

Defeat—at Your Own Hands

Don't trip yourself up by using appealing, "comfy" data to make decisions.

If you come to a fork in the road, take it." Laugh at Yogi Berra's (intentional) malapropism. But the intended observation—if a new path opens up to you, follow it—is true enough. Alas, in the investment business, I think we do the opposite. It has been my experience that we tend to grab an idea and hang on to it even when intuition and/or evidence suggest we move on. It's not always easy to see a new trend emerge, but it is an important skill to develop.

Why do we ignore business-changing facts to hold on to old truths? The study of behavioral finance offers us a number of explanations for when and why we do this. There is evidence that we process future and current circumstances very differently. ("Quasi-hyperbolic discounting" is the technical lingo.) What this means in real life is that retirement-plan participants do self-defeating things, such as considering increasing contribution amounts "someday," and then failing to follow through. While they "get" the importance of saving for the future, the current value of each dollar feels more important.

People also seem to add more weight to data that is more familiar to them, which can lead them to make bad decisions. Consider the basic formula for identifying good choices. The wisdom of a decision equals the odds of gain times the value of gain. If at any point we misidentify either variable (odds or value), we can make a faulty decision. For example, a study done by Harvard's Daniel Gilbert showed that most people thought tornados were the No. 2 cause of death in America. Turns out, it's asthma (see table on p. 86). True, this example is unrelated to investments, but it brings home the problem: We see many more headlines about the power

and destruction of tornados compared to the problem of asthma, and, well, we conclude that tornadoes are more lethal than asthma.

Honest Inquiry

So what does this have to do with mutual funds? Given the challenge of building successful portfolios and achieving superior returns for clients—something I hear about every day—we need to be sure we are looking at accurate and useful data, and that if we need to, we go ahead

People cited tornados as the No. 2 cause of death in America. Turns out, it's **asthma**.

Perception v. Reality

People estimate that certain events are more dangerous than they really are, simply because they see and hear about them more frequently. Estimates and actual numbers are for cause of death per 200 million U.S. residents, per year.

Cause	Estimate
Drowning	1684
Tornado	564
Asthma	506
Fireworks	160
Cause	Actual
Drowning	7380
Asthma	1886
Tornado	90
Fireworks	6

Source: Daniel Gilbert, Harvard University



“Quasi-hyperbolic discounting” is the technical lingo. What this means in real life is that retirement-plan participants do **self-defeating** things, such as considering increasing contribution amounts “someday,” and then failing to follow through.

and tip over sacred cows to find new ones.

Applied to mutual funds, this means truly understanding how the portfolio manager (and/or team) actually decides when to buy or sell which securities. I don’t mean reading the statement that

everyone publishes about their buy-and-sell criteria, stocks meeting targets or falling by a certain percentage over a certain time period. I mean, what really happens in the investment committee meetings? Whose opinion holds the most weight? If people disagree, who makes the final call? Based on what? Does the portfolio manager make the final decision for her or his own funds, or is there a group leader who jumps in? Are the backgrounds and perspectives of all of the portfolio managers/analyst teams the same? Does anyone in the group have the ability to offer a counter perspective? Can that “different” viewpoint get traction for discussion and evaluation? These are the kinds of questions that are rarely—if ever—asked, but they should be. You can certainly see that the decision-making process can have a real impact on investment returns, but this is not something we typically hold out for scrutiny. It’s worth a closer look as you choose products for the long-term.

Pricing is another item that is rarely discussed openly, but is something that financial advisors use in screening funds. This sensitive issue is putting some hard choices on the table for fund shops. Fund complexes value the role of financial advisors as distributors of their offerings. Some small fund shops, however, have to acknowledge that they don’t have the infrastructure they really need to effectively distribute through this channel. If they want to leave the door open for advisors to use the fund, they need

to have a multi-share-class pricing structure. But this same structure precludes them from also going to do-it-yourself retail investors who don’t want to pay a load. (Do-it-yourselfers are generally not the most desirable clients for skilled investment advisors.)

Many advisors simply will not look at using funds that sell direct to investors. At one point, that may have been a good decision. Today, more than 80 percent of funds purchased outside of retirement plans are sold through advisors, according to the Investment Company Institute, the fund industry trade group; yet, sales of A shares are down to about 15 percent of broker/dealer sales, according to fund researcher Strategic Insight. Why? Because retail investors want advice. And enlightened advisors now see that it no longer makes sense to miss out on a good product because it doesn’t pay a load. Besides, advisor compensation is not actually driven by loads these days. There is pressure on fund managers to offer only load shares, since no fund manager wants clients to waste advisors’ time and then buy direct, of course. But they do want to be able to market to multiple channels that buy differently without being penalized.

Bottom line: It’s time to take a close look at the signposts we usually use and ask if they are serving our best interests. Are our mental shortcuts helping us select products and strategies that build wealth for our clients and grow our businesses? We’ve talked about a couple of ways to dig deeper into portfolios by looking at investment histories and decision-making processes, and we’ve suggested taking a closer look at good funds that use multiple distribution channels. It’s hardly an exhaustive list, but it’s a good start. Like Yogi said, “It ain’t the heat, it’s the humility.” ●

Lisa Cohen is CEO of Momentum Partners. www.momentumpartnersonline.com.