Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Timing badly: generating poor returns in good strategies

Iain Middlemiss

In the 1987 film Wall Street, Gordon Gekko is challenged by his prodigy, Bud Fox, on how much money is enough. Gekko responds that it's not a question of enough - it's a zero sum game. Money itself isn't lost or made, it's simply transferred. Somebody wins, somebody loses.

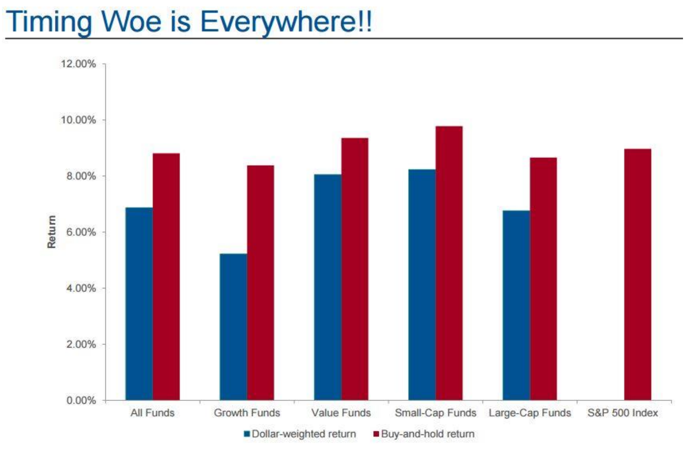
Significant new research soon to be published in the *Journal of Portfolio Management** reveals a win lose dynamic in mutual fund investing (what we call 'managed funds' in Australia). The key finding is the average United States mutual fund retail investor underperforms the fund they invest in by about 2% a year. While the fund's investment strategy may be sound and generating outperformance against a benchmark, investors' poor timing of when they buy in and sell out effectively transfers elsewhere the value premium created by the fund.

In reaching this finding the researchers analysed over 1 million fund flow observations across 18,665 funds between 1991 and 2013. The dollar-weighted average of investors' returns within a fund was compared to the buy and hold return for the whole fund.

As the researchers explain:

> *"The average return from a buy and hold implementation ignores the fact that many investors trade on a regular basis and that the actual return received by the average investor might be very different from the buy-and-hold return. Dollar weighted returns account for this trading by augmenting the average with information about fund flows."*

The pattern of average investors' underperformance against overall fund performance was consistent across funds irrespective of varying investment styles – value, growth, large and small cap, as shown below:



Source: Jason Hsu, Brett Myers, Ryan Whitby "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," *Journal of Portfolio Management*, (forthcoming Winter 2016).

The less sophisticated are worst at timing

Investors mistiming the market are underperforming by an average 1.3% to 3.1%, with worse investor underperformance seen in growth compared to value funds, and in large cap compared to small cap funds. For example, fund investors seem to time poorly by investing in value funds when the 'value' factor is expensive, and redeeming from value funds when 'value' offers opportunities. Poor timing is not confined to value funds, and confirms other studies which show investors attempt to time their allocations to funds.

The research reveals what is happening, but it isn't possible to definitively conclude from the data why investors time poorly, and nor was this a stated purpose of the research. What is especially interesting is that it examines the actual investment outcome for mutual fund investors, not the performance of mutual fund managers.

The data leads to an hypothesis that investors who time poorly are less financially sophisticated. This is deduced from more detailed multivariate analysis revealing the worst average returns were seen by investors who hold funds with higher expense ratios, and who invest in readily available retail-oriented mutual funds. Investors in these funds were observed as more likely to time poorly, buying after and selling before periods of strong performance.

Their poor timing may be unintended – for example investors may withdraw to meet unexpected financial needs. It may be related to low financial literacy. They don't understand their investment timeframe isn't suited to the fund's recommended timeframe. Or it may be from overestimating their investing prowess. They are consciously trying to time outperformance or chasing previous hot performance by the fund. Whatever the reason, they have timed poorly and are Gekko's losers. In fact, the authors subtitle their paper, "A Guide to Generating Poor Returns While Investing in Successful Strategies."

Value premium is transferred to the winners

So who are the winners on the other side of the trade? The research is based on United States data where mutual funds account for nearly 20% of the equity market. The authors suggest institutional investors are most likely to be capturing the return premium from retail fund investors: smarter traders adhering to more considered strategies. By giving away the excess return, retail investors in value funds might themselves be financing the value premium often seen in fund performance, and ensuring its continuance.

What might be done about it? After all, retail mutual fund Product Disclosure Statements are filled with recommended investment timeframes, likelihoods of negative returns over given time periods, explanations of different investment risks, statements that past performance is no indication of future performance and the importance of time in the market as distinct from timing. What is missing that will grab investors' attention and help them avoid poor timing?

