Beyond ETFs and the Self-Directed Fund

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Beyond ETFs & The Self-Directed Future

There I was in March 2017, staring at my 'professional' advisor's quarterly report. It was a beautiful computer generated graphic of the S&P 100 performance over the past five years going from the lower left to the upper right of the page as compared to my IRA's performance over the same period. Yes, sigh, it was about half of the S&P 100 index performance.

Self-Directed Fund (SDF) is a new category of financial services product

- Disappointment in advisor's performance led to the Brockmann Method, Beyond ETFs app
- SDF combines features of Mutual Funds, Exchange-Traded Funds and classic portfolios
- SDF is more focused than classic portfolios
- SDF has lower fees than Mutual Funds
- SDF delivers better performance than Exchange Traded Index Funds

This happens every quarter, in kitchens and apartments all across America. And it happened to me. Yuck. Needless to say, I was hugely disappointed. And to add insult to injury, my wife shook me out of my stupor to remind me that I had already paid them a 1% fee of assets under management regardless of that crummy performance. Not much upside for me. No downside for them either. They were so fired.

For me, disappointment became a powerful catalyst to change the game. Change the rules. And the catalyst to take control of my future.

I called my brother Wilf, who is a financial analyst and told him what I had done. He said he was proud of me and then asked a simple but haunting question, "What are you going to invest in now?"

I took a deep breath, "I'm going to buy an Index fund, because then I can beat my broker's crummy performance and not have to suffer the humiliation of poor performance on top of those awful fees." There. I said it.

Here comes the twist that changed my world: “Peter,” he said. “Wouldn’t you rather ***beat*** the Index, instead of just meet it?”

And the rest is history. Wilf taught me the **Brockmann Method**[1] and I’ve been using it ever since. In fact, I’ve also codified it into an iPhone app that you can use too.

Self-Directed Fund - a new category of Product

As I was building this app, I realized that I was creating a new category of investment product. This isn’t just a classic portfolio, it’s my own Self-Directed *Future* with my own Self-Directed Fund. No bonds. No index funds. No mutual funds. Just stocks.

In fact, they’re just the S&P 100. The biggest and best managed companies in America. Name brands, every one. In the period March 2017 through January 2018, my SDF is up 34.0 % compared to the S&P 100’s 20.6%. I’m beating the Index!

Now, I don’t think of myself as a sophisticated investor by any stretch of the imagination. In fact, I’m quite simple. I like rules in investing and have struggled with a range of rules that didn’t really work.

I’ve had a personal discount broker account for about fifteen years. I originally seeded the account with $10,000 and considered it a kind of ‘playground’ for advancing my understanding of how the market works and to practice my immature investment strategies with a couple of stocks. I’ve owned Motorola and RIM with the expectation that they’ll swing back soon (bad idea, since sold), Cisco and IBM too. In fact, for most of my adult life, I have owned stock in a number of companies including my various employers. At one time, my goal was to buy them cheap and hang on (another bad idea).

At other times, it was to invest in only those companies in industries that I knew something about. The sad realization is that I was investing in companies in the same industries where I was working. That meant that

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[1] Wilf Brockmann, **Introducing The Brockmann Method: How I Consistently Beat The Index And So Can You**, BAT, https://www.brockmann.com/the-brockmann-method/, December 2017

when I was having a 'rainy day,' it was a pretty good chance that my employer and its peers were having rainy days and therefore my portfolio would be full of water too.

However, I admit that I never really understood the dynamics of how to invest successfully - nor did I have the discipline or attention span to nurture that understanding properly. I often bought terrible stocks or held onto them way past their prime. Knowing my weakness, is exactly why I left the bulk of my available funds with a so-called 'professional' in the first place, but now I know better. Way better.

Table 1 - comparing various financial service product classes.

