Rochester Business Journal
RBJ
VOLUME 29, NUMBER 27 WWW.RBJDAILY.COM SEPTEMBER 27, 2013

Stick to basics; they go a long way toward meeting objectives

VIEWPOINT
Mark Armbruster

The world is full of investment pornography. This is a term coined by a mutual fund marketing executive I know to describe misleading claims in the investment industry. One such claim is that smart, hard-working investment managers with cutting-edge technology can outperform the market by actively trading stocks or other investments. Although it seems intuitive that this approach would produce positive results, the evidence indicates differently.

I started my career working in equity research for a large investment bank. We were perennially ranked as one of the top research departments on Wall Street. Every year our group would put together a fund that invested in the top ideas from the entire research department. We formed a committee made up of research management, the strategists, economists and market technicians. On average, each of the committee members had roughly 30 years of Wall Street experience. Each of the analysts in the department, who followed stocks in various industry groups, presented their best ideas for the coming year to this committee. The committee ultimately selected what it viewed as the 15 most promising stocks for inclusion in the fund.

This was about as rigorous a process as you could imagine: The top people from one of the leading firms using their best ideas, significant technological resources and decades of experience. The result: The fund usually underperformed the S&P 500.

We were not alone. When you look at the objective data, it turns out that a large majority of professionally managed investment products fail to provide returns in line with or above what you could get by using a naive index fund.

The problem, largely, is that all of the required ingredients for outperformance are expensive. Smart portfolio managers and analysts don't come cheap. Neither does cutting-edge technology. So just to earn the return of the market, professional investors must perform significantly better on a gross-of-fees basis. A high level of trading activity, which is characteristic of most actively managed funds, can also result in significant tax expense. In combination, investment-related costs and taxes can consume half of your return if not managed properly.

The evidence of these frictions is pervasive. Standard & Poor's conducts a biannual study of actively managed mutual fund performance. S&P's data show that over shorter periods, the odds of a mutual fund outperforming its benchmark index are reasonable, although less than 50 percent in most asset classes. Over longer periods, however, very few mutual funds provide returns in excess of what you could earn with index mutual funds (which generally charge very low fees and are quite tax-efficient). Though there are always some active funds that outperform, past winners are statistically unlikely to repeat in the future, making the job of finding truly stellar fund managers exceedingly difficult.

This also renders past performance all but useless when looking for fund managers who will outperform in the future. In fact, a recent study by fund company Vanguard shows that rainfall predicts future stock returns just as well as past performance.

Where does that leave us? Well, some strategies have proved to be effective in the investment world. They are all very basic, common-sense strategies, but interestingly, many are largely ignored by the professional fund managers.

The first step is finding the right mix of risk and return for your unique investment objectives. You have to get the right asset allocation, or mix of risky and more stable investments. A portfolio that is too aggressive can cause great anxiety, but one that is too conservative may not meet your long-term goals. A balanced approach is necessary, and both financial and psychological factors should be considered.

Staying in the market is also important. Trading in and out of the market can result in higher costs (in the form of commissions and bid-ask spreads), higher taxes (for realized capital gains), and the opportunity for emotional decisions to take over and impair long-term wealth creation. Selling out of the market during bear markets and buying in during bull rallies is a comfortable approach, but it is the opposite of what is likely to be financially rewarding.

Diversification—spreading your risk across a number of different asset classes (such as stocks, bonds, cash, real estate or commodities), subclasses (such as domestic stocks, international stocks, large-cap stocks or small-cap stocks) and securities—is essential to reduce risk and build an efficient portfolio. It also helps protect against a downturn in any one asset class and allows you to stay the course during difficult market cycles.

Keeping investment costs to a bare minimum helps you keep more of your return. These costs include investment management fees, trading costs, commissions, mutual fund expense ratios, and potentially others. In his paper "The Arithmetic of Active Management" and a recent follow-up, "The Arithmetic of Investment Expenses," Nobel Prize winner William Sharpe showed that added costs all but guarantee that investors will trail the market. While these costs may seem small in percentage terms, they can have a very large impact on your ending wealth when compounded over many years.

Taxes can be the single largest expense if left unchecked. Fortunately, there are strategies to manage the tax bite. For example, you can put investments that pay income that is taxed at ordinary income rates, such as bonds and real estate investment trusts, into retirement accounts. You can also use low-turnover strategies so that realized capital gains are kept to a minimum. Finally, you can harvest tax losses, when available, to use against current or future realized capital gains.

Although there is no silver bullet in the investment world that guarantees a successful experience, these common-sense strategies go a long way toward helping investors meet their long-term objectives. While the strategies discussed are not as sexy as stock picking and market timing, they are more likely to build long-term wealth.

Mark Armbruster is president of Armbruster Capital Management Inc.

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