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The Evolution of Ferguson-Johnson Wealth Management

John Ferguson, Principal

The firm, as it exists today, was different from the one we started in 1978. The world of investments is also different, meaningfully different.

Prior to our founding, John Ferguson was a stock and commodity broker. Success in that business was measured in commissions. Many large national firms would internally list their top ten producers for each month. This was the era which created the phrase: “Where are the customer’s yachts?”

Research was also different then. It was possible to use information that others did not possess to gain an advantage in a stock transaction. Now, insider information may get you jail time and a hefty fine. The markets today operate on the assumption that all information is and must be publicly available for everyone. Knowing the sister of the company’s president, for example, gets you no investment benefits without the above mentioned penalties.

Back in the ’60s and early ‘70s there wasn’t a “know your customer” rule. The stockbrokers back then were not required to consider a client’s goals or tolerance for risk. In fact, when the rule became mandatory, many brokers considered it to be a waste of time.

Sometime in the mid-1970’s a new discipline arrived on the scene, known as Financial Planning. John became an early advocate of the practice and earned his CERTIFIED FINANCIAL PLANNER™ designation before starting his one man show. In 1978, Ferguson & Company was primarily a financial planning business and asset management was left up to the clients.

This began to change as we realized clients were having difficulties getting the newly recommended asset allocations implemented through the major brokerages. One client (who is still a client, by the way) asked John to manage her assets, and that began what has evolved 37 years later into Ferguson-Johnson Wealth Management.

In the beginning, John was picking individual stocks and bonds for client portfolios. He bought research from private institutions and leading analytic firms. The problem was, most of the recommendations assumed you were buying into a large number of positions in a multi-million dollar portfolio. One month he recalls receiving about 100 new buy recommendations and none to sell. It was impossible to put that number of holdings into the size of accounts he was managing. That was like creating your own mutual fund.

It was then that he turned to mutual funds for client portfolios. What an eye opener that was in the 1980’s. However, we were still having a hard time finding the consistency we were looking for. There were growth funds whose managers were bearish and held the majority of their assets in cash, conservative income funds that made speculative bets on interest rates, and small cap funds with large cap stocks. Style slide was a common practice and investors' funds were not being employed as the prospectus suggested

The Securities and Exchange Commission began cracking down on Fund disclosures in the 1980's. If the fund said they were a foreign stock investment, then you didn't expect to find General Motors in among the holdings. Finally, some semblance for an asset allocation model was available for investors.

Around this time, a group of academics were investigating the performance and the returns of actively managed mutual fund portfolios. They found that results were sometimes skewed to favor short term results or, that after tax returns, were far less than advertised in funds with high turnover.

Included below is an excerpt from the 2014 SPIVA US Scorecard displaying what percentage of actively managed mutual funds underperformed its respective benchmark.

Report 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks

Fund Category	Comparison Index	One-Year (%)	Three-Year (%)	Five-Year (%)	Ten-Year (%)
All Domestic Equity Funds	S&P Composite 1500®	87.23	76.77	80.82	76.54
All Large-Cap Funds	S&P 500	86.44	76.25	88.65	82.07
All Mid-Cap Funds	S&P MidCap 400	66.23	70.48	85.37	89.71
All Small-Cap Funds	S&P SmallCap 600	72.92	80.40	86.55	87.75
All Multi-Cap Funds	S&P Composite 1500	83.74	76.31	84.02	84.03
Large-Cap Growth Funds	S&P 500 Growth	96.01	71.08	91.50	89.52
Large-Cap Core Funds	S&P 500	79.28	77.32	88.77	84.30
Large-Cap Value Funds	S&P 500 Value	78.59	80.98	86.67	58.76
Mid-Cap Growth Funds	S&P MidCap 400 Growth	56.25	66.48	89.42	91.81
Mid-Cap Core Funds	S&P MidCap 400	58.39	70.43	85.62	88.42
Mid-Cap Value Funds	S&P MidCap 400 Value	73.61	72.73	78.35	85.71
Small-Cap Growth Funds	S&P SmallCap 600 Growth	64.49	71.50	85.95	91.71
Small-Cap Core Funds	S&P SmallCap 600	67.92	82.13	89.25	88.14
Small-Cap Value Funds	S&P SmallCap 600 Value	94.31	90.00	89.68	86.59
Multi-Cap Growth Funds	S&P Composite 1500 Growth	87.85	72.20	84.51	83.33
Multi-Cap Core Funds	S&P Composite 1500	86.60	81.62	85.94	85.20
Multi-Cap Value Funds	S&P Composite 1500 Value	69.42	68.35	82.47	79.64
Real Estate Funds	S&P US Real Estate Investment Trust	80.14	86.23	91.49	78.08

Source: S&P Dow Jones Indices LLC, CRSP. Data as of Dec. 31, 2014. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

We are constantly solicited by mutual fund companies that tout their positive performance returns, but aren't as forthcoming that their fund did not perform as well as their benchmark.