	Mutual Fund	Exchange-Traded Fund	Classic Portfolio	**Self-Directed Fund**
Management Style	Active	Passive	Active	**Active**
Number of Owners	Many	Many	1	**1**
SEC Has Specific Regulations	Highly Regulated	Highly Regulated	None	**None**
Prospectus	✓	✓	-	**-**
Annual Report	✓	✓	-	**✓**
Manager	"Rock Star"	Robot	You	**You**
Performance	Mixed	same as Index	Mixed	**Beats Index**
Average Number of Stocks	91	Hundreds	25 - 30	**10**
Source of Decisions	Proprietary research	ETF Filings and Prospectus	Vanity' investing: tips, personal analysis, TV, news	**subscription-based research**
Convenience Model	Buy & Forget	Buy & Forget	Always buying, never selling	**Signals when to sell, what to buy, ~27 trades/year**
2017 US Funds	$14.7 Trillion	$3.4 Trillion	$8.8 Trillion	**< $ 0.001 Trillion**
Growth In Usage	Decline	Growth	Stable	**High Growth**

Now, they're all in my SDF.

SDF is a new category of financial services product. It combines many of the features of conventional Mutual Funds, Exchange Traded Funds and the classic stock portfolio with the power of knowledge, discipline and personal control. SDF is designed to deliver superior performance as compared to the Index since it is also one's Self-Directed *Future*.

This paper examines the core features of the Self-Directed Fund and details the three compelling ways that the SDF is differentiated from a classic stock portfolio, from a Exchange Traded Fund or from a Mutual Fund. Table 1 above provides a summary of the comparative features of the four financial services products and their relative roles in the capital markets today[2] and into the future.

[2] Asjylyn Loder, **As First ETF Turns 25, Exchange-Traded Funds Dominate Investing World**, Wall Street Journal, https://www.wsj.com/article_email/as-first-etf-turns-25-exchange-traded-funds-dominate-investing-world-1516626000-lMyQjAxMTE4MDIwMjkyMjI4Wj/ , January 22, 2018

The Self-Directed Fund is More Focused Than a Classic Stock Portfolio

The classic portfolio, involving a single owner and the buying and selling of stocks and other financial instruments such as bonds or options for their own account is the original stock market product. In this setting the owner is the manager and is able to employ any number of investment strategies with or without discipline, with or without knowledge and of course, with or without successful results.

The SDF has many of the same features as the classic portfolio but differs on five key attributes.

Table 2 - comparing features of the classic portfolio and Self-Directed Fund.

	Classic Portfolio	**Self-Directed Fund**
Average Number of Stocks	25-30	**10**
Annual Report	NO	**YES**
Performance	Mixed	**Beats Index**
Source of Decisions	Vanity' investing: tips, personal analysis, TV, news	**subscription-based research**
Convenience Model	Always buying, never selling	**Signals when to sell, what to buy, ~27 trades/year**
2017 Funds	$8.8 Trillion	**< $ 0.001 Trillion**
Growth In Usage	No Change	**High Growth**

Ten stocks
The SDF typically owns no more than ten stocks. Classic diversification theory suggests 25-30 stocks is more appropriate, however the downside is that with more diversification, you also get lower returns. SDF managers agree that concentration enables value creation.

Keep in mind that the number ten and therefore ten stocks is a solid number because it is so directly correlated with human physiology - ten fingers and ten toes is pretty common - and the ubiquitous currency counting systems around the world is based on 10-base. Ten also happens to fall within the span of the typical manager/owner's attention, so as manager you won't easily let any of your stocks fall through the cracks and get your SDF into trouble. Limit your holdings to a maximum of 10 stocks.

Research[3] shows that mutual fund portfolios typically contain an average of 90 stocks, while the most diversified portfolios contain an average of 228. Impossible for any one person to manage and follow!

Goals Matter
In contrast to the classic portfolio, the SDF requires a disciplined approach with a single, measurable goal. Goals must be measurable and should be have a definite time period associated with them. In my case, it is the goal of my SDF to beat the Index each year.

Annual Report
SDF managers/owners also prepare an annual report for themselves to review decisions - good and bad - and update their goals - good and bad. Annual reports are required features of ETFs and Mutual Funds, but not of classic portfolios.

Decision Sources
In the case of SDFs, the source of decision-making material is typically provided through a subscription service that signals when to sell and what to buy. In contrast, classic portfolios more commonly rely on personal research, TV personalities, neighborhood tips or financial newsletters.

Often the classic portfolio manager/owner gets plenty of advice on what to buy, but never advice on when to sell. What to buy and when to sell are the two most important pieces of information that should be expected from a bona fide SDF decision support content.

