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WEALTH MANAGEMENT

Shiny Object Marketing

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By Jaco Jordaan, CFA, CFP®, ChFC®, CAIA, EA
President

In marketing, the "shiny object" is something which is attractive to the buyer, and which can distract from focusing on other less desirable characteristics of an offering. As consumers, we make decisions based on shiny objects all the time. Car buyers get a rate discount or cash back on a purchase – if you buy now. Home shoppers get not one, not two, but three magic cleaning solutions - if you order in the next ten minutes.

The investment world is not immune to the shiny object. However, where consumers actually get something in return on most products with incentives (you did actually get the second magic cleaner), there is some question whether the investment shiny object will actually provide a benefit, or whether it simply is a marketing gimmick which might be too good to be true.

Star Managers

Mutual fund distributors are happy to highlight outperformance by star managers over a particular period. The implication to investors is that you have an opportunity to invest with the manager today to get similar outperformance in the future. Of course, there's plenty of small print indicating that continuing outperformance is not guaranteed. The downside of this shiny object experience is that such a manager inevitably goes through a period of underperformance and investors sell the fund to jump to the next outperforming manager. This could result in adverse tax consequences and could reduce overall returns as an investor effectively ends up buying high and selling low.

Whether star managers are actually good is dependent on whether their track record was established through luck or by skill. Quite frankly, sometimes even the manager doesn't know – although they most likely believe it was skill and the mutual fund distributor is going to sell based on a presumption of skill. From my experience interviewing hundreds of mutual fund portfolio managers, they always take credit for outperformance, but they are never wrong if they underperform.

Academic evidence suggests skill may not exist. In a study intent on determining whether some mutual fund managers have been able to outperform through skill, Eugene Fama and Kenneth French established that the number of fund managers that outperform are not different from the number of managers one would anticipate outperforming purely by chance.[1] That is, if you create a hundred portfolios and randomly select securities for those portfolios, some of those portfolios will end up doing better than the broad market, simply by chance. If you simultaneously had one hundred portfolio managers actively running a portfolio, one would expect more managers with outperforming portfolios than the random sample of portfolios - if manager skill existed. Fama and French's research suggests this is not the case. In fact, after expenses, the number of managers who have been able to outperform is actually slightly less than predicted by chance alone.

Lesson: Be cautious if you are being sold on the prowess of a star manager. It's likely just a shiny object.

Tactical Portfolios

A frequent shiny object offered to investors are tactical portfolios. These strategies suggest that management will reduce portfolio risk if they feel risk is too high, or will increase portfolio risk if risk is too low. Which investor would not like this? Management will limit losses by reducing risk at the right time, and increase returns by increasing risk at the right time, and the management team knows how to do this. Perfect! Sign me up!

Once again, the academic research does not support the notion that managers are able to enhance returns or reduce risk by accurately timing market movements. The first problem with trying to time through market volatility is the requirement to be right – twice! You have to get out of the market before it bottoms, and you have to get back into the market before it surpasses the value at which you exited. Due to a variety of behavioral biases and flaws, investors and managers tend to be better at reacting to markets than predicting markets. That is, they tend to reduce risk AFTER the market has declined, and only add risk back AFTER the market has established a recovery. This pattern of trading may actually result in a net loss versus an investor that simply held through the cycle.

[1] "Luck Versus Skill in Mutual Fund Performance," Eugene Fama and Kenneth French, Fama/French Forum, Nov 30, 2009

From a shiny object perspective, an investor may feel like their manager is at least doing something proactively. In reality, the actions more frequently are reactive and can be damaging to long term portfolio return. Historically, some of the biggest daily returns have come during periods of substantial market volatility, sometimes immediately following large declines. If an investor exists immediately following a large decline, they may not participate in any rebound. With the market, statistically speaking, you generally must be present to win.

Lesson: Be cautious if you are being sold on a manager's ability to timely reduce or increase portfolio risk. It's likely just a shiny object.

So, What Should Investors Do?

The first thing to do is to change your perception of market volatility and market behavior over time. Consider the following, if there was no volatility in the markets, why should there be any expectation for higher returns than something like cash, which also has no volatility?

There are products available in the financial marketplace which offer effectively no downside risk – savings accounts, certificates of deposit, certain insurance products. At the same time, those products currently offer returns only slightly higher than zero, and that limited return is the price of stability. If you want to pursue potential returns in excess of these products, you have to accept that downside risk is both likely and necessary. Once you accept that basic market truth, it can free you from worrying about market movements.

The above is not intended to suggest everyone should put all of their assets into the market and just let it ride. Every investor has a different willingness and ability to take risk and withstand portfolio drawdowns. As a financial advisor, it is my job to help identify how much risk you can and should take, and to help structure an investment portfolio which fits within those parameters. I can also help to periodically adjust portfolios, not in an attempt to predictively time markets, but to maintain a level of risk which is consistent with your financial goals and priorities.

If recent market movement has you concerned, feel free to reach out to me to discuss your financial situation.

Sanitas Wealth Management, LLC
4845 Pearl East Circle, Suite 101
Boulder, CO 8001
(303) 325-7945