On Course Financial Planning
Facing the Future with Optimism and Courage
November 2017
Vectors
geo@oncoursefp.com
425-861-9997

Is It Investing or Gambling?

Many conservative and novice investors consider investing to be just another form of gambling. The financial media enhances this notion when it promotes short-term trading strategies and insinuates that successful investing requires knowing when to be "in" and when to be "out" of the market. Many investment books promote trading schemes and investment strategies that are more appropriate for a casino than the personal finance section of your local bookstore. Following the financial crisis many people swore off the stock market; considering it a casino where the odds are heavily stacked against them. They failed to understand that markets and economies are cyclical and that some downturns will severely test your risk tolerance. From 1926 through 2016, the S&P 500 Index fell 10% or more 153 times, and 20% or more 39 times. Yet during that time it averaged a 9.8% annualized rate of return and $1 invested in 1926 would have grown to more than $4,500 by year-end 2016 - $315 in inflation adjusted dollars.

Many timid investors shun stocks for fear that they might lose everything, just as a gambler can lose everything in a bad bet. Although there may be some superficial similarities between investing and gambling, they are nothing alike. Equating investing with gambling is a mistake that has prevented many people from enjoying the financial rewards of investing in stocks which, over the long run, have been the best investment for individual investors.

Dictionary.com defines **invest** as –

"to put (money) to use, by purchase or expenditure, in something offering potential profitable returns, as interest, income, or appreciation in value."

It defines **gamble** as -

"to stake or risk money, or anything of value, on the outcome of something involving chance."

When you invest in an S&P 500 Index fund, you're purchasing an ownership stake in 500 companies and you own a share of the profits and dividends that those companies generate. Over the long-term, the stock market has had an upward bias and if the price of the fund rises, you can sell at a profit. If the price of the fund declines, you don't have to invest more money to recover the loss. The value of the fund will eventually recover as the economy and stock market recover. This benefit, however, doesn't apply to investors who own individual stocks which can suffer drastic, permanent losses. For example, as of Nov. 10th, the S&P 500 Index is up 15.3% year to date. Yet by my count, 148 stocks in the index are in the red this year – led by Envision Healthcare Corp (EVHC) which is down 60%. This is a clear example of how diversification increases the odds of a favorable outcome over time for investors.

When you gamble, your money doesn't purchase anything. The "house" (the organizer of the game) has the odds in its favor and the longer you gamble, the more likely it becomes that the house will profit at your expense. No matter how smart or experienced, the gambler is always at a mathematical disadvantage against the house. A winning streak is the product of chance and eventually must end. Gambling losses are unrecoverable unless you "invest" more money into the game and there's nothing that a gambler can do to increase the odds of a favorable outcome over time.

Many people who call themselves investors are really gamblers; using stocks as their chips and hoping to profit from short-term price appreciation. They don't call it gambling, they call it trading. Trading the market is exciting; it produces emotional highs and lows just like gambling. Typically, these investors are performance chasers, owning portfolios containing assets that have performed well in the recent past. They use valuation metrics, charts and graphs or other indicators to determine if they should be “in” or “out” of the market. Regardless of the strategy employed, they're gambling, and their decisions are likely to be based more on emotions than intellect. They've convinced themselves that they have found a way to see into the future and avoid losses. Unfortunately for them, the capital markets eventually punish foolish speculators who overestimate their skill and underestimate the amount of risk they are taking.

In gambling, the odds are set so that gambling yields a negative total return in the aggregate. The gambler wants to be "in" the game only when he believes that the odds are in his favor. Conversely, the expectation of investors is a positive total return in the aggregate so there is no need to know when to be "in" or "out" of the market. Attempting to avoid losses by timing entries into and exits from the stock market is the most common mistake investors make. It's an impossible task and the main reason why so many investors underperform the market. It's important to know your risk

tolerance so that you can create an asset allocation that you'll stick with through thick and thin. By doing so, you'll avoid the "in" or "out" gambler's mindset and maximize the long-term benefits of stock investing.

Investing in stocks is different from gambling, yet these activities both contain risk. The risk in investing is the uncertainty about future returns. Investing for higher expected returns usually involves accepting greater volatility, which many people equate with risk. If you invest in a strategy or product that you don't fully understand, you have no idea what level of risk you're taking.