Convenience Model
The 'convenience model' refers to the style and process of decision making. Products like Mutual Funds and Exchange Traded Funds have highly convenient models because they're designed for 'buy and forget' which of course makes them suitable for most corporate 401(k)[4]s or Investment Retirement Accounts. Their active managers (Mutual Funds) or robot managers (Exchange Traded Funds) keep them on their legally-defined and

[3] Terry Smith, **Too many stocks spoils the portfolio**, Financial Times, https://www.ft.com/content/220c76fe-a1bd-11e2-ad0c-00144feabdc0, April 12, 2013

[4] 401(k) Plan is a US-specific employer-sponsored retirement savings scheme where employees save and invest a portion of their paycheck before taxes are deducted and sometimes receiving a matching gift from the employer. Taxes are paid on plan withdrawals.

legally-chartered paths which makes them appropriate for many retirement planning processes.

Classic portfolios typically engage with so many different sources of buys, they often buy too many stocks and hold them for too long which is more of a ‘buy many and never sell’ model.

SDF managers are also the SDF owner. They have an incentive to invest in more convenient methods than classic portfolio managers. Because they’re not really interested in anything more than what to buy and when to sell, they are most often rewarded with better returns. They don’t over-think what to Buy*, and don’t procrastinate on when to Sell*.

Automated publishing services, such as the **Beyond ETFs**[5] app for iPhone (available in the Apple App Store), are ideal for automatically coordinating the signals of what to Buy* and when Sell* stocks. These kinds of publishing services are better for informing SDF managers than print or email newsletters because changes in the market inform the software and are instantly and always up-to-date in your pocket.

Beyond ETFs, for example, constantly updates the actions (Beyond ETFs calls it ‘Zone Changes’) to take, but also allowing the diligent SDF manager to know the score at a glance - Was today a $1,000 day? A $2,000 day? Did I beat the Index today? SDF managers know.

And, they know how they compare to their goal too. SDF managers have a disciplined ‘convenience model’ at play. They trust their tools and act only when necessary.

[5] Peter Brockmann, **Beyond ETFs**, Brockmann & Company, https://itunes.apple.com/us/app/beyond-etfs/id1239982859?mt=8 Learn more: https://www.brockmann.com, December 2017

The Self-Directed Fund Has Lower Fees Than a Mutual Fund

Jason Zweig is a reporter for the Wall Street Journal who has been exposing the seedy side of the financial services industry for many years and more recently applied his laser-guided vision to the Mutual Fund industry. In an article published February 2, 2018, Jason identifies a litany of issues[6] with opaque industry practices - quiet on returns, the appearance of collusion on fees, conflicts of interest and overly complex organizational structures.

He reports that four out of five funds ‘fail to match the performance of the market they are purporting to invest in’, and reminds his readers that research has shown that professional investors have underperformed for the past 80 years! Jason also brings attention to the very high margins in the financial services industry - second highest net margins in any industry other than tobacco.

That margin comes from only one source - your investment capital - and it has to also cover the mutual funds myriad costs.

Table 3 - Comparing fee components of Mutual Funds and Self-Directed Funds.

Fee Component	Mutual Fund	Self-Directed Fund
Management Fee	✓	-
Marketing Fee	✓	-
Compliance Fee	✓	-
Consultant Fee	✓	-
Transaction Fee	✓	✓
Subscription Fee	-	✓

Even the humble corporate 401(k) plan, administered on behalf of the nation’s employers by behemoth companies such as Fidelity Investments, TD Ameritrade, Morgan Stanley and others have been dinged as these administrators change their fees and product lineups to make it more expensive for some customers to invest in low-cost

[6] Jason Zweig, **Financiers, Heal Thyselves**, Wall Street Journal, https://blogs.wsj.com/moneybeat/2018/02/02/financiers-heal-thyselves/ , February 2, 2018

Vanguard mutual funds[7].

