Welcome to Money For the Rest of Us Plus. This is the premium podcast episode for Plus members, episode 313. I'm recording this Friday morning, September 11th, 2020. In today's episode I have a question from a member on hiring an investment advisor when you are an ultra-high net worth individual.

I have a question from a member on annuities, variable and fixed annuities. A question on trading, and then a question on commercial real estate.

Hiring an Investment Advisor

The first member has a net worth of around 20 million dollars, and he's struggling with the fees that investment advisors charge. Some charge up to 1% or so annually, he points out. Robo Advisors charge a low rate of 0.5%, but it's still a percentage of assets.

He writes "Frankly, these percentage fees seem too high to me. $100,000 to $200,000 annually. I would expect an advisor to do some work in year one to understand my situation and resources, but after that it should be rebalancing only. For this reason, I've managed my investments myself."

The first thing to understand is that most investment advisors/financial advisors - their asset-based fees are geared toward individuals with lower account balances. There are not that many individuals that have 20 million dollars in assets that need to be managed or overseen, and as a result, with that level of net worth you can negotiate a fixed fee, rather than pay an asset management fee.

The member continues: "I'm not satisfied with my own results, and I think I need professional help. I'm not an active investor; too busy with work, and I don't know what I'm doing. My portfolio looks like my daughter's room. I never rebalanced. I got worried about Covid and sold a big slug of mutual funds at the bottom of the market in March and didn't have the courage or discipline to invest. Instead, I keep stockpiling more cash as the stock market keeps climbing, waiting for the crash. I need a portfolio house-cleaning, a plan, someone who knows more than me to help make wise decisions, but I don't want to pay $100,000+ annually for a few hours of advice."

Negotiate a Fixed Fee

Well, first, negotiate a fixed fee. You can negotiate a project fee, but it comes down to what is the objective. Are you seeking help with your overall financial picture, or is it specific to setting up an asset allocation? And when we talk about the objective, at that level of net worth I don't know what this member's living expenses are, I don't know what his long-term plans are for his wealth, but 20 million dollars seems like a lot of money, and it is. But relative to an institutional account, or an endowment for example, this investment could be done with two exchange-traded funds - a global stock market ETF and some type of bond ETF, perhaps a municipal bond ETF.

How Much Risk?

The key is to determine, like we all have to do, how much risk we're willing to take in terms of looking at the maximum drawdown of a particular allocation, the years to recovery, and how it impacts our lifestyle. This member could invest very conservatively, and decide they have enough, sufficient wealth that they're fine earning 2%-3% per year, and adopt a conservative allocation, with just a couple of ETFs.

Investing Doesn't Have to Be Complicated

The point I'm trying to make is sometimes as our net worth grows, we think we need to make investing more complicated, and it doesn't have to be if we don't want. My portfolio is more complicated because I enjoy investing, and I like the variety. But as we talked about in this week's regular podcast episode 313, there's all kinds of portfolio decisions that need to be made, that can be made, but many of them can be simplified. And I'm all for hiring some advisory help to get an outsider's perspective, to assist with an asset allocation, to walk through what it is you're trying to accomplish, to look at your tax situation.

It could be done on a project basis and then you can implement it yourself, negotiating a fixed fee. This member doesn't necessarily need somebody to oversee and manage their investments on an ongoing basis, but perhaps they just wanna check in with somebody once a year. Or maybe they do, in which case they can negotiate a much lower fee than 1% of assets under management.

Annuities

The next question is a follow-up from also this week's regular podcast episode, where I profiled a member, as we talked about portfolio management... He had some specific questions on annuities, or really the philosophy of annuities. I mentioned in that episode that he has recently purchased several annuities: fixed annuities, variable annuities, and he said it was an extremely challenging intellectual exercise to understand what he was buying. And that is true when it comes to annuities, particularly annuities that involve an investing component.

