THE MYTH OF SMART MONEY

Glimmers of light?

The Myth

- In investing mythology, there are smart investors and stupid investors.
  - Smart investors sense when markets are going to turn, and get in sooner than others, and get out sooner than others. After every crisis, there are a few who are anointed as gurus. They are also much better at picking the right stocks to buy and sell
  - Stupid investors are uninformed, act on emotion, and panic quickly.
- In this mythology, professional money managers and talking heads on financial TV land are smart investors. Hedge fund investors are really, really smart and retail investors are stupid investors.

The Basis for the Myth

- Anecdotal evidence: Over time, we have all read about great investors who have beaten the market. In fact, Warren Buffet alone probably has a library of books testifying to his greatness.
- Self Promotion: Almost every money manager seeking your money bases it on a track record, real or invented, of beating the market.
- Academia: In the last fifty years, academics in finance have filled journals with articles on how easy it is to beat the market, using public information (from market cap to PE to PBV to pure momentum).

1. The Problem with Anecdotal Evidence

- Statistics: If you start with millions of investors in the market, the laws of statistics suggest that a few can win even over long periods, purely based upon luck. In fact, it is very, very difficult to separate luck from skill, even over long time periods of investing.
- Selective story telling: Even with great investors, there is often little attention paid to the actual returns delivered, and more to a company or an event that made them money. Thus, the stories of Buffett’s enormous success with Am Ex in the early 1960s and Soros huge win betting against the British Pound in the early 1990s are told and retold as the basis for their legend status.
- Time and Place: Even if the stories are carefully told (controlling for luck), the success of an investor reflects not only his or her investing methods/philosophy but also the time/market during which they generated their successes. As markets change and time passes, what worked well may cease to work.

2. The Problem with Investor Track Records

- Real or on paper? Most active money managers present track records showing that they have beaten the market over time. These track records, though, can reflect actual returns (if the money manager has been managing money for a while) or hypothetical returns (if he or she has not). The former are more trustworthy than the latter.
- Drains on Returns: Since the returns in these track records are often before transactions costs, management fees and taxes, as an investor, it is worth asking what the returns will look like after these are factored in.
- Luck, time and scale: As with investment legends, it is worth asking the questions of whether it is luck or skill that is driving return and whether the returns were a function of the market and of the scale (some strategies don’t scale up well).

3. The Problem with Academic Research

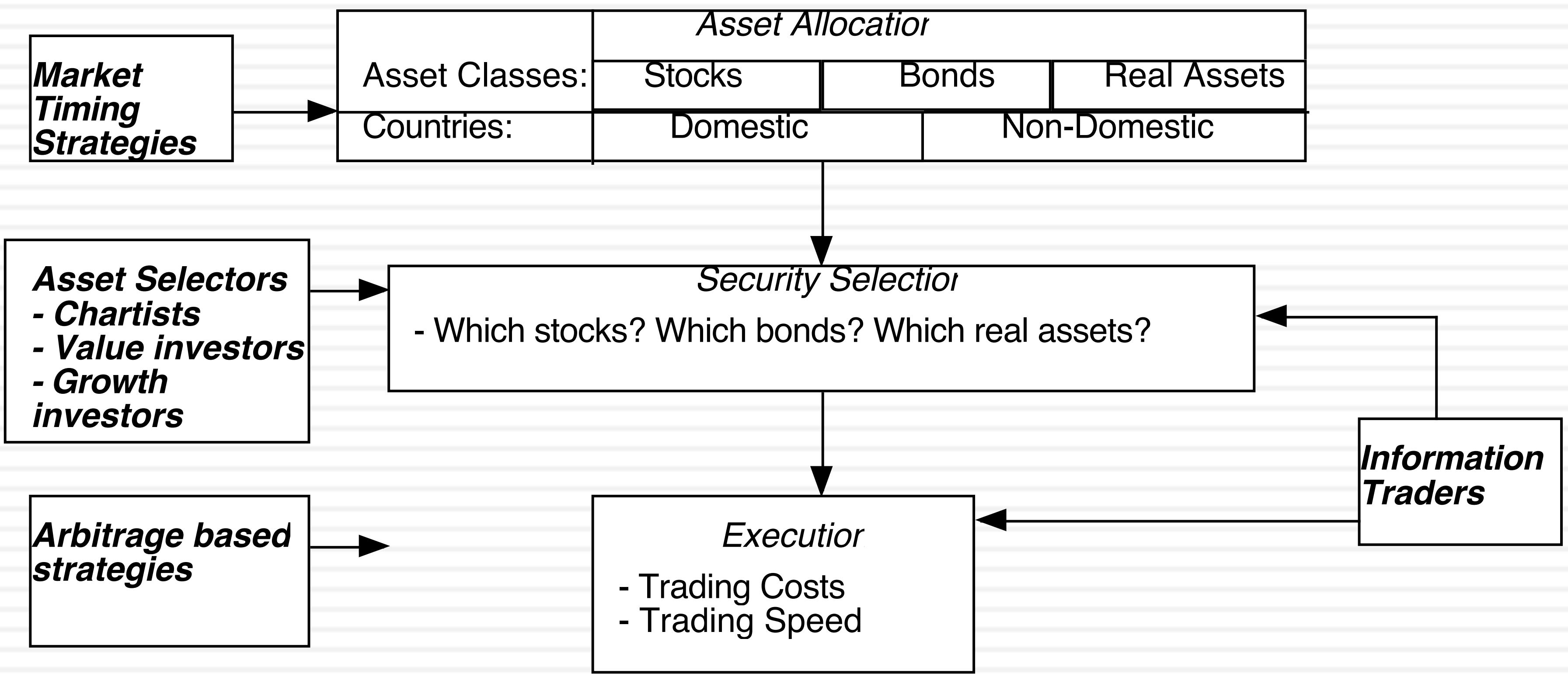
- Many a slip between the cup and the lip: It is easy to make money on paper, but much more difficult to convert these returns into actual returns in practice. Almost every academic study that claims to find a market-beating strategy has to come with a caveat that it does not fully incorporate the costs of replicating the strategy in practice.
- Data mining: It is no coincidence that as our access to data has increased the number of market-beating strategies that people claim to find has also increased.
- Agenda-driven investing: If you don't think academics have priors that lead them to find things that back up their priors, you are mistaken.