Investors may reconsider their own behaviour if presented with the hard real dollar impacts of poor timing experienced by others. Perhaps fund providers could undertake similar analysis on observations within their own funds and present key findings to investors and financial advisers (assuming of course empirically the same pattern holds). It points to a need for greater financial education to protect investors from themselves.

Without behaviour change poor timing will continue and many investors will miss the returns their mutual funds generate. They lose and somebody else wins.

*Jason Hsu, Brett Myers, Ryan Whitby, "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies", *Journal of Portfolio Management* (forthcoming Winter 2016).

Iain Middlemiss was Executive Manager Strategy at Colonial First State and Head of Strategy at Superpartners. This article is for general educational purposes only.

Competing for alpha

David Bell

In finance, the excess return of a fund relative to a benchmark is called the alpha, and never has the competition for alpha been so intense. And it is just that: a competition. Ultimately, total alpha across the marketplace must equal zero on a gross (of all fees) basis. Investment banks are not charities and so net alpha is more negative on an after-transaction costs basis. There aren't that many not-for-profit fund managers either, and their fees take another slice off aggregate alpha. While some negative alpha may be experienced by arguably less informed investors (commonly industry puts retail investors in this category, but perhaps this is not always the case), it is naïve to assume that the investment management industry has a licence to produce positive alpha.

Stricter judgement of 'real alpha'

Historically in a world of passive funds and active funds, alpha was simply defined as the performance of an active fund against its market benchmark. Now we have around 25 years of academic literature behind us exploring how simple style factors such as value, size and momentum can explain stock portfolio returns (see Fama and French (1992) and Carhart (1997) for early seminal examples – www.scholar.google.com makes this easy).

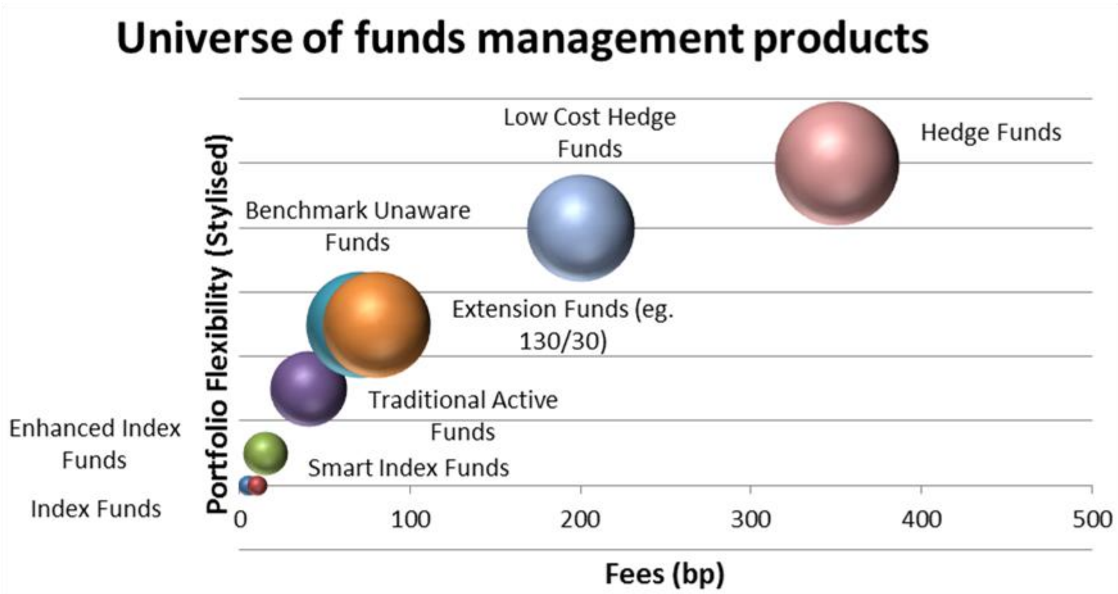
Many of these factors are now being used to manufacture low cost product under various names such as smart beta and smart indexing. Consultants the world over, super funds and any quality institutional investor assess the performance of funds against a range of these benchmarks. In some cases this type of analysis (often simply regression-based) explains some of what may have been labelled as 'alpha'.

Fierce competition for alpha

Where historically the universe of investment management products consisted of passive and active funds, today we have a broader spread of product. The competitors for alpha charge different levels of fees, have varying degrees of flexibility and take different amounts of active risk. This is all presented stylistically in the diagram below (with the size of the bubble being a proxy for the level of active risk).

The flexibility in some of these structures (for instance hedge funds are not benchmarked and can use a wide range of techniques such as leverage, short selling and derivatives) potentially provides an advantage. On the other hand a simple active traditional fund may keep life simple from a risk perspective and allow the manager to focus on idea generation.

