On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

geo@oncoursefp.com

425-861-9997

New Research Reports

My inbox is overflowing with research papers and academic studies about investing and investor behavior. Let's look at a few of the more interesting ones.

Last month, I discussed the results of the latest SPIVA Scorecard which noted the inability of most active fund managers to outperform their benchmark index over multiyear timeframes. A common critique of the SPIVA Scorecard is that it compares the net of fee performance of mutual funds to the performance of un-investable benchmark indexes that lack the expenses of portfolio management. Morningstar addresses this issue in its semiannual Active/Passive Barometer, which compares the net of fee performance of actively managed mutual funds to the net of fee performance of the average index fund in its asset class.

As one might expect, the results of the SPIVA Scorecard and the Active/Passive Barometer are similar. Both reports noted that 2017 was a relatively good year for actively managed funds. The Morningstar report noted that in 2017, 43% of actively managed domestic stock mutual funds outperformed their average index competitor; an improvement over the 26% of active managers who achieved this feat in 2016.

In the nine asset classes into which Morningstar divides the domestic stock market, the 15-year outperformance percentage of active funds varied from a low of 7.5% for large-cap growth funds to a high of 23.4% for small-cap value funds. In summary the report noted: *"Though 2017 marked a clear near-term improvement in active managers' success rates, in general, actively managed funds have failed to survive and beat their benchmarks, especially over longer time horizons…The average dollar in passively managed funds typically outperforms the average dollar invested in actively managed funds."*

The fact that most actively managed stock funds have failed to outperform a comparable index fund provides strong evidence that capital markets do a good job of pricing securities. Relying on a fund manager's ability to find mispriced stocks has been a poor strategy for most investors. A better strategy is to own a diversified portfolio of index funds under the assumption that market prices are the best estimate of a stock's fair value.

As difficult as it is to find tomorrow's outperforming funds today, creating a portfolio of active funds that will outperform a similar portfolio of index funds is even more difficult. The likelihood that an active portfolio will outperform a similar portfolio of index funds is inversely proportional to the number of funds in the portfolio and the number of years that the portfolio is owned.

From 1926 through 2016 the S&P 500 Index (with dividends reinvested) yielded a real (inflation adjusted) average annualized return of 6.9%. Over the same period, the 30-day U.S. Treasury bill, which is considered risk-free, yielded a real average annualized return of 0.5%. The difference in these returns is known as the "equity premium". So, there appears to be no reason for the academic paper: "Do Stocks Outperform Treasury Bills?", recently published by Prof. Hendrik Bessembinder of The Department of Finance at Arizona State University. He analyzed the variation in the performance of 26,000 common stocks from 1926 through 2016 and made the following surprising discoveries –

- Less than half of the 26,000 stocks yielded a positive lifetime return.
- More than half of the 26,000 stocks yielded no lifetime gain and the most common lifetime return was a 100% loss.
- Only 43% of the stocks had a lifetime return greater than that of the 30-day Treasury bill over the same time interval.
- Slightly more than 4% of the 26,000 stocks accounted for all the equity premium for the past 91 years. The remaining 96% of the stocks collectively matched the return of the 30-day U.S. Treasury bill.

In summary Professor Bessembinder stated –

"While the overall US stock market has handily outperformed Treasury bills in the long run, most individual common stocks have not. The positive performance of the overall market is attributable to large returns generated by relatively few stocks…The results presented here reaffirm the importance of portfolio diversification…(and) focus attention on the likelihood that poorly diversified portfolios will underperform because they omit the relatively few stocks that

generate large positive returns…the key question of whether an investor can reliably identify such "home run" stocks, or can identify a manager with the skill to do so, remains."

Prof. Bessembinder's analysis shows why diversification is critical to long-term investment success. Last year, the range of returns for companies in the S&P 500 Index ranged from +134% to -84% while the index itself return 21.8%. Owning a portfolio of broadly diversified index funds gives an investor part ownership of every company, ensuring ownership of all of tomorrow's "home run" stocks. One reason why I'm not a fan of overweighting a portfolio to dividend paying stocks is that fast growing, "home run" stocks typically don't pay dividends because they are using earnings to grow the company.

The 2012 study "Political Climate, Optimism, and Investment Decisions" disclosed that people's optimism toward the financial markets and the economy is influenced by their political affiliation. The authors of the report noted that individuals become more optimistic about the future and perceive the stock market to be undervalued and less risky when their preferred party is in power. This leads them to overweight their portfolio to riskier equity holdings. Just the opposite happens when the opposition party is in power. This is another example of the type of behavioral biases that plague individual investors and lead to poor investment decisions.

A research report by the BlackRock Retirement Institute (BRI) in conjunction with the Employee Benefit Research Institute (EBRI) took a close look at the spending habits of current retirees. The results seem to indicate that fears of a future retirement crisis might be overstated. Some significant findings in this study were –

- On average, across all wealth levels, most current retirees still have 80% of their pre-retirement savings after almost two decades in retirement.
- Across all wealth levels, more than one third of current retirees have more assets than when they retired—leaving considerable potential consumption on the table.
- The fear of high, out-of-pocket medical expenses is a major reason why retirees retain assets. But except for very small portion of the population, this fear does not appear to be warranted.

