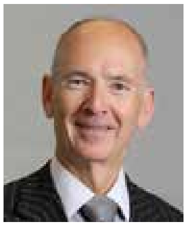
WHITE PAPER

Does the Investment World Suffer From ADHD?



BY **BILL SPITZ**, PRINCIPAL

Attention Deficit Hyperactivity Disorder (ADHD)-A brain disorder marked by:

- *A lack of persistence and difficulty sustaining focus*
- *Hyperactivity*
- *Impulsivity*

Source: National Institute of Mental Health

I recently wrote a paper titled *Imagine the Unimaginable* that outlined changes in the economy and financial markets during my career, and one of its primary areas of focus was the increased complexity and frenetic activity of the investment world. There is nothing inherently wrong with either complexity or activity as long as they assist investors in achieving their objectives.

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So, the key question is whether more is better; are both individual and institutional investors better off by virtue of the huge variety of investment vehicles available, the ubiquity of information, the advance of investment technology, the frequency and precision of performance measurement, and the frenzied level of trading activity? To answer this question, I briefly review the evolution of the investment world and then provide some data on the results achieved by various types of investors. Finally, I translate this into recommendations as to the right level of management of a portfolio. Trigger warning; this is about as close to a rant as you will ever see from this writer!

The Evolution of the Investment World

While the details are somewhat different, there has actually been a parallel change in the worlds of individual and of institutional investors. Let's begin with individuals. Going back to the 1960's, most individuals owned only blue chip U.S. stocks and bonds and these securities were typically held in brokerage accounts. In aggregate, individuals directly owned 70% of all stocks and they held them for about six years on average. In the two decades from 1980 to 2000, there was a fifteen fold explosion in the number of mutual funds and a fifty fold increase in mutual fund assets. Previously, the mutual funds that did exist were also invested primarily in large capitalization U.S. stocks or a blend of stocks and bonds. But, the explosion consisted of a huge variety of more focused funds that were differentiated by capitalization, style of investing, geographic concentration, sector specialization, and many other ways of slicing and dicing the capital markets. According to the Investment Company Institute, there are currently about 8,000 funds. The next wave was the development of Exchange Traded Funds and Notes of which there are now about 2000 in the U.S. and almost 7000 globally. Once again, there is an incredible variety of funds employing every conceivable strategy and type of security. Along the way, High Net Worth Investors had access to so called "Non-traditional" assets such as private equity, real estate, commodities, hedge funds, and so on. But, even these asset categories have found their way into vehicles designed for smaller retail investors. I could go into more detail but the message is clear; there is an incredibly large and fairly daunting number of vehicles from which to choose.

As mentioned above, the path for institutions has been fairly similar. For many years, pension funds and endowments were managed by one or two "balanced" managers who invested largely if not solely in U.S. stocks and bonds. Next came the era of specialized managers, frequently boutiques, who invested in very narrow segments of the markets. There were large cap stock managers, growth managers, global managers, short duration bond managers, mortgage back security managers, and so on. In order to assess the performance of these managers, Wall Street developed very specialized market indices or benchmarks and it was recently reported that there are now actually more indices than stocks! Following the lead of endowment funds, many institutions

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invested in the non-traditional categories mentioned above, typically using partnerships as the investment vehicle. Taking all of this into account, it is not at all uncommon today for large funds to employ considerably more than one hundred different managers of every ilk. In order to manage this complexity, pension funds and endowments now employ large teams that are frequently supplemented by outside resources such as consultants.

The 24/7 Investment World

There is a condition frequently associated with ADHD called Sensory Overload in which one or more of the body's senses experiences over-stimulation from the environment. Common stimuli include urbanization, noise, media exposure, and most notably, the explosive growth of information. Wall Street certainly provides enough stimulation to bring on this malady! Today, we have 24/7 financial news through Bloomberg, MSN, and other media sources, and financial talk show hosts such as Jim Cramer have converted finance into a form of entertainment. Investors historically relied on brokerage firms, rating agencies, and a small number of other vendors for information on securities and companies, but financial data is now available at little or no cost from a myriad of sources. Most investors now have continuous access to their accounts through their computers and mobile devices, and performance measurement has become an industry in and of itself. For retail investors, services such as Morningstar evaluate and rate the performance of mutual funds, and most institutions employ a custodian or consultant who provides monthly or quarterly analyses with incredibly detailed information on the performance of every component of the portfolio. The net result of all of this is that even modest investors have a continuous flow of "actionable" ideas or recommendations as well as voluminous and instantaneous information on the performance of their existing portfolio. According to psychologists, two of the most common symptoms of Sensory Overload are extremely high or extremely low activity levels. While I have certainly known individuals who were paralyzed with regard to financial decisions due to information overload, I think the more common result is hyperactivity.

