Volume 8 //

Acuity

The greatest wealth is **your peace of mind**...

Dumb products, smart choices

Occam's Razor:
'numquam ponenda est puralitas sine necessitate'
or 'a simpler explanation is better than a complex one'
Father William of Occam, 1285-1349

Flying on autopilot

When you get on a plane to fly off on your holiday, do you feel reassured by the smartly-dressed pilots with their pressed uniforms and gold braid that you can see through the open cockpit door? Most of us do. After all, flying along at 33,000 feet at 500 mph in a metal cigar feels like a risky business (even though it is not[1]) and it's comforting to have someone who knows what he or she is doing, with lots of training and experience, rather than a computer, to get you to your destination safely. The hard reality these days is that it will actually be the auto-pilot flying the plane most of the time, possibly from take-off to cruise and landing.

Thank goodness for that. The majority of aviation disasters are actually due to pilot error (around 55%) or other human error (5%) rather than mechanical failure (25%).[2] For the one successful landing on the Hudson River in New York (good work Captain 'Sully' Sullenberger!),[3] there are many other circumstances where the outcome is tragic. And so to the fund management industry...

Investment pilot or auto-pilot?

The fund management industry is a highly competitive environment. This is perhaps not surprising since it is full of bright, talented, hard-working, highly ambitious, self-confident people. Basically the industry breaks down into two camps. The first are 'active' managers, who believe that through their skill, insight and hard-work they can beat the return of the market, by taking advantage when the market gets it wrong. Sounds like a nice promise.

The second group, 'passive' managers, believe that markets work pretty well and that the chances of picking up and exploiting any mispricing is slim, so they do not try. Their aim is to capture the market return as closely as possible for the investors in their funds, by buying every stock in the market (or specific index) in the same proportion as the index.[4] For example, a FTSE 100 index fund may well own all 100 stocks in the same proportion as they appear in the index. How dull (and dumb, in active managers' eyes)!

Dumbing down the dumb products

The polarisation of these two camps is the source of much debate, some of it quite heated at times. Passively managed funds - sometimes known as 'index trackers' or 'index funds' - are often positioned as being in the dumb part of the fund marketplace.[5] Common arguments built against passive funds are often based on themes that seek to put them down and talk up the sophistication of an active manager's proposition. Here are a few you might have heard, and the underlying inferences:

Why would you blindly want to own '*rubbish*' stocks just because they are in the index (e.g. the FTSE 100)? (The inference being that a skilled active manager would avoid the rubbish and pick '*good*' stocks.)

Why would you accept '*certain defeat*' because index funds will always slightly underperform the return of the market due to their costs? (The inference is that if you invest with an active fund, you at least have the hope of beating the market, though no probability is ever attached to this implied promise.)

Why would you want to have an unthinking, rules-based, computer-driven approach to managing the fund? (The inference being that what you really need is a skilled pilot to pick the right investments and be there when you need them, in order to avoid market falls by moving into cash.)

In fact, the passively managed index fund has suffered a torrent of put-downs from the active industry from the day the first fund was launched in the US several decades ago. As an American, it was even deemed to be unpatriotic not to try and beat the market! At first glance these charges may seem reasonable. However, if one digs a little deeper, it quickly becomes evident that the charges do not stick and the tables quickly turn on the active management promise.

Looking more closely

It is easy to think that a smart, well-educated fund manager should be able to beat all the other dumb investors in the marketplace. After all, if you ever need a barrister to defend you in court, you want to engage the brightest, sharpest QC you can find, who will back your corner and deliver an outcome in your favour, and thus justify the enormous fee that you end up paying him or her. The value of doing so is quite straightforward. In the investment world, this is not the case, by any stretch of the imagination (or evidence). Here's why.

The perception of how markets work divides the two camps

The first thing to remember is that in aggregate all investors are the market. In the UK around 80% to 90% of all money is managed by professional fund managers on behalf of individuals (via funds) and pension funds. So, when active managers claim that they are going to *'beat the market*', what they are really claiming is that they are going to beat the majority of the other smart, well educated, and motivated professional investors, often backed by vast global research resources. Active management is a zero-sum game - one fund manager's profits must come from another's losses.

The simple maths behind the zero-sum game (all investors are the market, so the average investor will receive the return of the market) needs to be extended to take into account the comparative costs of implementing the strategy of the two camps. Actively managed funds generally have significantly higher costs than passively managed funds, both in terms of the fees they charge and the costs of buying and selling securities between each other. The mathematical reality is that the average passive fund will beat a majority of active funds due to their cost advantage. The cost advantage of passive UK equity index funds (e.g. an index tracker following the FTSE All Share) versus the average costs of an actively managed UK equity fund is in the region of 2% p.a.[6] The odds in favour of the dumb product already stack up well at this level.