Mutual fund fees and expenses are also an important consideration. We do not and have never received commissions or 12-b1 fees from any firm. There are funds with front or back end commissions, redemption fees, and distribution fees. According to Investopedia "the average equity mutual fund charges around 1.3%-1.5%."[1] We found these onerous, and the practice of putting clients into such funds deceptive.

During the '80s and '90s as retirement plans became part of employment benefits and our personal wealth grew, the middle-class began to have a larger stake in the stock market. Over the course of the bull market that reigned throughout much of the '80s and '90s, the S&P 500 Index value jumped from 102.42 to 903.80[3]. Even with two large declines in the 2000's, the S&P stands today at 2,114.07[4].

This indeed was a rosy period for individual investors and for the mutual fund business, but problems still persisted.

- Strong Capital Management was forced by the SEC to pay 458,000 investors monies from "ill-gotten gains and civil penalties for distribution to defrauded shareholders."[5]

- Janus was the fifth-biggest mutual fund firm in the U.S. with $325 billion in assets in early 2000. However, by 2005 their assets had fallen to $130 billion[6] following the burst of the dot.com bubble and violations stemming from improper trading[7].

- Legg Mason's Value Trust fund was managed in the nineties and early 2000 by Bill Miller, who famously outperformed the S&P 500 for 15 consecutive years. However, the financial crisis brought the fund back down to earth with 58% declines, 20% worse than the S&P 500. This places the fund as one of the worst performers on one-, three-, five-, and ten-year periods, according to Morningstar[8].

Over the past 20 years, former winners have lost and former losers have won. The past has been no gauge for the future. Some reasoned that perhaps the individual investor could do better on their own.

According to DALBAR, a firm that does Quantitative Analysis of Investor Behavior, the average investor's 20 year return through July 2012 was "Astoundingly Awful." "After including inflation, the average investor got a negative return." It appears investors await conformation before acting. They get in near the top and out near the bottom[9].

We, as others, were searching for investments that might match or come close to performing as well as their benchmarks. A benchmark example would be the Russell 2000 index that is currently comprised of 2,000 small-cap companies. These companies are from a broad range of industries and represent approximately 10% of the total stock market capitalization value. It is an unbiased monitor that is reconstituted annually "to ensure larger stocks do not distort the performance and characteristics of the small-cap opportunity set.[10]" The Dow 30 Industrials and the S&P 500 are well-known indices and another thirty or so are used for benchmarking analysis, such as the MSCI EAFE index (EAFE stands for Europe, Australasia and the Far East).

In 1976, Vanguard Funds, started the first index fund[11]. The Vanguard 500 Index Fund mirrored the performance of the S&P 500. That fund also had a low expense ratio and did not charge commissions. Naturally, the brokerage industry was uninterested, but fee-only advisors took notice. We began using

Vanguard Funds in portfolios in the 1990’s supplemented with some individual stocks, bonds, and internationally focused mutual funds.

Allocation is the new word that began popping up in earnest during the 1990’s. In 1993, Drs. Eugene Fama and Kenneth French, of the University of Chicago, developed an asset pricing model that became the foundation Dimensional Fund Advisors was built upon.

After significant research on our part, complete with trips to Dimensional headquarters, we were approved by Dimensional to employ their funds in our portfolios. Please note that I said *approved*. In order to offer Dimensional Funds to their clients, an advisor must demonstrate an understanding of data-driven investing and a subscription to a disciplined, long-term approach.

Dimensional Funds are index-like funds with some of the lowest management fees in the industry. They do not compensate us or even reimburse us for our frequent travel to their research meetings. We use their funds because we believe, in most situations, they are the best investment vehicles available for helping our clients achieve their goals. Of course, we still chose to include some of the other thousands of securities and funds for our clients, but have found that returns and risk are best served using Dimensional as our core holdings.

Going forward, we will continue to seek out the best opportunities for our clients. We are committed to our clients and know that in order for us to be successful, our clients must be successful.

Ferguson-Johnson Wealth Management

[1] Investopedia Staff, "Mutual Funds: The Costs," Investopedia, Accessed 6/3/2015.

[2] "Wilshire 5000 Total Market Index," Wilshire, Accessed 6/3/2015

[3] Petruno, Tom. "A Look Back at a Great Bull Market," Los Angeles Times, August 13, 2002.

[4] "S&P 500 Index," Market Watch, Accessed 6/4/2015.

[5] Strong Capital Management, et al. The Securities & Exchange Commission, Accessed 6/3/2015.

[6] Condon, Christopher. "Janus Adds Funds as Managers and Investors Head for the Exits," Bloomberg Business, May 30, 2013.

[7] Frick, Bob. "Janus Rebuilt," Kiplinger, July 2007.

[8] Lauricella, Tom. "The Stock Picker's Defeat," The Wall Street Journal, December 10, 2008.

[9] Maye, Michael. "Average Investor 20 Year Return Astoundingly Awful," The Street. July 18, 2012.

[10] "Russell 2000® Fact Sheet," Russell Indexes, Accessed 6/4/2015.

[11] Bogle, John. "The First Mutual Fund: A History of Vanguard Index Trust and the Vanguard Index Strategy," Bogle Financial Market Research Center, Accessed 6/3/2015.