Strategy Thoughts

May 2015

Disappointment!

Introduction

Disappointment may seem an odd title, particularly given that many world equity indices are at or near all time highs, but this current elevation, in both equity markets and investor mood, needs to be put into some perspective. The MSCI All Country World Index is actually only 1 ½% above where it was back in late June of last year and has only risen at an annualised rate of slightly greater than 3% over the last seven years. The period a retail investor has been able to invest in the index directly via an ishare exchange traded fund. Obviously I have been selective in choosing the past high points in the index to make these calculations, they would look far more flattering if I measured returns from recent and long term lows (14% since last October and an annualised return of 17% from the March 2009 lows) but the problem is the vast majority of investors never get anything close to the best possible return, and many get something closer to the worst. In this month's Strategy Thoughts I explore why this is and raise some possible solutions to this challenge. I also review the danger of elevated long term expectations and revisit the AT&T Apple substitution I discussed last month.

Disappointment

The majority of investors are disappointed most of the time, they rarely get the returns that they thought they were going to get, markets don't behave the way they had been advised they would and when they are introduced to the next great idea they invariably discover that they are amongst the last to be joining that particular party. This may seem a particularly bleak view of the investment environment that the majority of investors experience but sadly it is a reasonable description of what the majority are subjected to.

Morningstar research confirms that the average investor does worse than the funds they invest in. A little over a year ago Russel Kinnel, the director of manager research at Morningstar, published a paper titled 'Mind the Gap 2014', in it he highlighted just how wide the gap was between average investor returns and those of the funds they invest in. At the end of 2013 the average annualised return over the prior ten years, experienced by all investors across all funds, was 4.8%, yet the average return of all funds was 7.3%. The 'gap' between what the average investor received and what the average fund delivered was greatest for sector funds which delivered 9.5% p.a. over the prior decade yet the average investor only received 6.3% and closest for US equity funds, but even there the average investor received 1.7% less than the 8.2% that the funds generated.

A more extreme example of this 'disappointment' experienced by the average investor was written up by Jeff Fischer of the Motley fool a couple of years ago. The key points of his article were;

- The single best performing mutual fund from 2000 to 2010 was the CGM Focus Fund.
- Over those years the S&P 500 was flat yet this fund managed to deliver an annualised return of 18%.
- Such performance would have increased an investor's investment more than fivefold had they held their position for the entire period.
- Amazingly, Morningstar reported that the average investor in this fund over that period LOST 11% p.a.

These results reported by Morningstar seem on the surface to be 'too bad to be true' but others have shown similarly poor results. Davis Advisors calculated that the average annual return of all equity holding mutual funds from 1991 through to 2010 was 9.9%, yet the average annual return received by investors over that same period was only 3.8%, an even larger 'gap' than Morningstar highlighted.

These very large 'gaps' occur because they quite rightly look at the dollar weighted average return investors received. Obviously if any investor had sat passively in the CGM Focus Fund from 2000 to 2010 they would have received the terrific 18% returns that the fund generated, but that is not how the average investor invests.

The CGM Fund had a fantastic year in 2007 soaring 80% in value; this performance understandably made headlines and attracted a multitude of new investors. Sadly they were getting in at just the wrong time as the fund plunged 48% in 2008, so the multitude of new investors who only suffered the loss and none of the prior year's gains dramatically skewed the average return. Compounding this was that when the outlook for investing appeared most grim, at the depth of the market's plunge in early 2009, many investors gave up on the fund and exited at just the wrong time.

This CGM Fund anecdote beautifully illustrates a couple of the reasons why the average investor gets disappointed, they succumb to very powerful behavioural biases of herding and anchoring. I have detailed and described these biases many times in the past but these real life examples help.

In October of 2007 the CGM Focus Fund was highlighted in a New York Times article with the headline;

Three Strategies That Kept Sizzling

Three months earlier the fund was featured on Bloomberg under the headline;

Investing's Smartest Players

By the end of the year Morningstar were highlighting the success of CGM in their article;

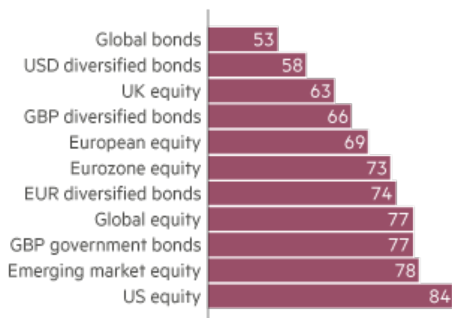
Five Nominees for Domestic-Stock Fund Manager of the Year

It is no wonder that investors wanted to join this incredibly successful 'party', we all want to be part of the successful 'herd' and we actually feel safer being a part of a herd. We also are happy to look upon the amazingly successful trend that has been put in place and extrapolate that trend into the future. It was no wonder the money flooded in. Equally with the doom and gloom that was pervasive in the first quarter of 2009 it is no surprise that the 'herd' gave up after suffering such large and persistent losses.