The Big Question: Active vs Passive

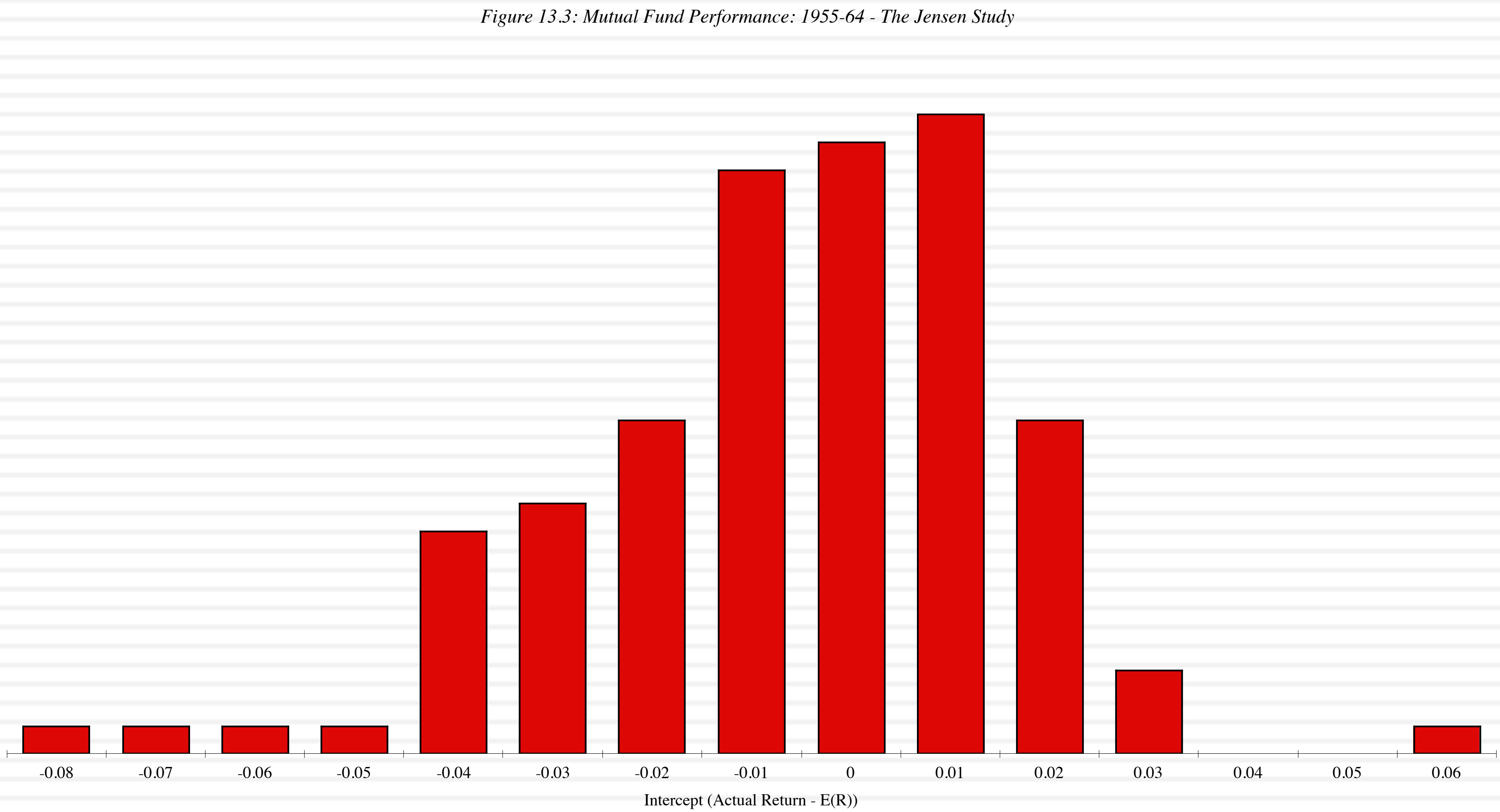
- In passive investing, as an investor, you allocate your wealth across asset classes (equities, bonds, real assets) based upon your risk aversion, liquidity needs and time horizon, and within each class, rather than pick individual stocks, bonds or real assets, you invest in index funds or exchange traded funds (ETFs) to cover the spectrum of choices.
- In active investing, you try to time markets (by allocating more money to asset classes that you believe are under valued and less to those that you think are over valued) or pick individual assets that you believe offer the potential for higher returns.
- Active investing covers a whole range of different philosophies from day trading to buying entire companies and holding them for the long term.