An immediate annuity, where you pay a one-time premium and then receive income for the remainder of your life - they're less complicated. But some of the annuities that he was looking at is it pays out the return of the S&P 500, but it's capped at 7.5%, and then you're protected from the first 20% of losses, and anything over that, you sustain the losses. Similarly, there was one that the return was capped at 13%, but then you took any losses greater than 10%. And there was another one that was more a straight up 4% return, with some additional protections. But the point is they can be complicated. We need to understand the fees, and you need to read through the documents. But they can have a role in the portfolio if they provide the investor with peace of mind, and feel comfortable locking in a particular return.

I've mentioned that there's a new video on the site on hedging portfolio losses, and how expensive that can be. An insurance company that's offering some type of annuity where there's a cap, and there's some downside protection, they're facing the same market. So they have to buy the derivatives, buy the options to make sure that they're able to deliver on their particular contract.

I personally have a hard time conceptualizing an annuity where there's some downside protection up to a certain amount. In this case, you're protected against the first 20% of losses, and then if the market fell 30%, you would be subject to a 10% loss. I don't like the potential for unlimited losses when it comes to an annuity. I would rather take the first 20% of losses and then have the annuity take everything below that, and it would perhaps be a cap on the upside. I'm fine with caps on the upside.

There are all types of flavors of these annuities, and the bottom line is they can have a role. Read the documentation very carefully, understand the fees, and consider how they fit in your overall portfolio. But if they give you some peace of mind, then certainly consider them as an aspect of your investment portfolio.

Trading

A question from a member in the forums about trading... I'll preface this by saying I'm not a trader. I've tried trading; I'm not very good at it. I discussed trading in detail in episode 239 of the podcast, "How to be a successful trader", but I also find trading enticing. The idea -- maybe there's just some romance of being a trader, making your money for the day, going away and then coming back the next day to try again. It's enticing. With trading and investing, we always have to ask who's on the other side of the trade. Who am I trading with? And that's where I get concerned about trading, because many novice traders don't realize it's professionals on the other side of the trade. And the securities they're trading, they have no informational edge to know what the right price is, so there's a lot of guessing involved.

When I tried my hand at trading, after I quit my investment job, I tried it for about six months and then gave up, because I found that the securities were just too volatile. And when I've experimented with stop losses, I've often found that - yes, I was protected, but the securities would move so quickly, it would hit the stop loss, the trade would be implemented, but then the security would bounce back. Again, it could be I'm just not a very good trader.

I have had more success, and I feel better - and I've mentioned this - about trading closed-end funds, where there's a yield, and buying them at a significant discount, and holding them until they reach a premium. This member's question was "What about exiting?" Well, if you trade, there should always be a target price, and when you reach that, you get out. I've done that with closed-end funds.

Now, I've not traded much in closed-end funds these last couple of years, as economic conditions have deteriorated, because of the uncertainty. I know that some members have, and have been successful in buying closed-end funds at very steep discounts, and then benefitted as those discounts narrowed, both in March, as well as back in late 2018. There is a guide on closed-end fund investing on the website.

The reason why I prefer to use closed-end funds for trading is most closed-end fund holders are individuals, retail investors. That's who you're trading against. Plus, you get an income yield while you're waiting for that discount to narrow. That's very different than trying to trade options on individual stocks or foreign exchange. That type of trading often ends up being trend trading, where you're trying to just jump on a trend, ride it along, and get out in time. There are investors that can do that; I am not one of those. But I'll admit, it can be fun. So I'm not saying don't experiment with it, but the key is it's an experiment.

Commercial Real Estate Update

Finally, I had a question from a member that asked about commercial real estate. He is a psychiatrist, and is considering buying a suite with 3-5 offices that he could rent out to colleagues and therapists. He writes:

"One would think that with people working from home and meeting via Zoom, the pandemic and the recession, offices would be dropping in price, but it doesn't seem like it to me." He is looking in the Delaware – Eastern Pennsylvania area.