It may be a little unfair to be using the example of CGM as the fund has delivered great long term returns, albeit it has been fairly volatile, however, a similar influx during the good times and exodus at the worst possible time is seen across all funds and markets. This has to be the case as great peaks in any market are made because more and more investors want to get in at any price and the reverse is seen at major troughs. The result of all this is that on average the majority of investors get into a trend far too late and often just before it reverses. Once the reversal has been seen they then become fixated upon the price they got in at and vow to get out if it is ever seen again and they can breakeven. Sadly

Most managers don't beat the market ...

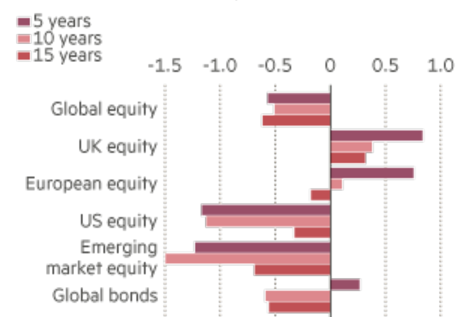
% that fail to beat market over five years



Source Vanguard UK using Morningstar

... and the underperformance often gets worse with time

Median excess returns over period (%)



Source Vanguard UK using Morningstar

FT

this often doesn't happen and they hang on as long as they can bear the pain until eventually they just want out at any price just so they can move on. Obviously this is a gross over simplification but these behavioural biases that are hard wired into us are hard to overcome.

It may seem as though a simple buy and hold strategy is the one that makes sense, and there is some validity to this, however, most investors just don't have the discipline to stick to even that simple strategy. Ken Fischer in his book 'Debunkery' points out that the average holding period for any mutual fund is just 3.2 years.

Discipline, and sticking to it, is at the core of all successful investors, and lacking in the majority of investors. This raises the question of where should one invest to then exercise that discipline and the answer sadly is not with the majority of professional fund managers.

The FT late last year included the charts (left) on active fund manager performance. They clearly show that the vast majority of fund managers fail to beat their benchmarks over five years and that the average underperformance actually gets worse the longer one waits.

One of the reasons that professional fund managers underperform is simply that investing has to be a zero sum game; everyone can't beat the thing that they are all invested in. Therefore after fees for management and administration etc are taken out the average fund manager will underperform. Other reasons include the fact that fund managers on average all suffer from, and succumb to, the same behavioural biases that individual investors do, and in some cases, particularly herding, the instinct is even stronger. Most managers don't want to look too different from either their peers or their benchmark. (This raises the question I have raised several times in the past when discussing 'Activeshare' of paying for active management and getting closet indexing).

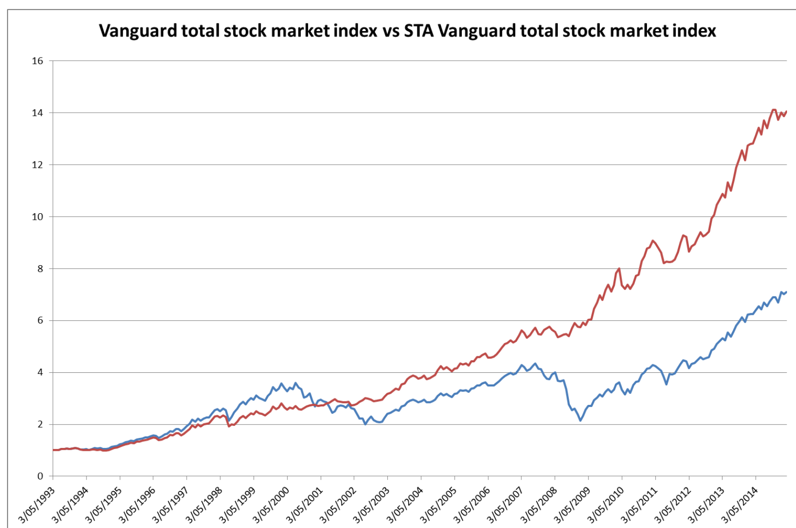
It is also the case that most fund management companies want to increase their funds under management, therefore they offer new products that are easy to sell, these tend to be the products that have captured the imagination of the herd and are therefore likely nearer the end, than the beginning, of their bull markets, think of tech in 1999 and commodities in 2007.