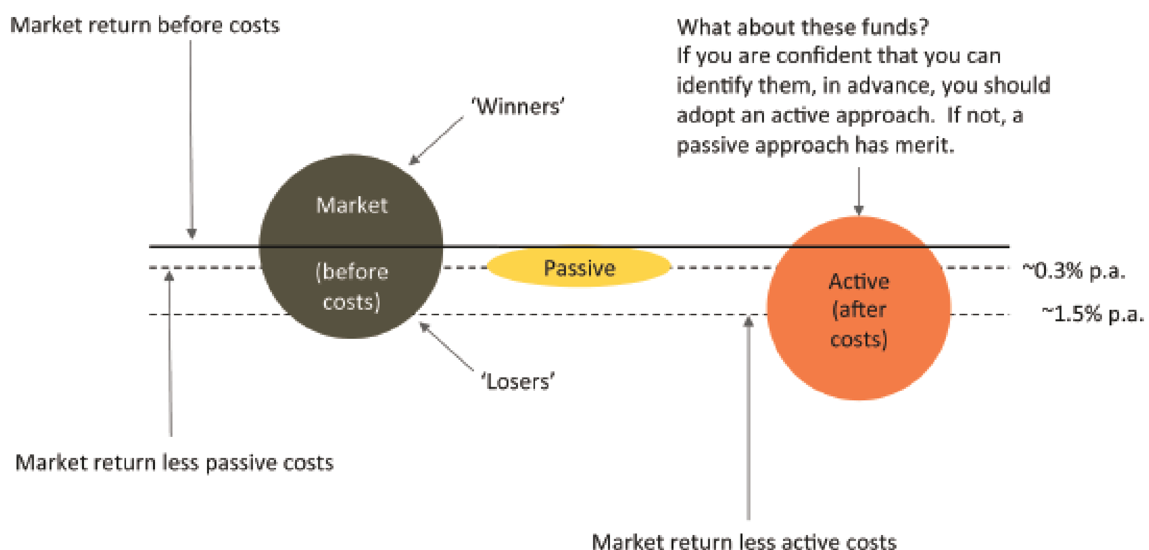

Figure 1: The mathematics of the less-than-zero-sum-game

Source: Albion Strategic Consulting

However, at this point we can draw no firm conclusions, because if even only a small number of active managers could deliver persistently strong, market-beating returns, and we can identify who they are today, and be reasonably certain that their good performance is due to skill and not luck, and will continue into the future, we should take that route - smart over dumb. Well, therein lies the challenge, as you will see.

How active managers can potentially win

One prominent theory (The Efficient Markets Hypothesis[7]) suggests that market prices reflect all publicly known information about a company. Thus the price of its shares, determined by the aggregate view of all market participants, is the best estimate of its true value. If that holds true, then one should adopt a passive approach to investing.

If markets do not work well, then skilled active managers should be able to take advantage. Paradoxically, the more skilled, talented and hard working the profit-seeking 'active' market participants (such as hedge fund managers, fund managers and equity analysts) are, the less likely it is that any profitable opportunities that may exist, will continue to exist. How long does a £20 note dropped in a busy high street hang around?

Crystal ball gazing - fun but ineffective

As active managers do not believe that markets work particularly well, they make short-term forecasts either about specific companies' earnings, or the valuation level of markets, to position their portfolios. The implication is that they a) either use the available information better than others or b) they have better information that others do not know, obtained via company visits and deeper industry insights. This often forms part of their marketing message such as *'We have 220 analysts on the ground in 58 countries...'* or *'we make 500 company visits a year'.* As before, these types of claims all appear to be logical and likely to improve the chances of a better (market-beating) outcome, or so it would naively seem.

By and large, the track record of forecasting across all walks of life is pretty weak (whether it's weather forecasters, politicians, economists, academics or fund managers) and has been subject to much research. All humans are suckers for a good, confidently told, forecasting story, as we can't bear uncertainty. That does not mean the story is right. One well-known study looked at a wide range of commonly used forecasting models used to predict the likely return from equities.[8] The authors concluded:

> ***We believe the evidence suggests that none of the academic models we re-examined warrants a strong investment endorsement today. By assuming that the equity risk premium was "like it has always been" an investor would have done just as well.***

Shades of Occam's Razor, perhaps? Passive managers, on the other hand, make no forecasts, as they do not believe they can outsmart the market. They simply seek to capture the return that the market (equity or bond) delivers, as closely as possible for its investors.

What does the hard evidence tell us?

There is a growing body of evidence to support the efficacy of 'dumb' passive products, over the majority of 'smart' active funds. Advisers who recommend the use of passive funds are simply following the evidence that they see before them.