And if the range of competitors was not enough, the degree of observation and analysis of a fund's activities is greater than ever. We have asset consultants and other research groups as well as institutional investors all analysing how managers generate their returns. Nor are investment banks shy about trying to identify trading opportunities. It



is easy to understand how proprietary trade ideas and process components get leaked across the market – many groups who analyse funds can be inadvertent disseminators of information. Consider the following innocent conversation:

Asset consultant to Fund Manager 1: *What is your competitive edge?*

Fund Manager 1: *Well, we search hard for this particular characteristic (insert name) in the stocks that we purchase and it has worked well for us.*

Asset consultant to Fund Manager 2: *Do you search for this particular characteristic (insert name) when you are screening for stock ideas?*

Fund Manager 2: *No … but, um, it is in our research pipeline (…* as he makes a note to himself*).*

I recall a US-based hedge fund we were invested with years ago who found a clause in some bond documentation that the market had overlooked. They placed some trades but in doing so the secret got out and they only made a marginal return for their efforts.

And don't forget the academics: they play their part in identifying what they call 'market anomalies'. They have their own competitive challenge: to produce research that extends the literature and is sufficiently insightful to get it published in top journals. This research is then available to the broader public, including fund managers. A paper by Bill Schwert from the University of Rochester, titled Anomalies and Market Efficiency (2002), identified that the returns from many market anomalies identified in academic literature deteriorated or even disappeared once the academic literature was published. This is reasonable: if the research is significant then it is being read by fund managers and investment banks and being incorporated into investment products. Indeed it is common, particularly in the US, to see many leading finance academics also working in industry.

Preserving the alpha edge

If a fund manager believes it has a true investment edge over the market then how can this be preserved and protected? Not easy but here are some considerations to look for:

- The competitive edge should be clearly defined. What is the foundation of the fund manager, what does it believe in? If that foundation feels like a general statement rather than something that is specific and well considered, then I would have doubts from the start.

- Continual self-assessment of the edge and performance. Has the market structure changed? Are there more managers thinking about the same thing? Does performance support their beliefs about alpha, accounting for the market environment? It is surprising how many fund managers do not assess their performance against a relative style index (e.g. a value manager should compare its performance against a value index).

- Ongoing process enhancement. A good example here is making the most of technological developments. It is impressive to see how many discretionary (where the analysis and decision is made by a person and not a computer) fund managers now use computer screening to help filter their universe down. They remain a discretionary fund but they are making good use of technology to keep them efficient.

- Diligence in managing fund capacity. Every strategy has a capacity limit before the alpha profile starts to decay. What I find interesting, and potentially flawed, is that many managers consider the capacity of their own fund without considering the capacity of their strategy as a whole, ignoring the size of other managers with similar strategies.

- Hard work and developing the right people are obviously key to success for any business.

For investors looking to construct portfolios of actively managed funds, the assumption of positive alpha across the portfolio is possibly a naïve one. And yet there is this magnetic attraction to invest actively – an extra layer of return compounds nicely through time. My advice is to make use of all the information available (including smart index data and research), invest across the entire universe of funds management products rather than just along product silos, and always invest pragmatically with the low cost solution being your default position.

David Bell is Chief Investment Officer at AUSCOAL Super. He teaches the Hedge Funds elective for Macquarie University's Master of Applied Finance and is studying towards a PhD at University of NSW.

Why are reverse mortgages unpopular?

Graham Hand

For the asset-rich, cash-poor retirees who were too late into the superannuation system to build a decent balance, reverse mortgages seem the ideal product. Banks will lend between 15% and 35% (rising with age) of the value of residential property as a lump sum or income stream, and it may give a standard of living the age pension struggles to deliver. There's no need to make loan repayments as the bank recovers the debt from the estate.

When Nobel laureate Robert Merton visited Australia in late 2014 to talk about retirement incomes, he argued the family home is no longer the treasure that must be passed on to future generations. "In retirement, it's a financial asset," he said as he pushed the potential of reverse mortgages in retirement plans.

So why have loan volumes been falling, with less than 40,000 reverse mortgages in Australia? The total market is only $3.6 billion, the average loan size is about $85,000 and the average age of the borrowers is 75.

My friend Susan (not her real name) was the perfect candidate and recently took out a reverse mortgage. Her house was almost paid off, but over her working life, she had not accumulated much additional savings. The single age pension per fortnight is $860. With a car and house to run, $60 a day does not go far. In retirement, she struggled to live the lifestyle she wanted, while her house was rapidly increasing in value. "I realised the only way I could get out of my financial problems without selling my home was a reverse mortgage."

After reading as much as possible online, Susan went to see a financial adviser, who had never arranged a reverse mortgage. The broker he referred her to also had no experience. Eventually, she found a broker who negotiated a loan with BankWest. Many banks do not even provide the product, ANZ and Bank of Queensland the latest to drop it.