All of the above supports the idea of passive investing via low cost index funds or ETFs as promoted so successfully over many decades by Vanguard. Jack Bogle, who founded Vanguard in 1974 has always contended that over time low cost index funds must outperform expensive active management as, on average, active managers can only deliver what the markets deliver and then their fees must be deducted. However, sticking to a passive buy and hold approach of holding index funds still requires immense intestinal fortitude and discipline. At the depths of the last two severe cyclical bear markets, from 2000 to 2003 and 2007, required immensely strong nerves and unfortunately many investors

who previously thought that they were indeed disciplined lost their nerve at just the wrong time. Both of those bear markets resulted in protracted declines in all markets and in Vanguard's broadest US index fund those falls were a little under 50% and a little over 50%, as can be seen in the chart below.

Clearly holding on through those dire periods was the right thing to do, with the benefit of hindsight, as in both cases within about three years those bear market losses had been totally recovered, however, the stress of riding out these roller coasters was great and the immense discipline, that proved essential, would have been hard to muster.

Given my views on investing not being a science, that economics and earnings forecast are a less than useful crutch to investors and that markets are a reflection of aggregate investor mood, one of the most frequent questions I have been asked over the last few months is why do I believe that the STA Portfolio can deliver superior long term returns? The answer is very simply that it is rules based, it therefore imposes a very strict discipline on investors and protects them from the behavioural biases that so beset the rest of the investment world.



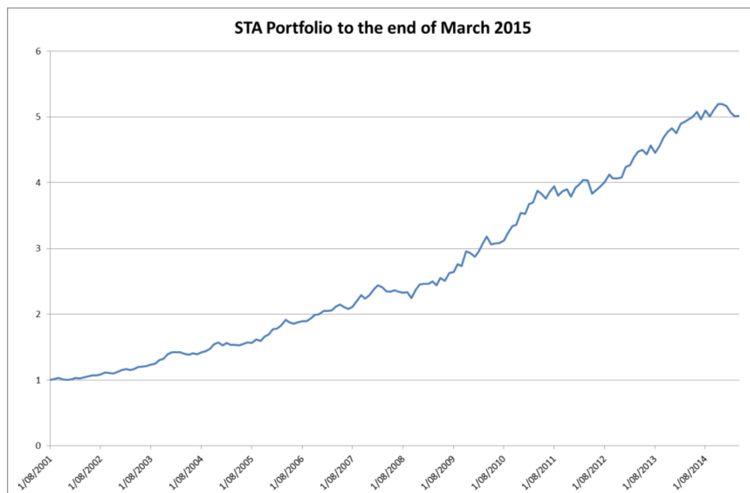
As an illustration I have included in the chart above of the Vanguard total stock market index the performance that the STA process would have delivered over the same twenty two year period. On average over that period this STA fund would have been invested in the Vanguard total market index 73% of the time, Vanguard intermediate treasury fund 14% of the time and Vanguard corporate high yield fund 13% of the time. The compound annual return of this STA fund would have been 12.74% compared to the 9.255 return that the total markets fund delivered. However, more important than the out performance was the lack of volatility. The STA fund would have suffered a negative rolling twelve months only 5.5% of the time whereas the total market fund suffered negative rolling twelve months more than 10% of the time. Equally important is that the worst twelve month returns were minus 43% for the total market fund and only minus 7% for the STA fund.

The downside of this improved outcome is that during the best of times the STA obviously underperforms as it clearly did through much of the nineties bull market and from the depths of the low in 2003. But the emotional ride would have been substantially less of a rollercoaster.

Does the current position and performance of the STA Portfolio tell us anything?

The STA Portfolio has corrected a little over the last few months, for the first quarter the fund fell 2.5%, over the last twelve months, through to the end of March, the fund rose 3% and for the last two

years it has risen 16%. Its ten year annualised rate of return is 12.5%. This means that it has lagged the US indices that it invests in over the short term but has delivered several times the return of those indices over the longer term, and with substantially less volatility.



What is perhaps more interesting is to look at what the fund is actually investing in now and how this has changed recently, then compare this to similar periods in the past and see whether the funds rules based decision making is giving any indication of what may lie ahead.

The STA Portfolio has steadily decreased its exposure to equities and into fixed income over the last nine months. In June of last year the fund was fully invested and held no positions in the fixed income markets, this has grown to be a 42% exposure to fixed income currently. It is also interesting to note that within this exposure to fixed income the portfolio has also changed, becoming substantially more conservative exiting its final exposure to high yield bonds in October of last year.

