INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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The unhelpful noise of short-term performance

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Investing is simple, but not easy. The decision to invest in the first place requires foresight, as well as the discipline to deny oneself spending today so that you don't have to eat own-brand baked beans out of the tin in retirement.

The second is deciding how much you want, need and are able to invest in equities, which will act as the drivers of positive portfolio returns, above inflation, that will help fund future spending goals. Getting this right is key and where good advisers can add value.

Next an investor needs to decide the broad structure of their equity and bond components of their portfolio. A good place to start for equities is the structure of the global markets, which defines the basic country, sector and company weights and offers broad diversification. As Eugene Fama, who won the Nobel Memorial Prize in Economic Sciences, said in a recent webinar:

> 'You need to be able to talk your way out of a market cap-weighted portfolio'.

By this he means that any decision to move away from this structure needs to be based on evidence and provide a good chance – although never the certainty – to improve the risk and return characteristics of this portfolio. That is a bit trickier and requires a reasonable degree of investment knowledge. Occam's razor suggests that the simplest answer to a complex problem is often the most effective. It certainly is in investing. Start with market capitalisation.

The final step is picking funds to implement the strategy. Yet for many DIY investors, this is one of the first steps they take, heading to the 'best buy' fund lists in the Sunday papers or some investment website. Here is where the fun and danger start.

Some funds – usually measured over short time frames such as three years – can have great looking track records. At this point many investors' decisions are driven by common behavioural biases. Hindsight bias is the most obvious – it's easy to identify a fund that has done well in the past, but difficult to pick one that will do well in the years ahead. Extrapolating the past into the future is rarely a successful strategy. The fear of missing out is strong but needs to be resisted. Overconfidence in the ability to pick a 'market-beating' fund manager goes against the grain of the bulk of the evidence we have to hand. Over the past 20 years, for example, over 85% of all US equity funds failed to beat the market index and only around one third actually survived the whole period![1]

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Different parts of the market do well at different times, but no-one really knows who the future winners are, not even the professionals. Naïve investors take good short-term performance as a sign of skill. Yet the reality is that much of the seemingly 'good' performance may be down to the part of the market that has performed well that happens to gel with the style of a specific fund. There is an old industry saying that markets pick managers, not the other way around. 'Good' performance may also simply be luck. You need at least 16 years of performance data to be 95% certain that skill rather than luck is the driver of outperformance, even for highly skilled managers[2]. Three- or five-year performance records are largely worthless in identifying good funds. Yet that is where best-buy lists and many IFAs tend to focus.

Spot the 'dog'

One example of the noise investors face is the 'Spot the dog' report published by Bestinvest (owned by Tilney) every six months – and often highlighted in the Sunday papers - naming and shaming a list of funds, coined 'dogs', that have performed poorly relative to a broad market benchmark over three years[3]. Simultaneously, 'pedigree' funds are celebrated based on strong recent outperformance. By and large the 'dogs' were value funds (made up of cheaper stocks relative to some fundamental company metric, like book value or earnings), and the 'pedigree' funds were growth-oriented[4] (more expensive companies) in their latest report. Over the three years, growth stocks in general outperformed value stocks. Without this context, investors risk making decisions based on hindsight, picking investment styles that have done well and potentially lucky managers within those styles. So far this year, many of the UK 'dogs' have outperformed the 'pedigree' funds, as value stocks have performed better than growth stocks[5].

'Expert' picks

Investors Chronicle also tends to provide an annual Top 100 Funds list by broad investment category. Its 2012 global growth list identified nine funds and investment trusts[6]. Over the past ten years, only two out of the nine selected funds beat the market index, but did so handsomely. They are both highly concentrated, high conviction funds holding just a handful of companies. One of the funds suffered a fund-specific 50% fall within the period, which would have taken a strong stomach to live with. The other has experienced a couple of years of explosive growth, driven by a handful of companies and one electric car manufacturer in particular! Will they continue to do so well in the future? No-one knows, not even the managers of these funds and certainly not the pundits creating best buy lists. And that is the point. Basing an investment strategy on 'I don't really know' seems a bit like gambling.

Capturing the market return with a well-diversified, low cost, systematic fund makes good sense and allows investors to ignore the best-buy and fund tips tables noise. Thank goodness for Occam and his razor!

End notes

1.
S&P Dow Jones Indices - US SPIVA Report Year end 2020. http://us.spindices.com/resource-center/thought-leadership/spiva/

2.
An information ratio measures how much skill-based return a manager delivers relative to a representative benchmark and how much relative risk they took to achieve this. A ratio of 0.5 (i.e. half a unit of return for each unit of additional risk taken on) is deemed to be outstanding.

3.
Bestinvest (2021) Spot the Dog. https://www.bestinvest.co.uk/research/spot-the-dog

4.
Albion Strategic Consulting April 2021, Governance Update 21.

5.
Refer to footnote 4.

6.
https://www.investorschronicle.co.uk/2012/07/03/funds-and-etfs/ic-top-funds-2tJw2RT28T6GH04lkFVcEL/article.html

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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