



Rehab for Investor Performance Addiction

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July 2010

Just as drug addicts seek help in rehab, it's time for us to go into rehab to address our chronic performance addiction. This addiction is rooted in a deep form of co-dependence across the entire industry: investors (institutions and individuals), their advisors (investment consultants, financial advisors), and their asset managers.

A version of this article was first published in the *Financial Times FTfm* supplement on June 21, 2010.

As lawmakers work on financial reforms, we in the investment community should reform persistent behaviors undermining investment outcomes. Just as drug addicts seek help in rehab, it's time for us to go into rehab to address our chronic performance addiction. This addiction is rooted in a deep form of co-dependence across the entire industry: investors (institutions and individuals), their advisors (investment consultants, financial advisors), and their asset managers.

In the spirit of full disclosure: I work for one of the largest global asset managers. Most asset managers exhibit "enabling behaviors" that reinforce investors' performance addiction by selling investment products on the basis of past – particularly short-term – performance. Although we all repeat the mantra that "past performance does not guarantee future success," we still pay too much attention to performance.

This behavior takes two broad forms: 1) investors jump into asset classes at the peak of their investment performance; and 2) investors plow money into *individual asset managers* at the peak of the managers' alpha cycles. In effect, most investors are constantly "buying high and selling low."

Consider two recent examples of herding into asset classes at their peak. Pension funds poured into private equity in 2005-08 in a vainglorious attempt to emulate the "Yale model," just as the heyday of leveraged buy-outs peaked. More recently, individual investors have piled into fixed income mutual funds, as they turn their scarred backs on equities. In 2009, 96 percent of U.S. long-term mutual fund net flows went into fixed income, primarily because bonds handily outperformed equities in the past decade.¹ But with interest rates at close to zero, investors are maybe pinning their hopes on the unlikely outcome that fixed income returns will be as strong over the next decade.

Investors also have a predilection for plowing money into individual asset managers at the peak of their alpha cycles. Most mutual fund investors do not earn the robust long-term returns of the funds in which they invest, because they buy these funds when the manager is "hot" and then sell when the manager cools off. The average U.S.

¹ 2010 *Investment Company Fact Book*, 50th edition, Investment Company Institute (ICI), January 2010.

Investors need to make peace with the reality that good managers' periods of underperformance over the course of a market cycle do not detract from their ability to add value in the long run. Greater emphasis should be placed on identifying asset managers that demonstrate the behaviours and characteristics typically associated with superior long-term performance.

mutual fund company holding period is less than four years.² This may not be a sufficiently long time horizon to judge the true expertise of an asset manager in delivering superior long-term performance. Institutional investors are not exempt from such performance-chasing behavior, as studies of plan sponsors' selection and termination of managers have demonstrated.³

The irony is that the real money is made by shrewd investors who can overcome this addictive behavior, in order to zig when the herd is zagging. To do so, investors and their advisors need to apply a more fundamental approach to their selection process, which often leads to contrarian investment decisions. Contrarian investors are those who can avoid the adrenaline rush of "hot" asset classes and managers that are past their prime, and focus on "cooler" out-of-favor performers that deserve sober consideration, while selling past winners.

When it comes to *asset classes*, in my opinion investors should judge future performance based on fundamental analysis, rather than extrapolating recent performance into the future. Investors may want to question why asset classes that have run up significantly will sustain such strong performance, since this is not the norm (in fact, past performance tends to be negatively correlated with future relative performance, since over the longer term the returns of asset classes typically regress to their intrinsic value).

As for selecting *individual asset managers*, investors must fully understand the philosophies and processes of the managers they are hiring. The reality is that even the finest asset managers have peaks and valleys in their ability to deliver alpha. This does not demonstrate any flaw. It is simply the nature of alpha cycles, since every skilled manager tends to have a certain type of "edge" that enables him to outperform. This "edge" doesn't work in all investment environments (e.g., think of value managers underperforming during the internet bubble years). Investors need to make peace with the reality that good managers' periods of underperformance over the course of a market cycle do not detract from their ability to add value in the long run. Greater emphasis should be placed on identifying asset managers that demonstrate the behaviours and characteristics typically associated with superior long-term performance. To this end, advisors should spend more time evaluating the integrity of an asset manager's leadership, process, culture and governance structures and less time surveying rankings and performance tables.

In turn, it is my belief that advisors and asset managers need to do a better job of fully explaining to investors what they are buying, and the periods during which such strategies are likely to underperform. Imagine a world in which every advisor and asset manager had to discuss three categories of investments with their clients: (1) out-of-favor strategies worthy of consideration; (2) high-performing strategies that continue to have legs; and (3) "hot" performers that have had their run, from which investors should scale back their investments. It certainly would lead to rather different discussions than what typically occurs today.

Performance addiction has deep roots and will not be cured overnight. The addiction to "buying high and selling low" is due to a combination of basic human instincts: short-termism, greed and the desire to be part of the herd. Make no mistake, we are all culpable: the asset management salesperson who promotes the "hot dot" product just as much as the advisor who focuses his selection process on top-ranked products and the performance-chasing investors. Bad habits are hard to break, but as they say in the addiction community, the first step is to acknowledge that we have a problem.

² 2010 *Investment Company Fact Book*, 50th edition, chapter 6, Investment Company Institute (ICI), January 2010.

³ Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *Journal of Finance*, vol 63, issue 4, pp 1805-1847.



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