One way to judge the odds of *'beating the market'* is to look at the universe of active funds available and see how many deliver on their market-beating promise over a specific time period. But care needs to be taken to make sure that any comparison is made on an apples-to-apples basis:

First, longer time periods are better as it filters out some of the noise (luck) in the data. A growing number of studies show that winners in one period are rarely winners in a subsequent period.[9] Past performance is not a reliable indicator of future returns, as all fund documents are required to state. Ignore the fund ranking tables in the Sunday papers - they are just noise.

Second, all funds need to be represented in the data set, including those that have been closed or have been merged during the sample period, otherwise the data will suffer from survivor bias. Generally, it is poorly performing funds that disappear. According to recent research, the average fund that is closed gives up over 3%, relative to the market return, over the last 18 months of its life.[10]

Third, all funds should be compared against a suitable benchmark, otherwise a manager who is simply taking on more market risk, e.g. having a high exposure to more risky smaller companies in their portfolios (therefore with a higher expected return), may claim credit where it is not due.

Finally, we need to see if the returns achieved are due to skill, not luck. After all, in any population of funds that own stocks in a proportion different to the market, some will simply be lucky.

The evidence is extensive in providing insight into the scale of the task of picking a market-beating fund manager, ahead of time, once all of the above have been taken into account. It would be impossible to review it all in this short article. Instead we will look at one long-term, reputable study that makes the point clearly.

Is a less than 1-in-100 chance the sort of odds you want to take with your money?

An elegant piece of research by Jack Bogle,[11] who has been a pioneer of index fund investing and a true advocate for investors receiving a fair deal when they invest, reviewed all 355 actively managed US equity funds over the 36 year period from 1970-2005. This is one of the longest studies undertaken on how well active managers have fared, and the odds investors face in trying to pick a winning manager, today, for the years ahead. This is what he found.

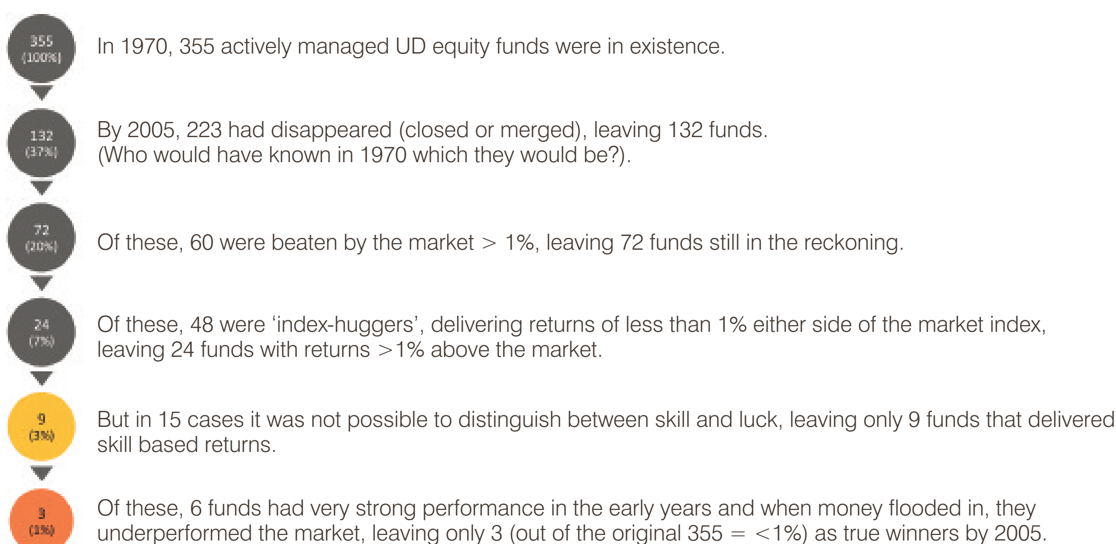

Figure 2: It is remarkably hard to deliver on the active promise
Data source: John C. Bogle, (2007), The Little Book of Common Sense Investing, John Wiley & Sons, Inc. Hoboken, NJ, pp. 78-83

Are those the sort of odds you want to play with your money?

Dumb products are actually pretty sophisticated

The term 'passive' is a misnomer and misleads some into thinking that passive management is a reactive, unthinking, rules-driven approach to investing. Far from it - in their own way, passive funds require considerable, proactive skills to execute successfully on their own promise of delivering the market return as closely as possible. It is just that these skills, focused on managing the myriad of costs that eat away at market returns, rather than the more sexy skills of the intelligent, Savile Row-suited stock-picker or market-timer, are a little dull and esoteric to talk about. These include: careful index replication strategies (should they own all the stocks in the market or a sample of them?); patient and clever trading strategies to avoid unnecessary transactions costs (e.g. providing liquidity to the market, not demanding it); marketing aimed at long-term 'sticky' investors to avoid fund asset turnover; less ostentatious offices; and lower remuneration scales. The cost-focused list is endless - passive investing is a mindset. The best funds (and one still needs to choose carefully between them) deliver returns that are almost indecipherable from those of the market.

