I Don't Pay My Financial Managers; They Pay Me

* ***** The Wall Street Journal recently (8.9.21) ran an article about the problems investors are having with the standard 1% financial advisory fee.

* ***** With the reduced returns the Journal says are expected the 1% fee will take a big bite out of investors' portfolios.

* ***** I have a different deal. My investments are managed by my two adult children (Erin and Matt). They do the work and pay me for the privilege.

The Journal article was entitled "Say Goodbye to the 1% Adviser Fee?". The subtitle was "Investors who don't want to pay that much now have an increasing number of alternatives". The piece recounted a number of cases of investors who had reduced their fees through a variety of less costly investment options or by using advisors with different fee structures other than the standard 1% fee.

I think we have a better approach. My two investment managers operate in accordance with the Make Your Family Rich (MYFR) System detailed in my recent book, ***Make Your Family Rich; Why to Replace Retirement Planning with Succession Planning.*** The key ingredients of the MYFR System are:

1. We own only Dividend Champions (DCs). That's those currently142 great American businesses that have paid increasing dividends for at least 25 years.
2. We never buy the stocks directly. Rather, we sell out of the money put options on days when a particular DC drops a lot.
3. We never sell a DC unless it stops increasing its dividend which rarely happens.
4. We DRIP all our dividends constantly increasing our DC holdings over time.
5. We think of ourselves as owning an asset management business the assets of which are the many DC businesses we own.
6. We will never retire because we simply migrate into administering our asset management business and each generation succeeds the prior in managing the business.

Scratch the Itch Businesses

It's not quite that simple. We do own businesses that are not DCs; at least not yet. For example we own some tech companies that pay increasing dividends but have not increased payouts for the full 25 years. We also own some community banks that we borrow from to finance our remaining real estate investments. We believe those banks likely are good prospects for takeover. We love the way community bank values pop on a buy out or merger. These varients to our DC concentration are discussed in our article entitled ***"Go Ahead; Scratch the Itch"***. The substance of that article is that no matter how well the MYFR System works folks will likely have some personal preferences. We believe you have to occasionally give vent to your personal picks so long as you do so moderately. By the way, any articles cited herein can be found on my Seeking Alpha blog. They are also reprinted on our web site, www.makeyourfamilyrich.com.

The Next Generation Takes Over

Starting on January 1, 2021, my two grown children Erin and Matt took over day-to-day management of our MYFR System. They had trained for the task and were ready to work together. Check out the article ***The Next Generation Takes a Step Forward. How It's Working.*** What their work amounts to most days is trading out of the money put options on DCs. They have created spreadsheets on Yahoo Finance of all the DCs and the Scratch the Itch businesses we might be interested in. On a joint call each day or so they identify the businesses where the market price has gone down appreciably. They then check out the pricing on the puts for those businesses of interest and determine how many puts to sell and what sale price to bid. To best understand our logic and methods for trading options you need to read my article; ***The Make Your Family Rich Method is to Sell the Dips; Put Options, That Is.*** Great article.

It is probably helpful to step back here and say that Erin and Matt have designed custom spreadsheets for determining the extent of our exposure to liabilities for outstanding puts. That is, they can determine how much we are potentially committed to should our puts have to be exercised. At this writing, we have a relatively modest margin balance. Using margin to sell puts is a great way to magnify returns. After all, the investor does not incur any interest cost unless the put executes. If the option expires unexecuted the debt is never incurred and the option seller experiences an infinite rate of return. Doesn't get any better than infinite. But selling margin backed puts can be very risky. Erin and Matt have designed systems to manage and mitigate that risk.

Managing Margin

Even though they have some margin currently Erin and Matt continue to sell puts on qualifying businesses. Those puts generally are for no more that three months in the future and at strike prices usually about 10% or so below the current price. As expiration dates approach, Erin and Matt make a calculation on the probability of the option exercising and adjust the potential liability accordingly. For example, on the Monday of a week where options expire on the coming Friday, Erin and Matt may reduce the probability of the option exercising by 40% or so if the current price is say 15% above the strike price.

The three of us have agreed that we should limit potential margin to 15% of the portfolio value. That can change with time but we believe the market is elevated right now and a 15% debt level is safe. I should note here we have some valuable real estate investments under contract for sale currently in due diligence and are expecting substantial distributions in coming months. So you always have to be careful of debt but we are in a reasonably safe position for carrying some debt.

The software developed and managed by Erin and Matt can also tell us the maximum possible debt we will incur in the event of various levels of market decline. Importantly, they can use the software to determine how much the market would have to decline before we would get a margin call. For example, the maket would have to decline about 50% from current levels before we would get a call.

The Next Generation's Skills

When I was actively managing our asset management business and selling puts to acquire DCs I did not have the kind of software available that Erin and Matt have designed and use. That is one of the advantages of a generational succession. Coming generations may lack experience but are likely better at certain skills than their predecessors. It is no surprise to many that a younger generation would have more advanced software and technical knowledge. I brought the basic MYFR System to fruition and Erin and Matt have designed and applied better, more contemporary operational and risk managementtools. That's the way succession should work and who knows where Erin and Matt's children will take the System.

How my Financial Managers Pay Me

Time for the explanation of this article's title. Yes, Erin and Matt are paid an annual financial management fee of 1%. But here's the rest of the story. A bit more that half way through the year they are on a path to generate about 2.2% of the portfolio's value on an annual basis just in put premiums. Their work adds increased value equal to more than two times the management fee.

That does not include the copious dividends our DCs throw off or the portfolio appreciation I likely will experience over the year. What's not to like? I get to spend more time at other things including writing books and articles as well as reading up on and visiting the businesses we already own. Did I mention I also get to do the work necessary to market all that real estate I have accumulated? I need to get rid of that stuff to get more capital to give Erin and Matt to generate more fees and wealth for me and our family. That's the way the MYFR System works. A 1% fee? Fergedaboudit, I like the deal.

Patrick J. Keogh is the author of: ***Make Your Family Rich; Why to Replace Retirement Planning with Succession Planning*** and ***Hey Kid; Wanna Own Great American Businesses?*** Available on Amazon.