Wall Street wants you to believe that the goal of investing is to “beat the market” and by emphasizing performance instead of planning, it has turned many investors into unwitting gamblers. In their pursuit of market beating returns – something that is mathematically impossible in the aggregate - most investors take more risk than they should. Many financial advisors subtly encourage gambling behavior in their clients when they support the idea of taking a small percentage of a portfolio – usually 5% – to "play" the market. By appeasing their clients' gambling instincts, these advisors are setting them up to pay more in taxes and fees and hindering their long-term wealth accumulation.

Investing is a rational behavior because the investor can expect to gain over the long-term. Gambling is an irrational behavior because the gambler must expect to lose money over the long-term. That's why gambling is so often promoted as entertainment – pretending that losing money in a rigged game is acceptable behavior if it provides excitement. Unfortunately, when done the wrong way, investing can turn into gambling and become irrational as well.

Morningstar

Morningstar's mutual fund database is the go-to resource for mutual fund research. The most popular feature of Morningstar's fund analysis is the star rating it gives to funds with three or more years of performance history. A long-lasting fund will have four separate ratings – one for the past 3 years, one for the past 5 years, one for the past 10 years and an overall rating based on these ratings. Each fund is placed into a category based on its asset class or investing style. A fund's star rating reflects its risk-adjusted past performance relative to other funds in the same investment category. The star ratings are awarded as follows -

- the top 10% of funds in an asset class receive 5 stars
- the next 22.5% of funds in that asset class receive 4 stars
- the next 35% of funds receive 3 stars
- the next 22.5% of funds received 2 stars
- the lowest 10% of funds receive 1 star

Note that a fund can be outperformed by 67% of its peers and still have a 3-star rating. Apparently, at Morningstar, average can mean slightly below average.

There are thousands of mutual funds; many with similar sounding names. Consequently, it can be difficult to decide which funds to own. Many investors and financial advisors select funds based on a high Morningstar rating; assuming that a 4 or 5-star rating is an indicator of future outperformance. They do this despite Morningstar's repeated disclaimers that a high rating alone is not a sufficient basis for investment decisions, that the star rating is only a starting point for fund research and that it only measures past risk adjusted performance.

A recent front-page article in the *Wall Street Journal*: "The Morningstar Mirage" warned investors not to be fooled by a fund's 5-star rating - *"A lot of investors, and the people paid to guide them, take for granted that the number of stars awarded to a mutual fund is a good guide to its future performance. By and large, it isn't."* The *Journal* examined the performance of thousands of funds dating back to 2003. Funds that received high star ratings attracted the vast majority of investor dollars but most of them failed to perform as hoped. *"Of funds awarded a coveted five-star overall rating, only 12% did well enough over the next five years to earn a top rating for that period; 10% performed so poorly they were branded with a rock-bottom one-star rating…For funds that had an overall 5-star rating at any point, the Journal found that their average Morningstar rating for the following five years was three stars."*

The performance falloff was even more dramatic for domestic stock funds. Only 10% maintained a 5-star rating for the subsequent 3 years, 7% merited 5 stars for the following 5 years and only one out of 16 maintained that top rating over the next 10 years. Over subsequent 3, 5 and 10 years, a five-star domestic equity fund was more likely to end up as a 1-star fund than remain a 5-star performer.

Morningstar responded to the *Journal* article the next day. It reiterated that the star rating is a starting point for research and should be combined with other data and measures to aid in fund selection. It noted that it is about twice as likely that a 1 or 2-star fund will be merged or liquidated over the next decade as compared to a 4 or 5-star fund. It claimed that a high rated fund is more likely than a low rated fund to achieve a subsequent 4 or 5-star rating. But I think this

misses the point. Investors don't use Morningstar data to find 1 and 2-star funds, they use it to find 5-star funds and over the past ten years, 43% of 5-star funds were merged, liquidated or sank to a 1 or 2-star rating – to the disappointment and detriment of their investors.