Active Investing Philosophies

Figure 1.2: Investment Philosophies

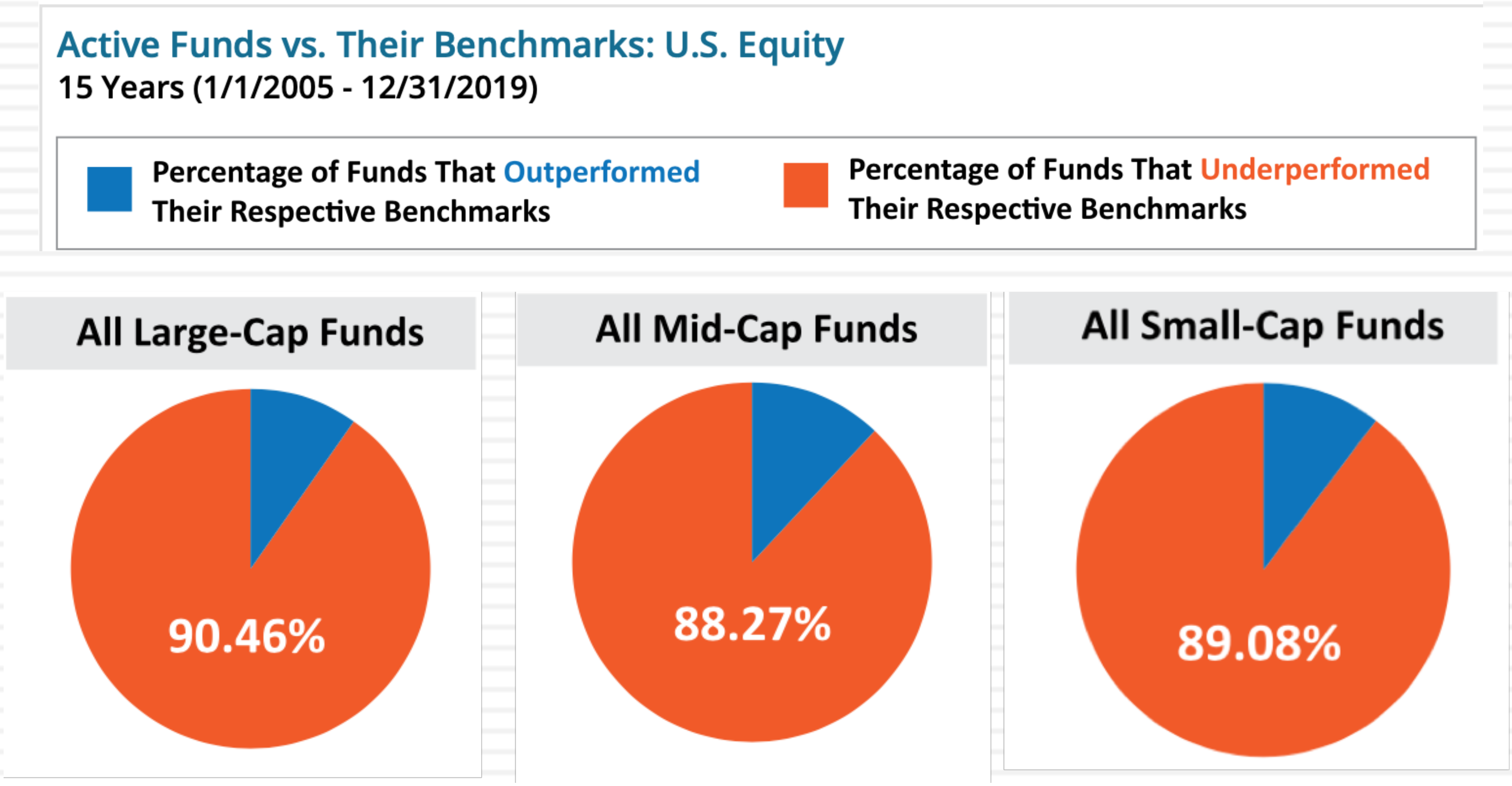


The Original Skeptic: The Jensen Study of Mutual funds in 1968

