Volume 1 //

Acuity

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

How to be the world's worst investor!

Common and costly mistakes to avoid.

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Weston

Question “How do you make a small fortune?”

Answer “Start with a large one!”

The $2 million dollar question

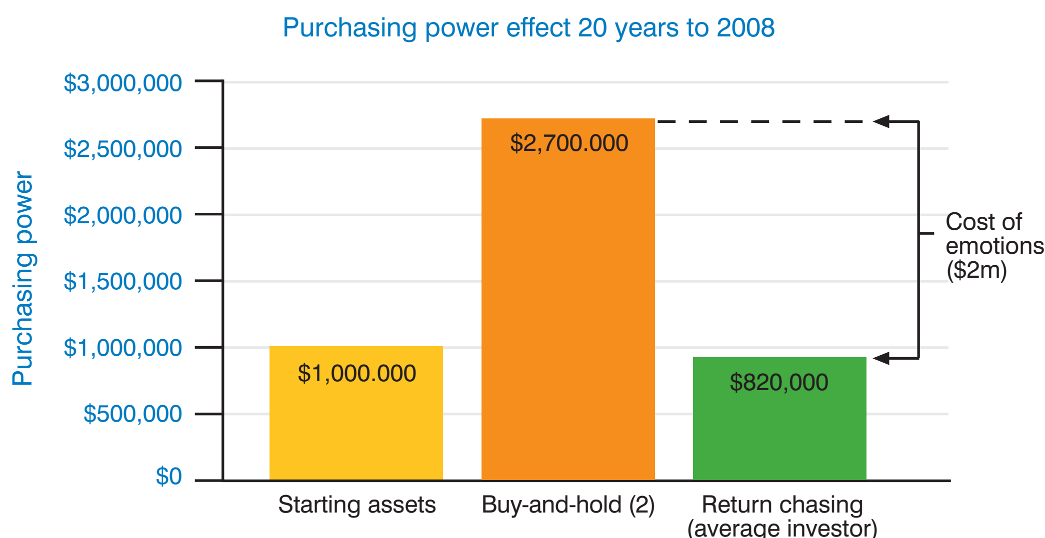
As you can see, the investment world is not particularly strong in the joke department. Unfortunately, this old joke is on us – the investor!

It is perhaps alarming to realise that a huge amount of wealth is destroyed by investors, as they fall into the traps set, either by human nature, or by those working in the investment and advisory industry itself. The harsh fact is that the wealth that is needlessly forgone will have a significant impact on their lifestyles and the opportunities that wealth brings to them, their families and their communities.

Let's try and put some numbers on this wealth destruction: an annual study in the US[1] compares the returns that the US equity market has delivered over the previous 20-year period, against the returns that the average investor has made by investing in US equity funds. The result: for the period to the end of 2008, the market delivered a return of 5.3% after inflation on average per year (that is the compound rate of return). Did the average investor receive a comparable return? Not at all! In fact, the average investor managed to lose 1% a year after inflation, thereby depleting the amount of goods and services their investments could purchase.

If we transfer those return numbers into dollars and cents (as it is a US study), we can gauge the true level of wealth forgone by many millions of Americans. Imagine yourself in their shoes – you invested $1 million in the market in 1988, in a fund that sought to deliver the return of the market as closely as possible (these are known as index tracker or passive funds). You forget about it until the end of 2008. Your return, after fund costs – of say 0.3% per year – and inflation, was 5% per year. Your $1 million was now worth $2.7 million in purchasing power terms (i.e. the goods it could buy). On the other hand if you had made the same mistakes as the average American investor, you would have turned your $1 million into $800,000. That is an enormous opportunity cost of almost $2 million.

Figure 1: Throwing money away[1]



Source: Dalbar (2009)

We should not become complacent here in the UK, as a recent study[2] revealed that the average investor in UK funds received a return of around 4% below the market, per annum.