It is likely that many retirees would like to spend more but have trouble making the transition from saving to spending. After years of thrift, they have developed a reluctance to spend and find it difficult to loosen their purse strings, causing a "consumption gap" between their actual consumption and the consumption made possible by their wealth. I describe this as turning deferred gratification into denied gratification. Typically, "denied gratifiers" are receiving poor or no advice on spending during retirement and are unsure if they possess sufficient assets to make it unlikely that they will outlive their money. The solution is to meet with an experienced financial advisor who can give you a clear picture of what you own, how it should be invested and how much money you can spend each year.

Future retirees will face obstacles not experienced by prior generations. 42% of the retirees in the study receive income from a defined benefit pension plan. Few future retirees will receive a monthly pension. Therefore, their retirement spending will be funded by withdrawals from their investment accounts. This may prove difficult for some people who are used to seeing their nest egg increase from one year the next and it remains to be seen whether they will be able to become comfortable depleting their nest egg.

Many financial strategies are developed after analyzing a small amount of data. The conclusions of the analysis are likely to be misleading due to the impact of randomness in small sample sizes. A 2006 report from the Investment Company Institute noted that historical returns are the primary factor that investors use when choosing a fund. The research paper "Fooled by Randomness: Investor Perception of Fund Manager Skill" sought to discover why mutual fund investors buy top-performing funds despite the universal disclaimer that "past performance is no guarantee of future returns". The authors noted the two primary mistakes that investors make that contribute to this type of performance chasing –

- Investors assume that manager skill and fund performance are positively correlated because they fail to understand that an unlikely event becomes likely if the population of funds is large enough. For example, let's assume that there is a 50-50 chance that a fund will outperform its benchmark index in any given year. If performance is independent from one year to the next (implying little or no manager skill) the chance that a fund will outperform in each of the next ten years is approximately 0.1% (one chance in 1,024). However, in a domestic fund population of approximately 9,500 funds (as of 2016) it is likely that nine funds will outperform in each of the next ten years, even if there are no skilled managers. Unless the number of outperforming funds exceeds what we expect by chance alone, investors can't assume that the outperformers did so due to manager skill. Conversely, if there are ten outperforming funds in a population of 1,000 funds, then investors can assume that manager skill played a part in the performance of some of the funds.
- Investors don't consider fund volatility when looking at past performance. They don't realize that risk and expected return are positively correlated. Many fund managers, in an attempt to achieve high performance and attract more assets, take unnecessary risks with investor money.

The authors concluded that even the fund managers themselves are often "*convinced that strong returns were the result of their personal skill even when there is clear evidence that they were lucky…investors underestimate the probability that a track record was generated by pure chance especially in large fund populations and when fund managers take excessive risks…These biases can lead to a misallocation of capital to unskilled managers."*

Will a Fiduciary Standard Help Investors?

A fiduciary is a person who owes to another the duties of good faith and trust and who will act in that person's best interest. Certain skills are beyond the reach of the average individual. Therefore, we rely on people who have achieved professional competence in certain important occupations who will act in our best interest. Most people assume that they have a fiduciary relationship with their physician, attorney or financial advisor. Unfortunately, only a small minority of financial professionals are required to always act in their clients' best interests.

For the past few years there has been an ongoing debate in the financial advisory community about the Department of Labor's (DOL) 2010 proposal which would require that all financial professionals who provide investment advice to an IRA owner or retirement plan participant act as a fiduciary and meet the standards of that status. The rule would require retirement advisors to act in the best interests of their clients and put their clients' interests above their own. It left no room for advisors to conceal any potential conflict of interest and stated that all fees and commissions for retirement plans and retirement planning advice must be clearly disclosed in dollar form to clients.

Financial professionals can be divided into two categories – brokers and investment advisors. A broker acts as an agent, making transactions in securities on behalf of a client. An investment advisor is someone who gives investment advice to clients for compensation. Investment advisors are held to a fiduciary standard in all client interactions. Their recommendations must be those that they believe to be the best choices for the client. Investment advisers must disclose to their clients, in writing, their qualifications, all sources of income, possible conflicts of interests and any disciplinary action taken against them by state securities agencies or the SEC, even if they do not ask. On Course Financial Planning is a Registered Investment Advisor registered in Washington state.

Brokerage firms insist that their brokers should not be held to a fiduciary standard because they are merely salespersons. As such, they are only required to recommend "suitable" investments and execute trades promptly. Any financial advice they give clients is incidental, not central, to what they do since they receive no additional compensation for such advice. A broker is not required to notify you of all payment incentives, conflicts of interest, disciplinary history, or qualifications - unless you ask. When choosing between comparable investments, a broker is free to recommend one that will pay the highest commission. That's not the impression you get from these firms' print and TV ads. They want to have it both ways, giving the impression of offering ongoing personalized financial advice while being held to the "suitability" rather than fiduciary standard. That's why this type of disclaimer appears in most monthly brokerage statements –

"Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time."