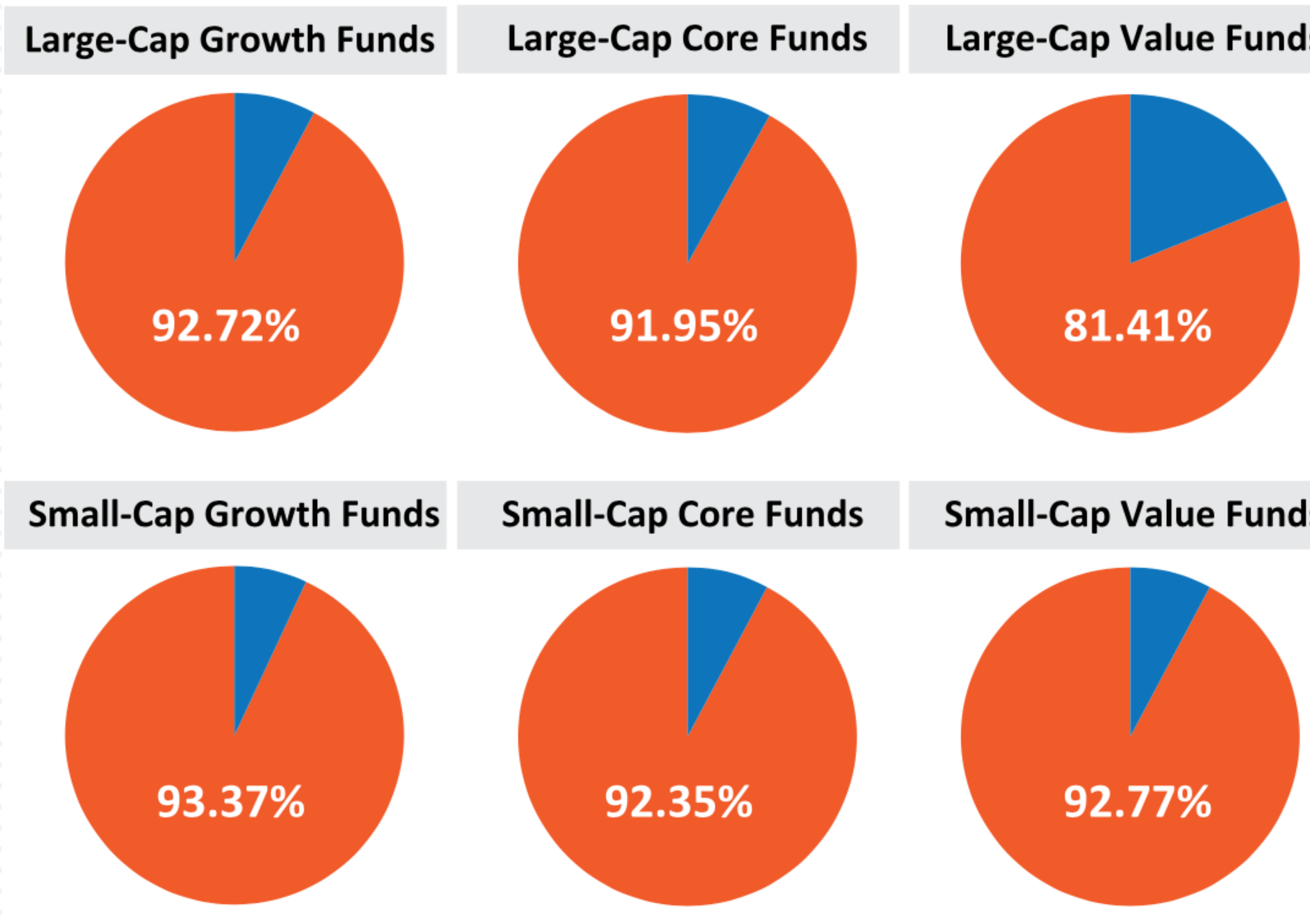


In 1968, the median mutual fund manager made about 1.5% less than the market, after adjusting for risk.