I was on a webinar - or I listened to the recording of a webinar - by Green Street; and if you wanna learn more about commercial real estate, what's going on in the different sectors such as office, retail apartments, they're a great resource. Green Street is one of the oldest real estate-specific research firms for both private real estate as well as equity real estate investment trusts. Their services are expensive, and so when they offer a webinar, I usually get on because they provide great information. And it's difficult to get information on commercial real estate and real estate investment trusts. That's something I've mentioned before, and it's been a source of frustration.

They pointed out in this webinar that property values in theory have fallen so fast that buyers and sellers are trying to figure out what the cap rates are, the cap rate being the net operating income divided by the price. So this is a yield calculation. And when purchasing an office building, like this member is considering, that's a primary factor - figuring out "Alright, here's what the gross rents would be, here's my expenses, including some for reserves, and here's the net income at the end, divided by the price."

Cap rates, for many sectors, were down to 4%-5% prior to the crisis. Now there's been a level of uncertainty, and this particular analyst on the Green Street webinar pointed out that there just haven't been that many deals to be able to see what new prices are, and so they made assessments of how much prices of private real estate have fallen, they said they were educated guesses. But they also pointed out that it appears that public REITs have fallen by 10% more than what they believe private real estate has been... And as a result, there are sectors of the public REIT market where the public REIT is just more pessimistic than what private real estate values have fallen to.

Areas where public REITs are much more pessimistic, or the most pessimistic was with office; there's a 23% gap. Public office REITs are selling for 23% discount to the value of offices on the private real estate market. That's a huge gap. There's much more pessimism in offices in the public REIT market than there is in the private, and part of that is the private side of offices haven't fallen much, because there hasn't been that many transactions, which I think this member is seeing - that prices aren't reflecting that yet.

In that webinar they mention if you're considering buying an office, take that into account, that the public REIT market is pricing those offices at a much lower price. Consider that when you make an offer.

Now, the other thing that they mention is the outflow from cities to suburbia, residences. People are leaving the city to go move out to suburbia. Their thought was that would benefit suburban office parks, and perhaps hurt offices in the urban centers. Now, that's an early trend, but another reason why this member might be finding it difficult to find an office park. There were some areas where REITs are priced at a premium to the private real estate market, such as industrial - it's 17% premium. Manufactured housing - 12%. Storage - 6%. In other words, the sectors of the real estate market that have been less impacted by Covid have done better, and it's showing up in the valuations in public REITs... Whereas the areas of the real estate market that there's more uncertainty - retail malls, strip centers, apartment lodging, offices - they're selling at a discount to the net asset value of the private real estate.

Green Tree expects real estate overall on a risk-adjusted basis to return 6% long-term, and they went through a bottom-up analysis of that - that would be similar for public REITs - and they point out that that 6.1% expected return is 2.8% above the yield on investment-grade bonds. Historically, real estate returns have only been about 2% more than investment-grade bonds... And that 6% return is higher than high-yield bonds by about a half percentage points. Typically, their returns have been similar.

Their point is, despite all the uncertainty in the real estate market which we're seeing, and the carnage in the public REIT market, returns are still positive, expected to be. That rents are continuing to be paid, that there have been some valuation adjustments, that the public REIT market appears to be more pessimistic in its pricing than the private real estate market... But even adjusting for those valuation differences, the returns are still positive as we look out 3-5 years.

I've mentioned how REITs are adapt as the real estate market changes, and this is why I continue to hold public REITs in my portfolio, and they continue to be in the adaptive model portfolios - because they are an income strategy that will continue to generate income. There will be adaptations, and there will be adjustments within the real estate sector, but real estate is not going away.

So I wish this member good fortune as he seeks out an opportunity. It sounds like you might need to be patient and recognize that there have not been that many deals in the real estate market right now because of the uncertainty... And it sounds like particularly in the office sector that those prices have not caught up with the pricing of offices in the public REIT market.

That then is Plus episode 313.