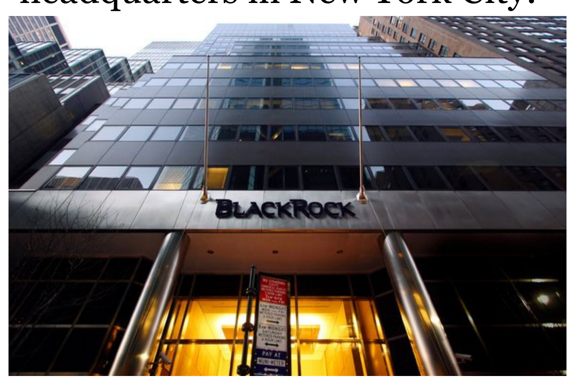
Table 3 provides a summary of the expense categories associated with operating Mutual Funds as compared to the expenses of operating a Self-Directed Fund. SDF attracts only the unavoidable transaction fees and typical subscription fees which is often a flat annual fee which is also independent of investor assets, while the typical mutual fund attracts many other 'costs' that are paid for by front-end (at time of purchase), back-end (at time of sale) and annual fees:

- **Operations Fees** - encompass the salaried, bonus and benefits costs of the professional staff of the fund - the fund staff including analysts, accountants, marketers, sales professionals, compliance specialists, information technology professionals, human resources managers, lawyers and managers. Most of these professionals need constant training in compliance, legal and ethical issues as the regulations and law changes frequently. This training cost is included as part of the management fees. As well, the real estate expense to attractively office these many professionals are not small sums.

Figure 4 - Vanguard headquarters in Malvern PA.

- **Marketing Fees** - Fund managers have to pay for the many branding initiatives including brochures, videos, corporate branding including golf tournament sponsorships, Olympic sponsorships, websites, advertising and distribution fees.

Figure 5 - BlackRock headquarters in New York City.



- **Compliance Fees** - Mutual funds are highly regulated entities and therefore attract regulatory fees

[7] Sarah Krouse, **Wall Street to Vanguard: We're Not Your Doormat**, Wall Street Journal, https://www.wsj.com/articles/wall-street-to-vanguard-were-not-your-doormat-anymore-1517157915?mod=searchresults&page=1&pos=2, January 28, 2018

include the cost of organizing as a mutual fund and complying with the requirements and regulations including reporting on the appropriate Securities and Exchange Commission forms and systems as the cost of doing business. Even still, these safety and security features have to be paid for, and are paid for by the owners of mutual funds. The cost of preparing, printing and distributing the fund's prospectus and annual report is often considered as a component of the compliance fees.

- **Consultant Fees** - Since mutual funds are special legal and tax entities, their formation and operation often attract complex questions that need to be answered within a broad context that only high-priced, third-party advisors can answer. Not to be confused with compliance fees, these consultants and their fees are for proactive advisory-type services, which could expand to encompass government filings and reports. In the event of a lawsuit, outside counsel may be engaged and identified as a professional fee element of the Consultant Fees component.

- **Transaction Fees** - Mutual funds buy and sell stocks and other financial products, which attract fees for execution, handling and settling. As it turns out, this is typically the smallest component of the fee structure and is the only portion of the mutual fund fee structure that is also required with SDFs.

- **Subscription Fees** - Investors need to learn what to Buy* and when to Sell*. Subscription services such as embodied in Beyond ETFs are convenient, fast and always in the subscriber's pocket. These fees are comparable to many renewing consumer services and are completely independent of the assets involved.

SDFs attract only the transaction fees and the subscription fees which are typically independent of the size of the assets in the SDF: the greater the assets, the smaller the percent of assets these fees represent. Regardless of the size of the portfolio to invest, the SDF subscriber typically trades about 27 times per year x $10 average transaction cost = $270/year. The subscription might cost less than $200/year for less than an estimated $470/year.

With mutual funds[8], the greater the assets, the larger the fee as a gross amount. Consider a front load large cap equity mutual fund with typical 1.22% of front-end fees. On a $100,000 portfolio the mutual fund would charge $1,220, and then extract a management fee, typically 0.5-2% per year. So if the mutual fund investment grows 5% in the first year, the first year's expenses are $1,220 + ($98,780 x 1.05 = $103,719) x 1% = $1,220 + $1,037.19 = $2,257.19.

Table 6 breaks out the comparative arithmetic for a simpler view at the end of a 5-year period of nominal 5% growth. The mutual fund shareholder would gain a net proceeds of $121,103.39 while the SDF owner would receive an additional $3,788 more.