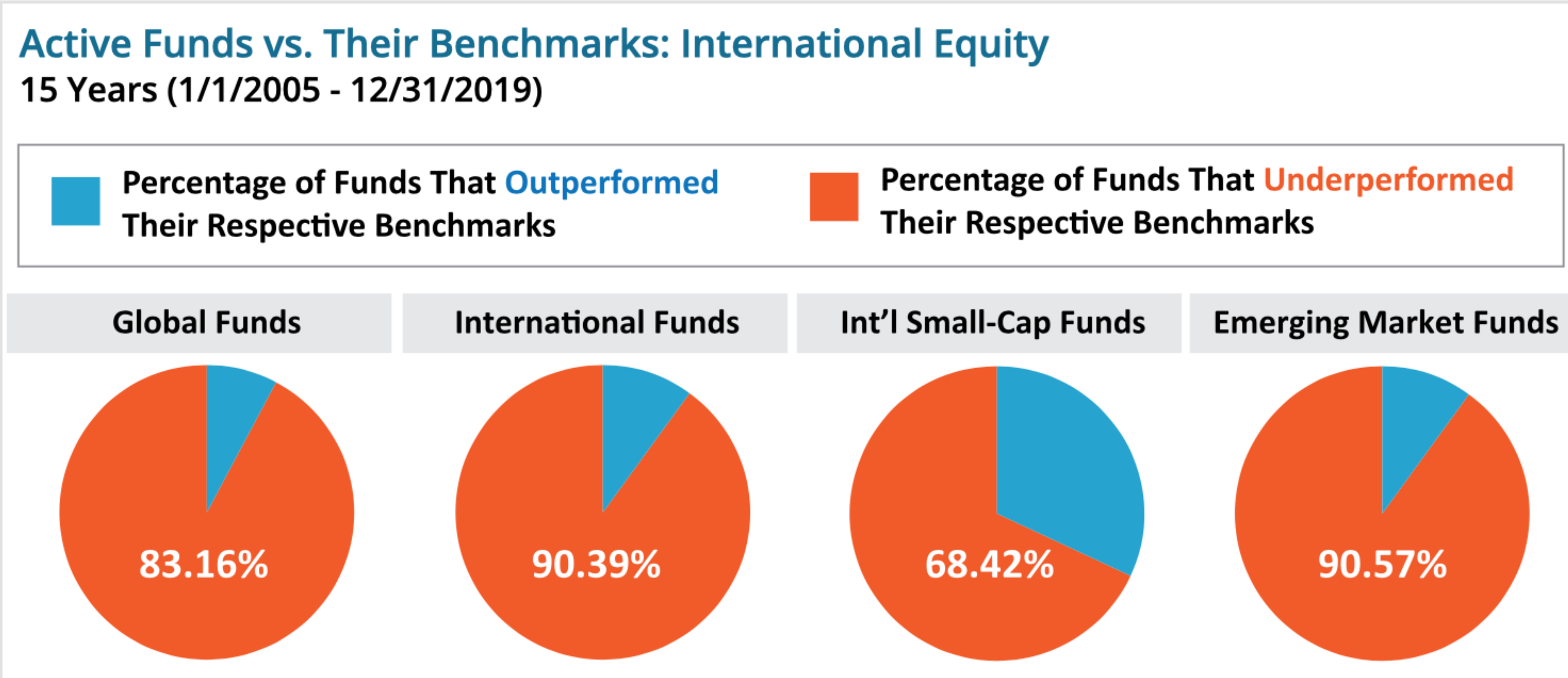
A 2020 Update: Mutual Funds versus Indices, by capitalization…