A similar shift was seen within the portfolio in md 2007. At the beginning of 2007 the fund was fully invested with no exposure to fixed income; however the fixed income allocation grew throughout 2007 reaching 45% in October. A further parallel with the current situation is that the exposure to high yield ended in June of 2007, it remained with a zero exposure to high yield for the next two years.

Over confident expectations

Currency markets have always provided wonderful examples of how it is human expectations and biases that drive markets, rather than the supposed 'fundamentals' that we hear discussed so often when it comes to currencies.

Over the last few weeks the business media in New Zealand has been obsessed with the New Zealand dollar and its apparently inevitable march towards parity with the beleaguered Australian dollar. In many ways the headlines that were everywhere reminded me of the same situation with the US dollar and sterling back in the mid eighties. Then expatriate Americans in London were all making plans for their 'parity parties' and their American friends were coming over to London with empty suitcases. Of course parity never quite happened. None of this is to say that Kiwi Aussie parity will not be seen but the degree of certainty across virtual all news media did alarm me. Repeatedly I was hearing economists explain why parity and beyond would happen based upon relative growth rates, interest

rates commodity prices etc when all I was hearing was actually an explanation of why the Kiwi had already been so strong. For the trend to continue the news in favour of New Zealand had to be even better than everyone was already expecting, naturally this gets harder the more expectations get raised and not surprisingly the peak in any market is invariably accompanied by peak expectations of the preceding trend continuing.

Given all of this it was therefore a little amusing when the Reserve Bank of Australia did not cut rates and the Kiwi reversed after getting so close to the invisible wall of parity. On the 8th of April Stuff.co.nz ran the story;

> **Aussies jealous as NZ dollar approaches parity**
>
> The Aussie dollar has staved off parity with the Kiwi… For now.
>
> A rate cut reprieve from the Reserve Bank of Australia (RBA) on Tuesday saved what the Aussies called an embarrassment: parity with the Kiwi.
>
> However, the market still expected the New Zealand dollar to achieve parity sooner than later as the RBA looks for a lower exchange rate to stimulate the economy across the Tasman.

A day later CNBC and Interest.co.nz both agreed that parity was inevitable;

> # Kiwi-Aussie dollar parity: A foregone conclusion?
>
> Thursday, 9 Apr 2015 | 12:20 AM ET
>
> Chris Tedder, research analyst at FOREX.com, explains why the New Zealand dollar will move past parity against the Australian dollar "sooner rather than later."
>
> The New Zealand dollar's run at parity with its Australian counterpart may have fallen short this week, but those who were planning a parity party should keep the champagne on ice, according to Dan Bell, director of sales at HiFX. Interest.co.nz

Still the broad expectation is that parity will be achieved, and seemingly everyone knows why. It is remarkable to compare the situation now with that four years ago. Then the story was quite different, Aussie interest rates were substantially higher than those in New Zealand, the outlook for growth was far stronger and no one it seems was forecasting any change in the situation. Back then when the Kiwi was worth only 73 Aussie cents it would have been useful to hear a forecast that the kiwi was set to rise by 35% against the Aussie dollar. It would certainly have been more useful than being told that it was set to rise to parity when it was already at 99 cents!

Later in 2011 confidence in the Aussie dollar had risen even further as it broke through parity with the US dollar and reached $US 1.11. This was an 80% rise over the prior three years and confidence and expectations were understandably sky high.

Two years ago in Strategy thoughts I discussed what was then the early stages of an Aussie bear market.

> In late 2008, having fallen precipitously expectations had become very bleak indeed for the Aussie as this Brisbane Times headline from October 20th 2008 illustrated;

Aussie dollar tipped to slump further

> The article quoted forecasts that the AUD/USD exchange rate in the first quarter of 2009 would fall to 62 cents, or even 59 from one bank economist. At the time the currency was at 69 cents. Just a few months earlier, in May of 2008 the article reported that many of the same economists were forecasting parity with the US dollar. The Aussie dollar did fall after that article appeared, for one more week. It then embarked upon an incredible bull market that took it all the way up to 1.10 US$ in late July 2011, by which time some economists were dangerously referring to a 'permanently high plateau' for the Aussie dollar and all were ratcheting their forecasts higher. What followed was a plateau, or at least a trading range between 94 cents and $1.10, but it has not proved permanent.

The bear market in the Aussie has obviously continued but the lesson for investors should be in the level of conviction and certainty that existed at its peak. Whenever expectations become severely extended and conviction that the preceding trend is set to continue or even accelerate it is likely that the majority of believers are in for a disappointment. It is highly unlikely that the news can be anything like good enough to deliver a positive surprise that will surpass those expectations, but that is what is always needed for a bull market to continue.