Investment Trivia

The best performing US mutual fund over the 10 years to the end of January 2010 (The CGM Focus Fund) delivered a return of 18% per annum, yet the average investor received a return of minus (yes, minus) 13% a year.

Avoiding key mistakes

The encouraging truth is that being aware of the mistakes that many investors make and avoiding the traps that are set, allows you to take some simple steps to capture as much of the upside that is on offer from the markets, and that is rightly owed to you for the risks YOU take with YOUR money. These words are emphasised as you need to protect your interests from those in the investment industry whose interests may not be sufficiently aligned with your own. So what are the $2 million mistakes?

Mistake 1: Being human!

Unfortunately, we have been bowled a googly* by evolution that makes us susceptible to making poor investment decisions. While the human mind is an incredible thing, it has evolved a number of biases that, while useful as survival tools for everyday life, are the very basis for the wealth destruction that is so often evident.

A deep seated subconscious battle is constantly played out in investors' minds, pitting greed and the desire for reward, against the fear of uncertainty, loss and social isolation. Its manifestation is irrational and emotionally driven investment decision making. Your emotions and innate biases - of which you may not be aware, such as over confidence, inertia, seeing patterns and trends where none exist, the desire to avoid regret, and going with the herd – can make you susceptible to poor decision making.

Following the leader

Humans have survived by applying what they have just experienced and extrapolating that into the future – successful hunting grounds this year are likely to be good next – but this makes us all susceptible to making bad investment decisions. Mix in a bit of subconscious greed and the result is the temptation to chase 'winners', both in terms of markets - such as gold and emerging market equities - for no other reason than they are going up (or because the case is backed by a seemingly plausible story), and to chase brightly shining 'star' managers and funds.

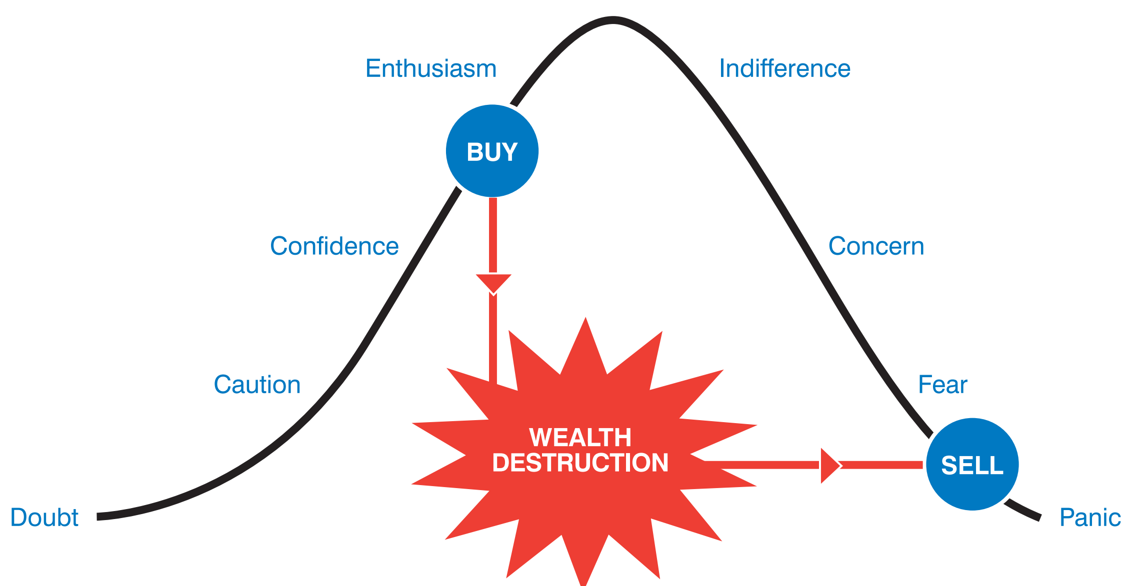
The trend is not your friend

The problem is that the past is not a good guide to the future, as every piece of investment literature is obliged by the Financial Services Authority (FSA) to state.