By Investment Style…

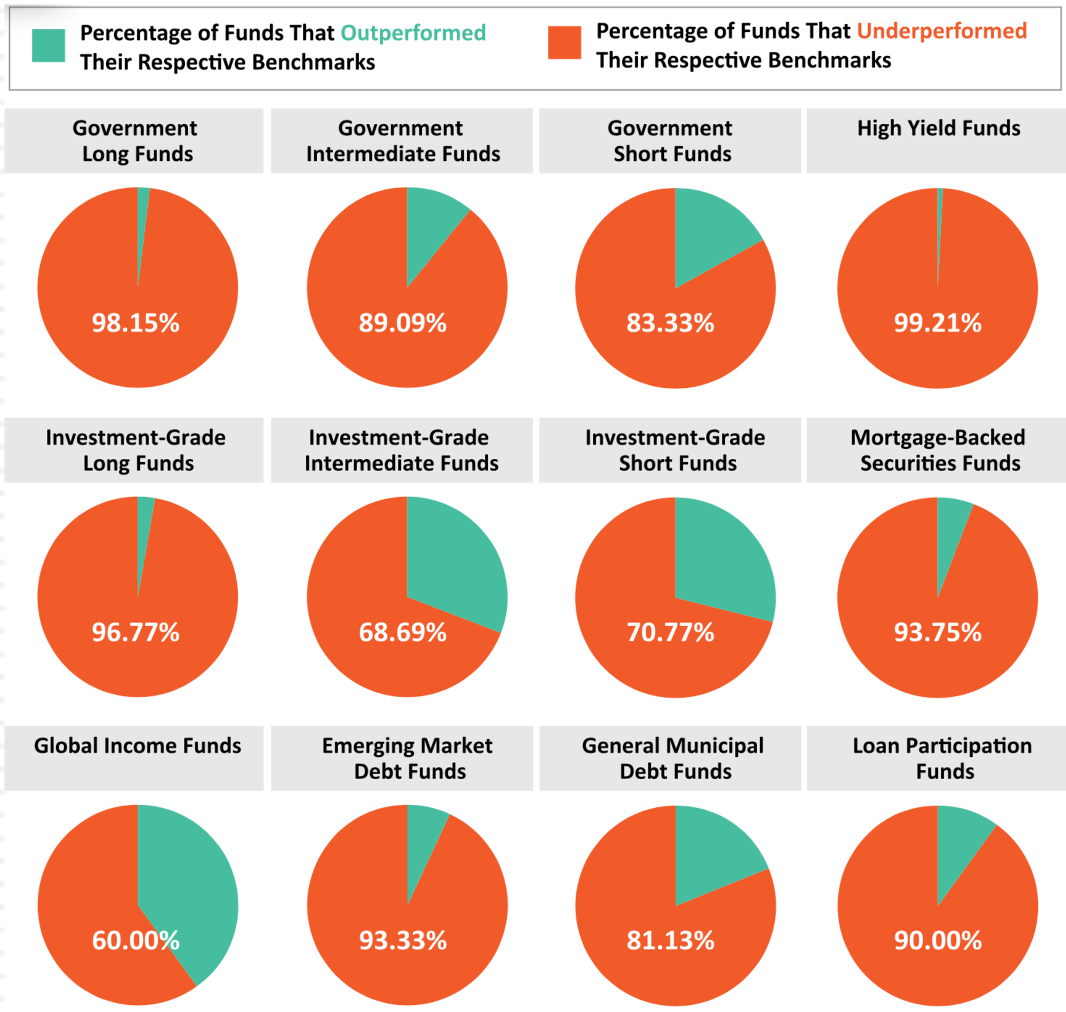


By geographies…



Source: S&P Dow Jones Indices LLC, eVestment Alliance. Past performance is no guarantee of future results. Indexes are not available for direct investment and performance does not reflect expenses of an actual portfolio. Chart is provided for illustrative purposes. This is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, product, service, or considered to be tax advice. There are no guarantees investment strategies will be successful. Investing involves risks, including possible loss of principal. © 2020 Index Fund Advisors, Inc. (IFA.com)

Not just stocks..



There is no consistency.. Winners don't stay winners for long

If there is consistency in performance, funds in a specific quartile should be more likely to stay in that quartile than move to another. The shaded numbers on the diagonal should all be much higher than 25%.

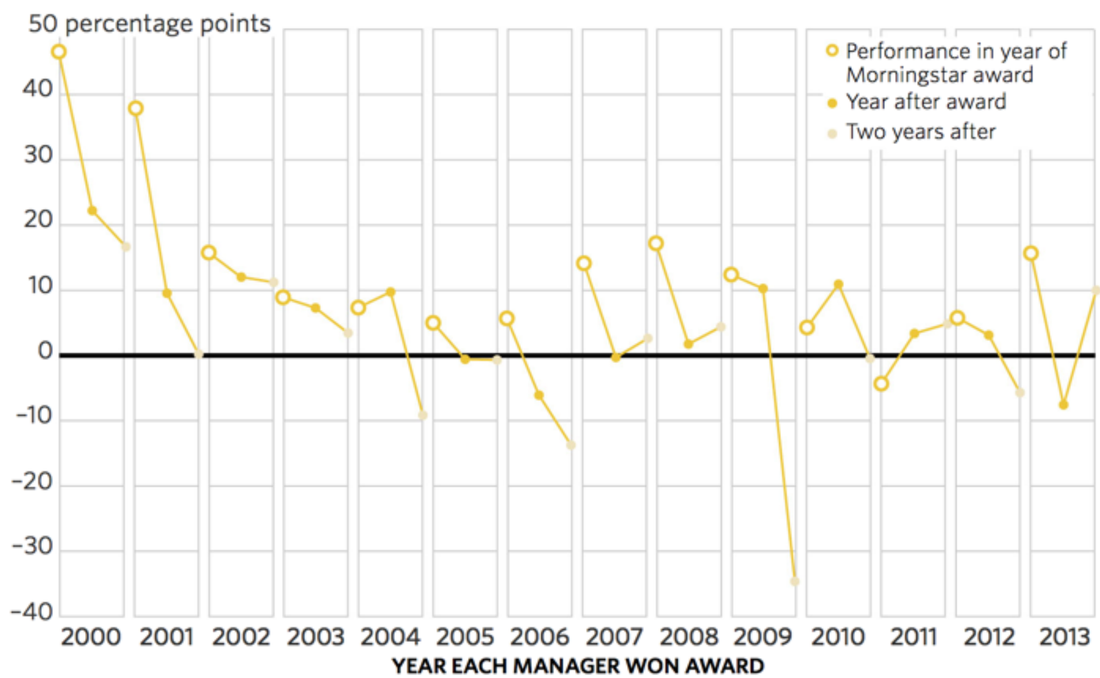
A top performing fund in the last year is more likely to become among the worst perfoming in the next few periods, than stay top performing.

		Following three year period				
		Quartile 1	*Quartile 2*	*Quartile 3*	*Quartile 4*	*Merged/Liquidated*
Last year	Quartile 1	16.53%	21.42%	25.80%	29.51%	6.75%
	Quartile 2	27.10%	23.06%	21.89%	19.19%	8.75%
	Quartile 3	26.31%	21.92%	19.90%	16.02%	15.85%
	Quartile 4	15.18%	18.72%	17.37%	20.40%	28.33%

A large percentage of the worst performing funds fail or are merged, creating a strong survivor bias. Consequently, any study that looks at the returns on only those funds that survived is likely to overstate the returns earned by actively managed funds.

And super star managers fade quickly..

