-of manager. In an ETF world it’s not based on who has better management, it’s based on who has the better index.

Monitor: What advice do you have for financial advisors and how has that evolved?

Chuck Jaffe: Everybody expected that my book, The Right Way to Hire Financial Help, was going to rip financial advisors. The interview methodology is there to help get a good match between advisor and client. I’ve had two types of experiences in the years since the book came out. First, you get the people who have written me because somebody walked into their office with a copy of the book and put them through the most exhausting, rigorous interview they’ve ever had and they’re kind of unhappy about it. Then you get the people who, having gone through it, go out and buy the book and want to make sure that every customer asks a certain segment of the questions.

One unhappy customer is a much bigger problem than 10 who are going to be thrilled with you. Advisors should be turning more people away because the advisor and the client are not a good match.¹

Endnote