The *Journal* article is the latest in a long series of studies that have attempted to discover if highly rated funds maintain their outperformance in subsequent years. A 2003 study*:* "The Kiss of Death: A Five-Star Morningstar Mutual Fund Rating?" analyzed the subsequent performance of newly minted 5-star diversified domestic stock funds from 1993 to 2001. The authors noted that a fund's initial 5-star rating increased new money inflows by more than 50%. In contrast, funds with rating downgrades experienced significant outflows beyond what would normally be expected. The report noted that during the three years after a fund received its initial 5-star rating, fund performance fell off and fund volatility increased. *"Once a fund receives its initial five-star rating, the fund receives so much new money that the fund becomes unwieldy to manage and hence cannot perform to the same level as before receiving the five-star rating…the past performance of a fund that has just acquired its initial five-star rating may simply be a matter of luck. Hence, given enough time, most winning funds will revert to the mean in terms of performance… a sharp drop-off in performance after a fund receives his first five-star Morningstar rating is very consistent with the literature that shows that winning performance does not persist."*

Identifying skilled fund managers has been an ongoing quest for investors, advisors, fund companies and economists. One of the most coveted awards in the mutual fund industry is Morningstar's Fund Manager of the Year (FMOY) award. Morningstar has been awarding this crown since 1987. A recent academic paper: "Superstar Fund Managers: Talent Revelation or Just Glamour?" analyzed the subsequent performance of domestic stock fund managers who were FMOY winners from 1995 through 2012 to determine if the winner continued to outperform the competition. The authors discovered that FMOY winners gathered 21% more assets over the 12-months following the award announcement, but they showed no evidence of outperformance in the 12, 24 and 36-month periods after the award. The authors concluded that the managers were unable to successfully cope with the new money and invest it efficiently; diminishing future performance. Skeptics, like your humble scribe, will note that there have not been any repeat winners of the coveted FMOY award, leading me to conclude that Lady Luck had more to do with winning the award than she's given credit for. In summary, the authors noted – "*because the managers' investment ideas are finite, the new money flows are not able to be put to productive use, which subsequently leads to zero net alpha*" (outperformance).

Star chasing isn't limited to individual investors and misguided advisors. Pension plan managers also drink the past performance Kool Aid. An article in the August 2008 issue of *The Journal of Finance:* "The Selection and Termination of Investment Management Firms by Plan Sponsors" studied the hiring and firing of 3,400 pension plan investment managers between 1994 and 2003. Typically, plan sponsors hired investment managers after a period of outperformance, but this return-chasing behavior did not deliver positive excess returns thereafter. The authors concluded that if plan sponsors had kept the investment managers that they fired, their returns would have been equal to or better than those delivered by the newly hired managers.

Morningstar shines light on an industry that often prefers to live in the shadows. Unfortunately, the in-depth fund data that Morningstar provides is often used incorrectly and its star ratings have been misunderstood and misused since inception. Financial advisors often promote a fund's 5-star rating because it makes a fund easy to sell to clients. They mislead clients into believing that they are putting their money to work under the guidance of the most skilled fund managers. If subsequent performance disappoints, no problem – just blame Morningstar. Most new money finds its way into funds with 5 and 4-star ratings. Fund companies pay Morningstar for the right to advertise the star ratings of their funds; fully aware that the ratings are backward looking and that they will be misinterpreted by investors. Not surprisingly, 1 and 2-star funds do not advertise and attract little new money.

The overwhelming body of academic research reveals that a fund's past performance tells us nothing about its future performance — with the exception that it is unlikely that a fund with poor performance and high expenses will ever achieve 4 or 5-star status. Academic studies repeatedly show that superior performance by active managers occurs in an almost random manner, with no consistency. Most mutual fund managers are exceptionally talented, aided by capable and motivated research teams. But the competition is so fierce that few managers can outperform competitors on a regular basis. So, be wary when any financial professional recommends the purchase of a 5 or 4-star fund and uses past performance as a basis for the recommendation.

Disclaimer - The information in this article is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how the content of this newsletter should be applied to their investment portfolio. This newsletter is not a solicitation to sell investment advisory services where such an offer would not be legal. Investing in stocks and mutual funds involves risk and the potential loss of principal. Historical data is from sources believed to be reliable. Past performance is not a guarantee of future returns.