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Skepticism

Jeff Troutner, Equius Partners

Longtime readers of Asset Class know that we do not subscribe to the traditional, old-school way of managing long-term investment portfolios. What they may not know is that we do not attempt to convert investors from traditional strategies to asset class investing. If prospective clients have not concluded on their own that active management has failed them in the past and/or is likely to fail them in the future, any attempt on our part to “sell” them on our approach will almost certainly be a waste of everyone’s time. What should be a meeting of discovery for both of us turns instead into a debate.

This is a sad reality of our job and our industry. We fix a lot of problems others have created for investors, and our efforts usually come after either a substantial loss, a series of less substantial losses (probably with multiple advisors), or a period when opportunity cost was particularly high (e.g., being out of stocks long after the March 2009 stock market recovery). Seldom, if ever, does a client come to us during a winning streak with an active manager. In other words, investors tend to “buy high and sell low” with investment advisors, as they tend to do with individual securities.

To prevent the same thing happening with us (need I remind you that our approach also incurs periodic losses and periods of relative underperformance?), we ask our clients to invest their intellectual capital from the start of our relationship with them. This means that they must take advantage of our transparency and our willingness to share our knowledge of markets, risk and return, modern portfolio theory, and investing behavior in ways that increase their confidence and help develop realistic expectations about potential outcomes. If we can’t get that commitment, we decline the relationship. We do not want prospective clients have not concluded on their own

Develop Healthy Skepticism

Skepticism has been getting a bad rap lately, as “skeptic” is often used today as a condescending term directed at a person who dares to question the implications of certain complex, multi-factor computer models by those who believe the science is “settled.” Yet most of us know that skepticism is the basis of all good science.

At Equius, we witness healthy skepticism whenever we have a chance to hear Eugene Fama speak. As Gene often says, theories are not facts; otherwise, they would be called facts (and he says this in reference to
his Efficient Market Theory and Three-Factor Model. Our own skepticism led us to abandon active management in 1993 and change our view of emerging markets in 2006, among other things.

So what should you do to make a graceful exit from the low odds of active management to the high odds of indexing and asset class investing? Be a skeptic. First, don’t take my word that active management will fail you eventually. Do some research.

You might start by examining your past. If you have allowed a stockbroker to make buy/sell decisions for you or even if you’ve made your own decisions, ask her to quantify your portfolio performance over a five- or 10-year period. Make sure she computes a time-weighted rate of return (TWR) on your account(s) so that contributions or withdrawals are accounted for properly. Computing TWR on a quarterly basis is sufficient.

If you have a fee-based advisor who reports your investment performance, make sure he is using the TWR calculation rather than an internal rate of return (IRR) or, heaven forbid, an average annual return using straight arithmetic. Then determine whether the returns came from manager skill (alpha) or from risk factors such as tilts to small cap or value stocks using factor analysis. Always measure and consider risk in ways that are relevant to your personal tolerance and long-term objectives.

Alternatively, you can skip right to an extensive body of research that shows how poorly active management has worked out for investors over many decades. You might start with Bill Sharpe’s “The Arithmetic of Active Management” and then go back as far as Jensen’s research on mutual funds in 1967. More recent research by Barra, Scarlet, and Wermers was referenced in our October 2013 issue of Asset Class.

Also consider the common sense of the issue. Remember that for every Wharton, Yale, Harvard, Berkeley, or Chicago grad on one side of a trade, there’s another on the other side. One is buying, one is selling. One believes a stock, a bond, the overall market, gold, interest rates, the economy, or whatever will go up, and one thinks it’s going down. Consider how accessible powerful computers are to all of these folks (and you) and how fast information is distributed and consumed in this modern era. Consider that 80% of trading volume in stocks is controlled by professionals and institutions. That’s a lot of “smart money” competing against one another to set security prices. Buyers and sellers. According to the World Federation of Exchanges, 99 million trades—representing $447 billion—are made every day.

**Why Do Most Investors “Buy” Old-School?**

With all the evidence and common sense, it’s hard to understand how active management dominates the investment industry. But then consider that most investment strategies are sold to investors, often as superior methods of stock picking that are unique to the advisor and far too “sophisticated” for the average investor to understand. Also, the more emotion elicited in the sale, the better.

Lack of transparency and an air of intellectual superiority on the part of many advisors effectively shields investors from having to delve too deeply into details many find too complex and emotionally challenging. At worst, this can lead some to hire a crook like Bernie Madoff to “manage” their money, only to find later that they were victims of a Ponzi scheme. Most of the time investors in opaque active strategies take on much greater risk than they think, underperform simple market index funds, and eventually find themselves on the merry-go-round of active management—moving from one pretty horse to another while making no real progress toward achieving their goals.

**Leave the Herd**

Once you’ve convinced yourself that active management is a “loser’s game,” take action.* If your portfolio is riding high, make a change to indexing or, better yet, asset class investing before your manager “loses his touch” or the markets decline. If capital gains taxes are preventing you from making the change, consider how lucky you are that you have gains and how likely it is that avoiding the (inevitable) taxes now will likely result in you effectively paying the tax to the market when prices decline or your manager suddenly loses his mojo.

And once you’ve decided to move into the modern world of investing and all it offers over the old school, consider hiring an advisor like Equius to help you reach your goals. Invest your intellectual capital in ways that increase your confidence and help you maintain the patience and discipline to see the strategy through to its expected conclusion.

Above all else, never lose your healthy skepticism. We haven’t lost ours. It helps us make sound decisions that benefit our clients and often run counter to the majority of advisors in our industry.

Properly channelled, your intellectual capital can yield incredible results. Healthy skepticism keeps you on course. Why not apply those to your investment plan today?

*Another great resource is Charles Ellis’s book “Winning the Loser’s Game.”