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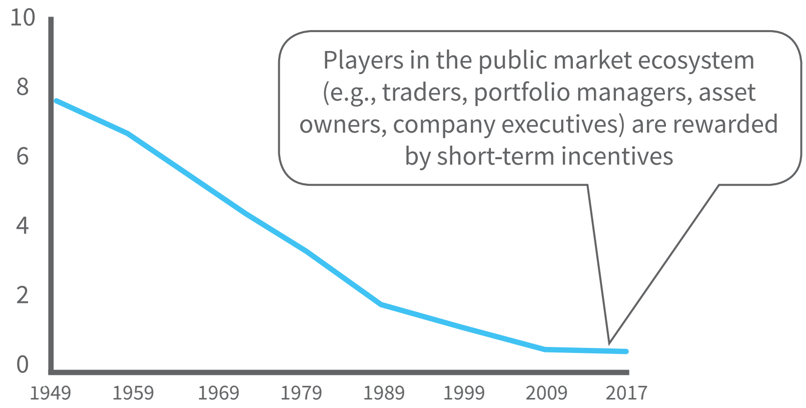
Frenzy!

When I began my investment career in 1975, New York Stock Exchange daily volume was about 15 million shares whereas today it exceeds 1.2 billion. You may have read that some hedge funds have installed very high speed transmission lines in order to speed up their transactions by a couple of nano-seconds! (one billionth of a second) As depicted in the following chart, the average holding period for stocks has declined precipitously:

NYSE average holding periods (years), 1949-2017



As just one example, the average holding period of stocks in equity mutual funds is approximately 9 months. The same pattern can be seen with respect to investors' patience in holding mutual funds. According to the Investment Company Institute, the total value of purchases, sales, and exchanges of mutual funds for 2017 was right at $43 trillion whereas the total assets held in mutual funds is approximately $18.7 trillion. Now that is what I call activity! Finally, it is very difficult to get data on the frequency with which institutions hire and fire their investment managers. But, while most institutions' governing documents call for evaluating managers over a full market cycle (whatever that is!), I believe most practitioners would tell you that actual time frames are much shorter thereby resulting in frequent changes in manager lineups. In support of this assertion, many plans place a manager who has underperformed for three years on a "watch list" which is the first step toward termination. A paper from the investment firm Research Affiliates found that the best performing managers still spend more than a third of the time on the watch list! So, even a three year time horizon is too short and is likely to spur poor decisions to change courses.

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Payoff?

So, does all of this activity result in better outcomes? Every quarter, J.P. Morgan publishes a chart that shows the performance over the past twenty years of the average investor versus nine different asset classes. Depressingly, the average investor has underperformed each of the nine asset classes. To place this performance in perspective, a simple 60% stock/ 40% bond portfolio outperformed the average investor by 3.8% per annum. Why, because investors tend to trade frequently and often at just the wrong time. What about mutual funds? A variety of studies have concluded that while there are always funds that do outperform over short periods of time (frequently due to luck), 70-75% of professionally managed funds underperform their respective market benchmark over ten year periods and approximately 80% underperform for twenty year periods. Finally, a study of pension funds by Goyal and Wahal found that the returns earned by newly hired investment managers are indistinguishable from those of the managers that were terminated. So, while there are certainly investors with excellent track records, there is little data to support the premise that more is better; that all of the information sources, technology, and activity have furthered the lot of most investors. And, perhaps the greatest irony is that despite these shortcomings, the financial services sector has grown from about 5% to 8% of GDP over the last thirty years.

We Are Our Own Worst Enemies

Unfortunately, the evolution of the Financial World has not saved us from ourselves. The fact that we can constantly look at the composition of our account and its investment performance does not mean that we have greater insights into the workings of the capital markets-we are just looking at the same information more frequently. The fact that we can instantaneously make and implement investment decisions does not mean that they are better decisions. And, the constant flow of information frequently leads to overreaction and other forms of impulsive behavior. The field of Behavioral Finance has identified a large number of human weaknesses and biases that impact investment decision making and they are all still with us despite all of the growth and development of the Financial World.

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But, All Is Not Lost

But, rather than bemoan the complexity and rapid pace of Wall Street, I would rather focus on how we can benefit from its growth and development. Among the positive features of the new world are:

- **In the "old" days, portfolios often consisted of a small number of stocks and bonds and were therefore under-diversified. The variety of funds available today make it easy to reduce risk through diversification.**
- **Similarly, non-U.S. investments were basically unavailable to U.S. investors. The variety of international funds now creates opportunity for both diversification and enhanced returns.**
- **The general direction of costs is down and there are a variety of very low cost vehicles such as passive ETFs. Some of these vehicles are also very tax efficient.**
- **For those who do not wish to manage their own investments, target date funds and similar vehicles provide diversification, sensible asset allocation, low cost, and rebalancing.**
- **There is a massive amount of low cost or free information and data for "do-it-yourself" investors.**
- **While complex and frequently illiquid, there are a large number of niche investment categories for those who have the energy and wherewithal to invest in them.**

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Back to Human Behavior

For many years, I have recommended that investors carefully formulate their goals and objectives, select an asset allocation consistent with those objectives, rebalance periodically, and otherwise leave the portfolio alone to do its work. I continue to believe that is the right approach for most investors but am acutely aware that the flood of information and activity discussed above makes it even more difficult to resist the temptation to tinker. I think the solution is to take advantage of the best features of the investment world and to construct a mechanism to filter out all of the noise. That would involve not looking at accounts too frequently, measuring performance over an appropriate time horizon, and ignoring headlines. For those who have a strong urge to micromanage, that may mean using a vehicle such as a target date fund, constructing an Investment Policy document with very specific guidelines and restrictions, or employing someone else to oversee your investments. In the end, despite all of the resources and technology, it all comes down to controlling human emotions.

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