Apple update

Last month I highlighted the danger of investing based upon what everyone already knows and illustrated this with the example of Apple being inducted into the Dow Jones industrial Average at the expense of AT&T.

Since the date of Apple's actual inclusion in the Index on the 18th March both Apple and AT&T have drifted down very slightly and both have slightly underperformed the index that they were, and now are, part of. It is obviously too early to say whether this change in the Dow is behaving in line with the average experienced over the last eighty plus years discussed last month. Time will tell, but I will certainly be monitoring the pair's relative performance.

The golfers amongst Strategy Thoughts readers, of which I know there are a number, may have, like me, seen something in the coverage of the recent Masters Tournament that hinted that AT&T may not be the 'sunset' story, compared to Apple's 'sunrise' story that so many believe. The bag of the very young champion, Jordan Spieth, is shown to the right as it appeared at Augusta!

Recommendation

Some months ago I recommended George Soros' book 'The Tragedy of the European Union' that was published early last year and a few years ago I recommended a book by George Freidman of Stratfor 'The Next 100 Years', well now I am going to recommend a book that sort of ties some of the themes from those two books together. It is again by George Freidman but this time his total focus is the past present and future of Europe. His conclusions for Europe and its union, arrived at from a totally different perspective, are potentially as bleak as Soros' and are captured well in the book's title 'Flashpoints. The Emerging Crisis in Europe'. As someone who has studied too little history I found Freidman's detailed historical analysis of how Europe came to look like it does incredibly useful and

could easily appreciate how his conclusions, that are far from optimistic, could occur over the coming years. I found the context he put around Russia and the Ukraine, given the very current nature of this potential flashpoint, particularly useful.

Conclusion

The majority of investors endure lengthy periods of disappointment for a variety of reasons, however, the core of this disappointment lies in the fact that the current approach to investing for most individuals doesn't work. It is based upon flawed expectations over what actually drives markets and flawed assumptions as to the efficiency of markets and rationality of investors. Even when executed well, and rebalanced regularly, the conventional approach to asset allocation still leaves investors exposed to the possibility of huge swings that can result in emotionally driven investment decisions generally at just the wrong time. Something other than the typical 'balanced' fund is needed for most investors and the STA Portfolio is a step in that direction. However, whilst its average exposures may be similar to some balanced funds its approach to asset allocation is totally different and certainly defies what has become accepted conventional wisdom. In many ways it is incredible that what was considered 'best practice' in portfolio construction and management twenty or thirty years continues to be considered as such despite its obvious shortcomings over the last fifteen years.

In addition to finishing George Freidman's book mentioned earlier I have also just got around to reading a book I first heard reviewed a month ago 'How to Fly a Horse' by Kevin Ashton. The sub title of the book reveals what it is really about 'the secret history of creation, invention and discovery', the 'fly a horse' reference is to how the Wright brother described their mission to build a flying machine.

Fairly early in the book Ashton describes the desperately sad experience of a Hungarian doctor, Ignaz Semimelweis. It was Semmelweis who first discovered that doctors washing their hands would dramatically improve the outcome for mothers delivering babies. When this was put into practice death rates among mothers collapsed from 18% to just 2%. Despite this obvious success Semmelweis was ridiculed, partly because it was believed that doctors are gentlemen and gentlemen's hands are clean, and partly because no one could explain why it should work. It wasn't until Semmelweis' sad premature death, after being beaten and locked in a mental asylum that Louis Pasteur discovered what would become known as germ theory. With Smmelweis removed from his hospital doctors went back to not washing their hands and the death rate among mothers understandably soared. Ashton goes on to explain just why, despite the obvious and hugely beneficial effect of Semmelweis' simple discovery, he and it were ridiculed and ignored.

> "Because powerful antibodies of the status quo mass against change. When you bring something truly new to the world, brace. Sometimes the hardest part of creating is not having an idea but saving an idea, ideally while also saving yourself."

I am certain that similar 'antibodies of the staus quo mass against change' in the investment world, fortunately I don't feel the need to be too 'braced' for suggesting the STA Portfolio.

For those readers in Britain

My middle son Michael, who has been a regular reader of Strategy Thoughts for a number of years, has two undergraduate degrees from Otago University, a Masters from Florida State University and a little over a year working as a senior feasibility analyst for Auckland Tourism, Events and Economic Development, has decided to utilise his British passport and is in the process of relocating to London.

If any readers have any thoughts as to where opportunities might lie for a 'bright Kiwi' in London then please feel free to contact Michael directly on; m.elliott.armstrong@gmail.com.

Kevin Armstrong

23th April 2015

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