Table 6 - Comparing Mutual Fund and Self-Directed Fund expenses and proceeds on 5% growth. Mutual fund has preLoad of 1.22% and annual maintenance fees of 1%. Self-Directed Fund trades 27/year at $10/trade and subscription of $200/year.

Starting Investment = $100,000	Mutual Fund	Self-Directed Fund
First Year Expenses	$2,257.19	$470.00
Sum of 5 Years Expenses	$6,856.15	$2,350.00
Proceeds after 5 Years	$121,103.39	$124,901.26
Starting Investment = $200,000		
First Year Expenses	$4,514.38	$470.00
Sum of 5 Years Expenses	$13,712.29	$2,350.00
Proceeds after 5 Years	$242,206.78	$252,529.41

The effects of lower fees and an independent cost structure are even more pronounced when comparing the proceeds of the $200,000 starting investment with the $100,000 case. For the mutual fund shareholder, the proceeds are exactly double - double the input, double the output. But in the case of the SDF owner, the proceeds are $2,726.89 higher than double because the fee structure of the SDF leaves more dollars to grow with compounding in investments.

Note that SDF transaction expenses typically happen throughout the year as the newsletter might signal to sell* at any time throughout the year and not necessarily at the beginning of the year, although the subscription fee might occur at that time. Nevertheless, we've taken a conservative approach on the SDF cost analysis.

[8] **Mutual fund fees and expenses**, en.wikipedia.org, https://en.wikipedia.org/wiki/Mutual_fund_fees_and_expenses

The Self-Directed Fund Has Better Performance Than an Exchange Traded Index Fund

Exchange Traded Funds, also known as ETFs are a type of investment product that is composed of many stocks like a mutual fund but is traded on stock exchanges like stocks.[9] They first appeared in 1993 and are each structured as a management investment company that owns assets such as stocks, bonds and options. It divides itself into shares that are owned by shareholders and generally, easily purchased or sold on stock exchanges. In contrast, mutual fund shares are purchased directly from the fund at Net Asset Value (NAV), which is determined once a day, after the close.

The management of ETFs are simple since the investment strategy is to adhere to the defined goals in the prospectus. Therefore it is a tiny bit of overhead compared to the mutual fund. This way, the ETF's trading price ends up being a close approximation of the sum of the value of the underlying holdings. Typical management fees could be 0.2% of assets with no front-end or back-end loading which is much less than typical mutual funds.

One such ETF trades on the New York Stock Exchange with the symbol, OEF. It is the BlackRock iShares S&P 100 Exchange Traded Fund.

OEF holds the stocks of the S&P 100, the largest and most highly capitalized companies in America. As good as these underlying companies are, some are struggling in their markets in early 2018 - General Electric, Ford, Proctor & Gamble, IBM and AT&T to name a few. Others such as Boeing, Amazon, Abbvie and United Healthcare are 'price momentum' leaders and are appreciating in value very quickly.

Because the SDF owner invests only in a small number (10) of the highest price momentum performing companies in the Index in question, the downside of owning these other seemingly momentarily lagging stocks is avoided. Owners of OEF own a portion of GE, Ford, Proctor & Gamble, IBM and AT&T, while SDF owners own the Boeing, Amazon, Abbvee and United Healthcare stocks. With SDFs, high price momentum performance is offset

[9] https://www.investopedia.com/articles/01/082901.asp?ad=ETF_Feat

with nearly as high a performance. So, in totality, with SDFs, the best performing stocks are owned and the least performing stocks are avoided.

The SDF owner will also sell* and buy* from time to time, as indicated by the subscription service, while the OEF will only ever respond to the changes in the Index - which hardly ever happen.

So it follows that by owning only a subset of the Index's stocks and then constantly comparing and rank-ordering the price momentum of the Index' stock, beating the Index fund is intuitively possible and very likely.

Summary

Self-Directed Funds is a new category of financial product that combines the best features of classic portfolios, mutual funds and Exchange Traded Funds to create an investment product with a high degree of focus, personal control and accountability, with the lowest fees possible and yet delivers the highest performance. The SDF is what's after Exchange Traded Funds and is an effective method for assuring a Self-Directed *Future*.