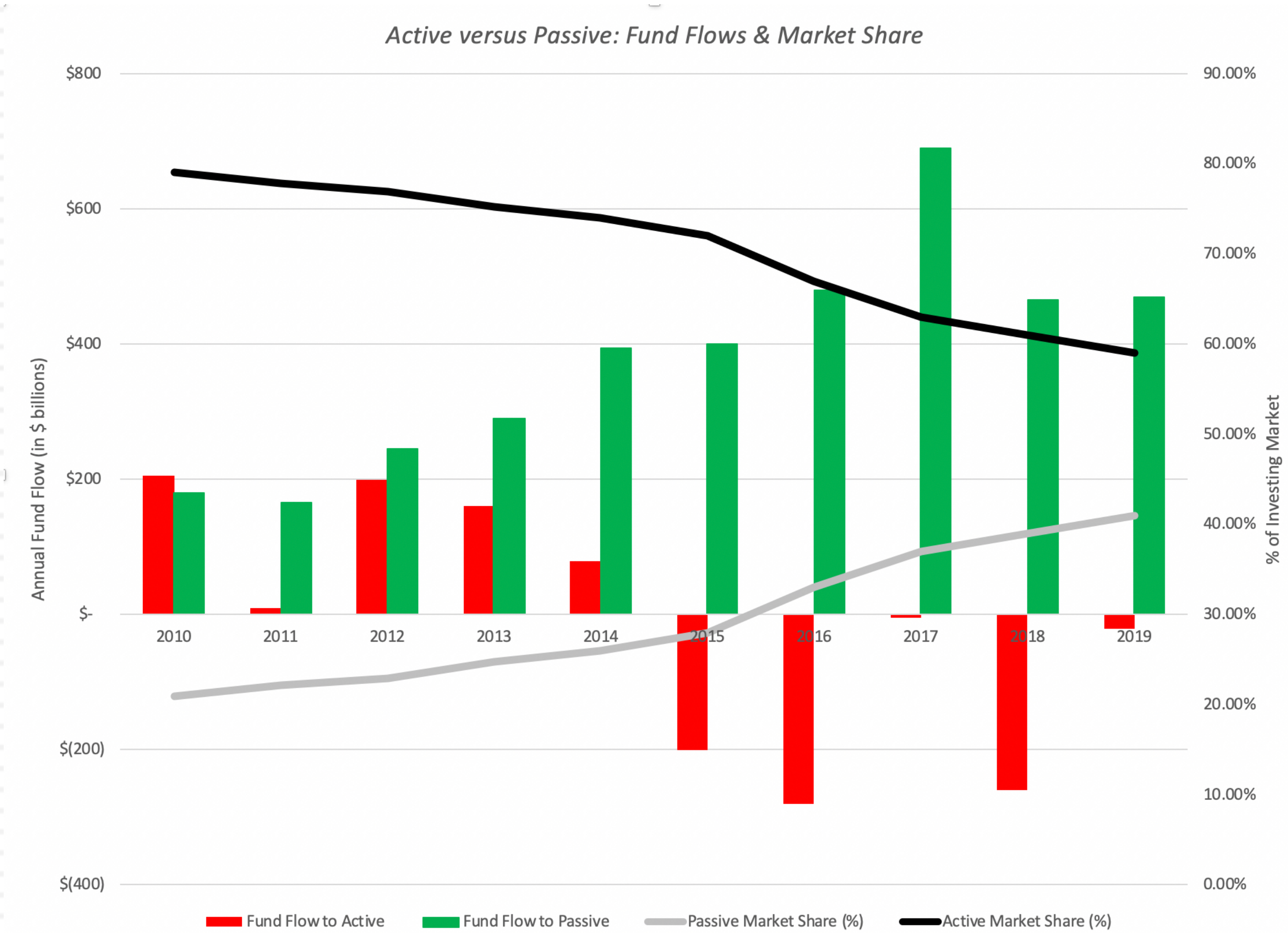
Managers named by Morningstar as top performers for a given year generally didn't perform as well relative to the S&P 500 in subsequent years.



Note: Performance of Morningstar Domestic Stock Fund Manager of the Year, relative to annual total return of the S&P 500. Analysis uses largest fund if manager helmed multiple funds.

Source: Morningstar

A Not Surprising Consequence: Its been a passive investing decade



The Active Investing Counter

- During the last decade, as active investors have lost ground to passive investing vehicles, active money managers argued that we would all see their worth if you entered a crisis.
  - The active market timers were arguing that their expertise would allow them to get you out of stocks before a crisis hit, and back into stocks at the right time.
  - The stock pickers contended that they would pick stocks that were less affected by the crisis, as stocks fell, and move you into stocks that would benefit as stocks came back.
- The COVID crisis has given active investing a chance. Let’s see how it has measured up.