In conclusion

Most supporters of passive investing have become so as a consequence of looking at the evidence available. Most will admit to some sort of a 'Damascene' moment when the realisation dawns on them that success in investing comes not from chasing long odds (hot markets and star fund managers), but by consistently making decisions that maximise the chances of a successful investment outcome. Most too will readily accept that a few truly skilled active fund managers do exist, but recognise that no-one has defined any robust and consistent means of picking them ahead of time, and they will not take the chance with their clients' money trying to do so.

One can conclude from the evidence that markets must work pretty well, and that any opportunities that do exist to profit are either hard to exploit successfully after costs, or cannot be accessed (or 'arbitraged' in investment speak) for some reason. In any event, they are not likely to persist in the form of any long-term, repeatable strategy, given the intense competition between intelligent and profit hungry active market participants. Thank goodness for active managers! Far from being dumb, passively managed index funds offer the thoughtful investor a robust investment tool to build their portfolios with. The crux of the matter is best summarised in the quote below:

> ***"The significance of the evidence is not that passive investing will always outperform active investing, but that when an investor has to make a decision about which way to invest, the probability of success always lies in favour of passive investment."***
>
> **Professor Simon Keane, Glasgow University**

This frees up the investor and their adviser to focus on the really important issues that they can control; their plans for the future, their expenditure and the overall structure of their portfolio. It avoids wasting time on things that they cannot control such as what markets to move into next, or how their active managers are performing, this month, next month or next year.

...and finally

A note from the World's most successful active manager:

> ***"When the dumb investor realises how dumb he is and invests in an index fund, he becomes smarter than the smartest investor…most investors, both institutional and individual, will find the best way to own common stocks is through an index fund that charges minimal fees."***
>
> **Warren Buffett, Chairman, Berkshire Hathaway and legendary active investor (one of the few).**

If dumb products, such as index tracker funds had been around in the fourteenth century, the Franciscan monk, father William of Occam, would have been a fan.

And next time you get on a plane and peek a look at the captain through the cockpit door, keep your fingers crossed that it is either Captain Sullenberger in the seat, or that the autopilot is switched on.

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End notes

1. If you fly with one of the top 30 safest airlines, your chance of dying on your next flight is only 1-in-30 million (www.planecrashinfo.com). To put this in perspective, the chances of dying driving your car in any one year is around 1-in-20,000 and 1-in-250 in your lifetime. (www.medicine.ox.ac.uk)
2. www.planecrashinfo.com - data from the 2000s
3. Chesley, B., Sullenberger (2009), Highest Duty: My Search for What Really Matters, published by William Morrow, is a good read if you want to gain an insight into what exceptional skill and a good dose of luck can achieve. If you are of a more nervous disposition when it comes to flying, perhaps you should not read it!
4. In practice, there are several ways in which passive investors capture market returns. The method used e.g. full replication or partial replication with sampling, depends on the markets involved and the strategy employed by the manager. Synthetic replication using derivatives is best avoided for most investors due to counterparty risk.
5. Some 'passive' funds do not follow common market indices, but seek to capture the returns associated with specific market risk factors such as company size or financial 'value' characteristics.
6. A note about how the cost comparisons are arrived at:
   The average UK All Companies actively managed fund has a total expense ratio (TER), which comprises the Annual Management Charge (AMC) and other fixed costs that can be offset against fund performance, of around 1.6% (Lipper 2009). Other costs that are a drag on performance relate to the decisions to sell and buy shares. The average turnover is around 55% of the portfolio a year (Lipper), which based on a round trip cost to sell and buy a share in the UK of around 1% (0.5% of which is stamp duty), means the average fund incurs around 0.6% of trading costs a year. That gives an 'all-in' cost of around 2.2% compared to around 0.3% for a well-managed UK equity index fund (including turnover).
7. Eugene F. Fama, (May, 1970) 'Efficient Capital Markets: A Review of Theory and Empirical Work,' Journal of Finance 25, no.2: 383-417
8. Goyal, Amit and Welch, Ivo, A Comprehensive Look at the Empirical Performance of Equity Premium Prediction (January 11, 2006). Yale ICF Working Paper No. 04-11. Available at SSRN: http://ssrn.com/abstract=517667
9. Standard & Poor's (Nov, 2011), Persistence Scorecard - Does Persistence Matter? Available at www.standardandpoors.com
10. Vanguard (2012), The case for index investing in the UK. Available at www.vanguard.co.uk
11. This is a great introduction to the active vs. passive debate, by one of the legends of the investment world. It is succinct, easy to read and while most of the data is US-based, the same principles apply in the UK and elsewhere, globally. Really well worth a read.

Other notes and risk warnings

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