Yet every Sunday paper you pick up will have a money section full of tables and commentary on the best funds and managers, usually based on the past one to three years. Investors are prone to extrapolate these returns into the future. Mix in a propensity for failing to take account of the role that luck plays in short-term fund performance (lucky coin flippers will inevitably exist in these rankings, given that there are thousands of funds in existence) and it is easy to see how you can get seduced into believing that the short-term, market-beating performance will inevitably continue long into the future – it rarely does[3].

** For non cricketers, a 'googly' is a cricket ball bowled as if to break one way that actually breaks in the opposite way, in order to deceive the batsman.*

Figure 2: The cycle of wealth destruction



Up like a rocket – down like a stick

The problem is that markets inevitably go down as well as up, and managers run out of luck. The reversal causes concern, discomfort, fear and finally panic selling. The result is a buy-high, sell-low strategy - a recipe for destroying that $2 million of potential wealth.

Looking at the CGM Focus Fund (mentioned in the Investment Trivia box overleaf) we can see an extreme example of these human weaknesses in action: in 2007 this commodity-based fund returned 80% and, as a result, in 2008 investors poured a staggering $2.6 billion into the fund. Commodity markets reversed and the fund fell by almost 50% and investors withdrew around $750 million. Buy high – sell low!

Mistake 2: Not understanding the game being played

Through no fault of their own, many investors have not stopped to think about the game in which they are participating. Imagine that two investors own the whole market. The first picks and owns all the companies that did better than the market. By definition, the other investor must own all the stocks that failed to beat the market. One investor's gains must be funded by another's losses – trading in the markets is a zero-sum game (before costs).

That would not matter if skilled investors, who either must have better information than others or use the same information better, could turn this information asymmetry into profitable market-beating returns. You could buy their funds.

We believe that markets actually work pretty well, despite what professional fund managers will claim[4]. Mispriced share 'bargains', on which those fund managers, pedalling the promise of market-beating returns, should thrive (otherwise known as 'active' managers), seem to be short-lived or hard to exploit profitably once costs are taken into account. There is no doubting the talent and hard work of those working as fund managers in the City, but the sad fact is that from the long-term evidence of their funds, most would provide a better service to their clients by staying at home![5]

The evidence would seem to suggest that you should not try to beat the market, but simply try to capture as much of the return that capitalism can deliver in reward for owning companies (equities) or lending your capital (bonds), by using low-cost index tracking (passive) funds.

Mistake 3: Ignoring the maths

That leads us to the question of maths. One of the reasons why many active managers fail to achieve their market-beating promise is that they have to overcome the costs of investing. These include the fees they charge for managing the fund and other expenses that are set against the fund's performance. This 'on-the-road' cost of investing is known as the Total Expense Ratio or TER for short. On top of these costs are the costs of buying and selling securities held by the fund (turnover).

Let's start with some simple addition

Active vs. index funds	p.a.
Average active UK equity fund TER[6] :	1.7%
Plus the estimated turnover cost[7] of:	1.8%
Gives a total active cost of:	3.5%
Less the total index fund cost[8] :	0.3%
Cost difference:	3.2%

That does not sound too bad if the markets have gone up by 30% in one year. However, in the context of long-term return history, equities have delivered a return after inflation of around 5% p.a. over the past 111 years[9].

Now for some simple percentages

3.5% is 70% of the 5% that equities have returned, over the long term, after inflation. In other words the investment industry participants have helped themselves to a large part of your wealth, yet you have taken all the risk, and it is your money and future at stake.

Now for some multiplication

Imagine that two identical funds exist and that they own all the shares in the UK equity market. The only difference is that Fund A has a cost structure of 3.5% p.a. and Fund B has a cost structure of 0.3%[8] p.a. Let's assume that the UK equity market delivers 5% p.a. over the next 30 years and you invest £100,000 in each.