The Crisis Test: Active Mutual Funds

	Returns in 2020, First Quarter		
Equity Mutual Funds	*Mutual Funds*	*MS Index*	*Active Excess Return*
Large Blend	-20.92%	-17.86%	-3.06%
Large Growth	-15.48%	-11.51%	-3.97%
Large Value	-26.77%	-25.10%	-1.67%
Mid-Cap Blend	-28.28%	-26.42%	-1.86%
Mid-Cap Growth	-20.64%	-17.00%	-3.64%
Mid-Cap Value	-32.53%	-35.52%	2.99%
Small Blend	-32.37%	-31.61%	-0.76%
Small Growth	-24.59%	-21.45%	-3.14%
Small Value	-36.89%	-39.68%	2.79%
All US Equity Funds	-21.94%	-20.57%	-1.37%

Exhibit 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks

FUND CATEGORY	COMPARISON INDEX	JAN.-APRIL 2020 (%)	Q1 2020 (%)	Q4 2019-Q1 2020 (%)	1-YEAR (%)	3-YEAR (%)	5-YEAR (%)	10-YEAR (%)	15-YEAR (%)
All Domestic Funds	S&P Composite 1500	64.3	62.4	67.2	71.5	72.5	83.1	87.3	88.4
All Large-Cap Funds	S&P 500	58.7	54.4	58.4	61.0	69.6	79.0	85.6	87.7
All Mid-Cap Funds	S&P MidCap 400	36.3	32.4	35.9	31.9	44.5	55.4	73.6	82.2
All Small-Cap Funds	S&P SmallCap 600	39.1	41.2	42.7	43.9	57.2	68.2	79.2	82.2

What about hedge funds?

Barclay Hedge Fund Index

MAY ROR† **2.67%†**

NUMBER OF FUNDS REPORTING† **1528**

YTD THROUGH MAY† **-4.72%***

†Estimated performance for May 2020 calculated with reported data from 1528 funds.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	-2.99%	-0.35%	2.45%	1.03%	0.62%	-0.04%	2.04%	0.73%	0.89%	-0.31%	0.82%	1.14%	6.10%
2017	1.34%	1.11%	0.51%	0.59%	0.34%	0.37%	1.08%	0.63%	1.03%	1.08%	0.64%	1.15%	10.36%
2018	2.07%	-1.52%	-0.72%	0.45%	0.74%	-0.47%	0.62%	0.13%	-0.09%	-3.30%	-0.41%	-2.75%	-5.23%
2019	3.64%	1.25%	0.61%	1.15%	-1.72%	2.11%	0.48%	-0.96%	0.32%	0.71%	0.99%	1.67%	10.64%
2020	-0.18%	-2.84%	-9.16%	5.33%§	2.67%†	-	-	-	-	-	-	-	-4.72%*

The Roots of the Active Investing Malaise

1. A Flatter Investment World: The advantages that professional money managers have over retail investors have shrunk considerably.
2. No Core Philosophy: Most professional money managers seem to have no core philosophy, careening from one to another, based upon last year's winners.
3. Bloated Cost Structures: The costs of professional money managers reflect an older, more forgiving investment world.
4. Lazy investing strategies: Much of active investing is built around using publicly available metrics (PE, PBV etc.) to pick stocks and trusting in mean reversion to deliver results. If you bring nothing to the table, why would you expect to take something away.

And clients bear some of the blame..

- Don't ask, don't know: Knowing past returns are too good to be true, they refuse to ask questions, perhaps because they don't want to hear the answers.
- Long term in principle, short term in results: They claim to be long term, while demanding to see positive performance every three months.
- Make me a lot of money, but don't ever lose a lot: They complain about quasi indexing (while using tracking error to make sure that deviations from the index get punished)
- Not my fault: They refuse to take responsibility for their own financial affairs (blaming their financial advisors for all that goes bad).

In effect, clients get the active money managers they deserve.

The Future of Active Investing

- The active investing business will shrink: Fees will continue to drop but market share will also continue to decline. It will be less profitable and hire fewer people as analysts, portfolio managers and support staff.
- More disruption is coming: The businesses that are most ripe for disruption are ones where the business is big (in terms of dollars spent), the value added is small relative to the costs of running the business and where everyone involved (businesses and their customers) are all unhappy with the status quo. That fits the active money management perfectly.
- Quant investing is not the answer. Anything that can be quantified can be imitated and anything that can be imitated will.

If you want to be an active investor, here is your road map

1. Have an investment philosophy that fits you: The best investment philosophy for you is the one that best fits you as an investor, in sync not only with your views about markets but with your personal makeup (in terms of patience, liquidity needs and skill sets).
2. Balance faith with feedback: Investing requires balancing faith with feedback, faith in your core market beliefs with enough of an acceptance that you can be wrong on the details, to allow for feedback that can modify your investing decisions.
3. Find your investing edge: Drawing on the language of competitive advantages and moats, what sets you apart does not have to be uniquebut it does have to be scarce and not easily replicable.

If you are trusting someone else to invest for you, here's what to look for..

- Humble vs Arrogant: I think that investors are better grouped into humble and arrogant, with
  - Humble investors recognizing that success, when it comes, is as much a function of luck as it is of skill, and failure, when it too arrives, is part of investing and an occasion for learning.
  - Arrogant investors claim every investing win as a sign of their skill and view every loss as an affront, doubling down on their mistakes.
- If I had to pick someone to manage my money, the quality that I would value the most in making that choice is humility, since humble investors are less likely to overpromise and overcommit.