WSIA Newsletter

QUOTABLE

"It requires more than a day's devotion to know and to possess the wealth of a day." Henry David Thoreau

"Excellence is not an event, it is a habit. You are what you repeatedly do." William James Durant

" The most important quality for an investor is temperament, not intellect." Warren Buffett

"In hindsight, poor choices with happy endings are described as brilliant choices, and unhappy endings of well-considered choices are attributed to horrendous choices." Meir Statman - Glenn Klimek Professor of Finance at Santa Clara University.

Why 'active' investing is a losing bet

Charles Ellis is the author of the classic investment book "Winning the Loser's Game." He's also a former managing partner of the consulting firm Greenwich Associates and is on the Board of Advisors of the Yale School of Management. Ellis has spent more than three decades working on business strategy with major investment management firms in Europe, Asia, Australia, New Zealand, and North America.

In an article that will appear in an upcoming edition of the Financial Analysts Journal, Ellis describes the persistent failure of institutional investors to achieve their ubiquitous, but ephemeral, goal of beating the market. He says that extensive data show that the persistence of outperformance of active managers is well below what we would expect from pure chance (randomness). For example, in a random 12-month period, about 60 percent of mutual fund managers underperform. As you lengthen the time period, the failure rate increases. At 10 years, the percent of failures rises to about 70 percent, and at 20 years it's about 80 percent. Making matters worse is that the stock managers who underperform do so by roughly twice as much as the "outperforming" funds beat their chosen benchmarks. Thus, the risk-adjusted odds of outperformance become more daunting.

Ellis goes on to note that new research on the performance of institutional portfolios shows that, after risk adjustment, 24 percent of funds fall significantly short of their chosen market benchmark, 75 percent of funds roughly match the market, and well under 1 percent achieve superior results after costs -- a number not significantly different statistically from zero. ("False Discoveries in Mutual Fund Performance," by Laurent Barras, Olivier Scaillet, and Russ Wermers).

Why do people keep playing a game where only 1 percent of the players win and 24 percent lose? The evidence shows that institutional investors and their advisors are doing what Albert Einstein said was the definition of insanity -- repeating the same behavior but expecting different outcomes. Consider the following. Data from institutional funds show that large numbers of new accounts go to managers who have produced superior recent results. Of course, this occurs after these managers' best performance years. And assets move away from underperforming managers after their worst performance years. In a recent study of the experience of more than 1,000 institutional funds, the managers hired had achieved -- over the three years before their hiring -- significantly higher returns than the managers who were fired. (Before being hired, the to-be-hired managers produced substantial excess returns on domestic equities of 12.5 percent, 8.7 percent, and 4.3 percent annually over three years.) However, for the three years after the new managers were hired, the fired managers actually achieved slightly higher returns than the new managers.

Ellis's three decades of experience have convinced him that the main culprit for this underperformance must come down to investment managers themselves. He acknowledges that they're talented, hardworking, well-trained, and dedicated to their work, and they believe deeply in the value of their work. However, the truth of a theory often has nothing to do with how much you believe in it. Ellis notes that the managers are subject to what behavioral economists call the Semmelweis Reflex-- rejecting of new evidence that contradicts established norms, beliefs, or paradigms. The conventional wisdom in this case being that the past performance of active managers is predictive of the future.

But despite the overwhelming body of evidence to the contrary, institutional managers continue to believe that performance data can provide useful information for evaluating active investment managers. We don't need Sherlock Holmes to help us figure out why there's no persistence of outperformance:

1. The markets are highly efficient, making it difficult to uncover pricing errors.
2. Generating benchmark-beating performance is a zero-sum game before costs and a negative-sum game after costs. And the competition is incredibly tough, with as much as 80-90 percent of all trading being done by institutional investors themselves. That makes it difficult to identify a group of likely victims to exploit.
3. The costs of active management are high, and simple mathematics tells us that, in aggregate, active management must underperform passive management. And remember that all of the above data is before taxes. Even Ted Aronson, a successful active institutional money manager, stated that once you add the burden of taxes the hurdle for active management is almost insurmountable.
4. Successful active management contains the seeds of its own destruction. Success brings new cash flows, and the investment business is one with diseconomies of scale. Few active managers are willing to act in the interests of their investors and shut their doors to new money. So even if you could identify the few winners ahead of time (that 1 percent), by the time you have enough evidence to be convinced, it's too late. Either they have shut their doors to new money, or the fund has become "bloated," increasing the already high hurdle that needs to be cleared to generate true alpha.

Ellis knew that the winning strategy for investing also applies to the craps table: Don't play. The winning strategy is to accept market returns by investing in low-cost, passively managed funds, diversify, and have the discipline to stay the course.

If there is one lesson that you take away from this newsletter, we hope it is this: your behavior determines the type of investment experience you will have in the long run. It can be a successful one with a long term focus that delivers the returns available in the capital markets on a consistent year over year basis. Or it can be a frustrating experience of allowing your emotions to get caught up in the day to day noise of the economy and the markets.

Thank you for your continued trust and business. WS Investment Advisors, LLC. Invest Wisely. Live Fully.