Your investment in Fund A rises to about £156,000 – not bad until you look at Fund B which delivered you a little under £400,000 – a difference of £244,000!

The power of the mathematics of compounding (calculating interest-on-interest) combined with time is immense; small differences get magnified into large final outcomes. Costs really do matter in investing – the lower the better.

And finally some probabilities

The question you need to ask is: what is the probability that a manager will deliver skill-based, market-beating returns over the long-term? The empirical evidence indicates that we are probably looking at around 2%-3% of them[3]. Remember that these managers have been identified with hindsight. The next question is: what then are the chances that you or an adviser can pick the few truly skilled managers today, who will deliver over the next 30 years? Answer - absolutely minimal. As Jack Bogle, one of the pioneers of index investing states *"Don't look for the needle, buy the haystack!"*

At the end of this maths primer, it is probably easy to see the lesson that emerges – costs really do matter in the investment game. Again to quote Jack Bogle *"In investing you get what you DON'T pay for!"*

Good investing is not rocket science

At its simplest, investing is quite straightforward. You only have two things you can do with your money: buy part ownership in companies (equities), with the reward of dividends and hopefully share price rises; or lend your money to a government or a company, with the expectation of receiving interest and your money back.

It is not a get rich quick fix, but a slow controlled preservation of the purchasing power you have accumulated, and hopefully achieving some growth too, by taking, managing and living with specifically chosen and understood risks, accessed in a low-cost and effective manner.

A well-thought-through and evidence-based approach to investing should deliver better outcomes, over time. Perhaps most importantly we all need to hold our nerve when markets are either overly exuberant or in the depths of despair, and avoid the whipsaw of emotions and human biases.

If we can achieve that for our clients, we will have earned our annual relationship fee several times over.

Take-home points

- Investors needlessly destroy wealth.
- Emotions and human biases make us prone to poor investment decisions.
- We ignore investing costs at our peril.
- Sensible portfolio structures, robust process and hand holding by an advisor help to mitigate these risks.

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End notes

1 Dalbar Quantitative Analysis of Investment Behaviour, 2009

2 Schneider, L. (2007), Diploma thesis: Are UK fund investors achieving fund rates of return? Submitted in July 2007, Fachhochschule Kufstein, Tirol, Austria.

3 Bogle, John, C., (2007), The Little Book of Common Sense Investing, John Wiley & Sons, NY: NY.

4 The Efficient Markets Hypothesis was developed by Professor Eugene Fama. It suggests that markets work effectively, incorporating all public information in a share price, which is the best estimation of a company's true value. Prices change on new information and, as such, market movements are unpredictable and random. Mispricings are unpredictable and are rarely exploitable. The empirical evidence on the persistent failure of most professional investors to beat the market supports it.

Seminal works: 1) Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," Journal of Finance 25, no.2 (May 1970): 383-417. 2) "A Random Walk Down Wall Street", by Burton Malkiel.

5 Many studies reveal the same message. They are recorded in our Investment Process Manual.

6 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 1.7% (Lipper 2009). Within that there is around 0.5% trail commission passed to commission-based advisers each year but not refunded to you if you invest direct.

7 Other costs that are a drag on performance relate to the decisions to sell and buy shares. The average turnover is around 100% of the portfolio a year (SCM Private 2010), which is based on estimated round trip costs (James, K.R., (2000), The Price of Retail Investing in the UK. London: FSA, FSA Occasional Paper) to sell and buy a share in the UK of around 1.8% (0.5% of which is stamp duty, 0.3% commission, 0.75% bid-offer spread and 0.25% price impact). This implies that the average active fund incurs around 1.8% of trading costs a year.

8 Investors can access the UK equity market these days for around 0.2%. Index funds tracking the broad market have very low turnover and associated costs, estimated at 0.1% a year.

9 Barclays Equity Gilt Study (2010)

Other notes and risk warnings

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