It should come as no surprise that broker-dealers, insurance companies and their representatives have done everything in their power to prevent the DOL's fiduciary standard from being implemented. After years of claims, counterclaims and lawsuits, the DOLs fiduciary standard was given the deep-six on March 15th by the 5th Circuit Court of Appeals, which called the rule *"an arbitrary and capricious exercise of administrative power."* The decision allows brokerage and insurance company advisors to continue with business as usual and avoid fiduciary accountability.

The impetus behind the DOL's attempt to enforce a fiduciary standard is the belief that financial professionals, most of whom are not paid directly by clients but earn commissions on financial products and mutual funds, regularly give recommendations that favor their own interest and compensation at the expense of their clients. "The Misguided Beliefs of Financial Advisors" is a report released last December that sought to determine if this common criticism of financial advisors is true. The report analyzed the financial recommendations made by brokers, who are not subject to a fiduciary standard, at two large Canadian financial institutions. The data included comprehensive trading and portfolio information of more than 4,400 advisors and almost 500,000 clients between 1999 and 2013.

The research focused on trading behaviors considered to be harmful to long-term performance: high turnover, preference for actively managed funds, performance chasing and a lack of portfolio diversification. The authors discovered that clients and their advisors purchased funds with better than average historical returns, overwhelmingly favored actively managed funds and exhibited trading patterns similar to non-advised, do-it-yourself investors.

The authors analyzed the advisors' trades in their personal accounts and noted that there was little evidence that the advisors recommended worse performing funds than those that they owned in their own accounts. The average expense ratio of mutual funds in advisors' and clients' portfolios were nearly identical. Clients and their advisors both earned a long-term alpha (risk-adjusted performance compared to the market) of -3%. The report notes that advisors who encourage clients to chase returns typically chase returns in their own portfolios. By analyzing transaction dates, the authors discovered that the timing of trades in client accounts for specific funds often coincided with the advisors' own purchases. The data disclosed that brokers purchased funds for their own accounts that had stronger past performance, higher expense ratios and more volatility than the funds that they recommended to clients. Not surprisingly, the average client and advisor had less than 2% of their portfolios allocated to index funds.

Most of the advisors surveyed reported that they possess a "high" financial knowledge, although a few admitted that they had "low" financial knowledge. In conclusion the authors noted –

"*Our results suggest that advisors' own beliefs and preferences drive their recommendations… Advisors' trading behavior also remains mostly unchanged after they leave the industry."* In other words, there's no evidence that the recommendations made by the brokers in the study were the result of any financial incentive or conflict of interest. The authors noted, "*Advisors are not random draws from a population and they may pursue their vocation in part because of their belief that active management adds value…The average advisor would earn higher returns if he copied his clients' portfolios…regulations that reduce conflicts of interest – by imposing fiduciary duty or banning commissions – do not address misguided beliefs. When advisors recommend strategies that underperform, they act as an agent exactly as they would as a principal, so aligning their interests would not change their behavior."*

It seems that the Canadian investors in this study suffered financial harm from the advice of financial advisors who are unskilled in their craft. The authors noted, "*Solving the problem of misguided beliefs will instead require improved education or screening of advisors...Policymakers could address misguided beliefs by imposing professional licensing requirements."*

Perhaps it's time for government regulators to place their focus on the likely cause of bad advice. The authors noted – *"the conflict of interest may lie between the advisory firm and its clients. Advisory firms may respond to poor incentives by hiring precisely those advisers who will deliver sincere, but expensive, advice."*

Fortunately for the big-name brokerage firms and insurance companies, most of their clients have been unaware of the ongoing debate over the DOL's fiduciary rule for the past eight years. It seems absurd that some of the largest brokerage and insurance companies fight against all proposals that would require them to adopt a fiduciary standard of care. Why do they need someone from the government to define integrity for them? Why are they so adamant against disclosing conflicts of interest? Why do conflicts of interest between these firms and their clients exist in the first place? What would their mothers say? I think it's time that government agencies take their focus away from the advisors who deal directly with clients and focus their criticisms and legislation on the business model of the companies that employ them.

The surprising conclusion of this report is that Canadian brokers did as much harm to their own portfolios as they did to the portfolios of their clients. This indicates that the typical broker knew little more about successful long-term investing than the people they were supposed to be helping. They may be knowledgeable about products and how to close a sale but it's apparent that most lacked the competence to help clients reach their long-term financial goals. It would be naïve to believe that US investors are receiving better financial advice than our neighbors to the north. Perhaps this is because there are few, if any, education requirements for financial advisors and brokers. I can think of no other profession that maintains, or pretends to maintain, a fiduciary standard of care in its client relationships that requires so little academic training or exam proven competency from its members.