When Susan first went to draw some income, the branch staff told her she needed to withdraw the lump sum. This was unacceptable because having the residual cash in her bank account would affect her age pension entitlement. She had to convince them she only wanted money as she spent it.

What are other reasons for the product's stigma, when the providers don't educate their staff and the public perception is not favourable?

- The interest rate is about 1.5% higher than the normal home loan rate, currently about 6.5%, meaning the debt doubles in about 11 years. This is why the maximum loan is set at only 15% of the property value for someone aged 55 – they may live another 40 years!
- Lenders are concerned about behavioural issues such as cognitive decline, especially given the ages of many of the borrowers.
- Heirs to the estate see their asset being whittled away by interest and fees, and lenders worry about their rights being challenged.
- Over 90% of loans are variable rate, exposing the borrower to rising rates. Fixed rates would need to include break costs.
- With compounding, the debt will rise quicker than borrowers expect.

The Australian Securities & Investments Commission (ASIC) provides a reverse mortgage calculator on its MoneySmart consumer website. All lenders must use it to show prospective borrowers a range of outcomes.

ASIC even requires the lender to enquire about the consumer's requirements and objectives, including the future need for aged care accommodation and consequences for reductions in the estate value. Susan does not recall this happening.

There are official guidelines on loan to valuation (LVR) ratios, stating that if a borrower is 60, an LVR over 20% is unsuitable unless the contrary is proved. Under rules legislated in 2013, the lender must also give a 'no negative equity' guarantee.

What is the money being used for? The top five uses are home improvements, debt repayments, regular income, travel and buying a car.

While every borrower needs to understand the risks, reverse mortgages may be an alternative to struggling through retirement after a lifetime of work and sacrifice.

Graham Hand is Editor of Cuffelinks. This article is for general educational purposes and anyone considering acting on the information should first consult a professional adviser.

Three rules to invest by

Martyn Wild

There are three investment rules by which to live in the current volatile environment – the same three rules we think by which investors should *always* live.

Very simply, they are:

1. Diversify sensibly but not gratuitously
2. Be opportunistic only at the margin
3. Stick to the plan and give your strategy the time it needs to work (this infers the actual existence of a plan. Surprisingly, not everyone has one!).

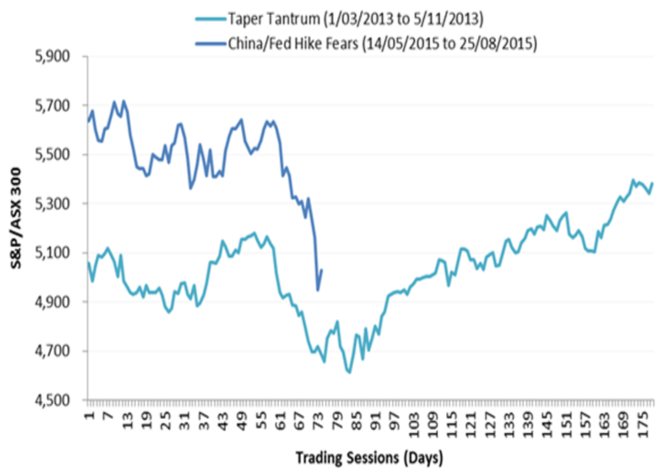
Most people do not want markets to fall. However, declines can be a useful experience for investors because they provide a real-world test of your investment strategy, your expectations and fortitude. When people invest in equities, for example, they often expect them to go up 10% a year or some similar figure. However, what is often conveniently forgotten is that even if they do that *on average*, they rarely do it year in and year out. What falling markets provide is the valuable experience all investors need to have when investing; particularly in 'growth' assets.

This is why you need to stick to the plan. Typically 90% of a standard 70/30* balanced fund's total returns come from one asset class: equities. As you become more defensive, your 'factor risk concentration' (or sensitivity to one or few assets) diminishes. This is why conservative funds are less volatile than growth funds, but it is also why their expected return is lower. Swings and roundabouts. The amount of diversification you employ should be consistent with your tolerance for risk and appetite for return. 'Over-diversifying' may save you in the short run, but will cost you when you retire.

In volatile times such as these, there is a natural, human temptation to just *do* something. Our view is that if your investment strategy was correctly matched to your risk tolerance to begin with then market gyrations (down *and* up) should just be part of your long-term investment journey. So does that mean that we don't advocate short term adjustments to the strategic asset allocation? Not quite. If you believe you (or your investment manager) have skill in short-term investing, by all means give it a go … but only at the margin, i.e. in small size.

Our tactical asset allocation process has been proven to add returns for minimal risk over 3+ years at a time but its risk budget is small. It relies on being right on average on many *small* investments held over the *long term*, rather than taking a few *large* bets over *short* periods – as is often the temptation. Savvy investors can still take advantage of opportunities when they arise, but they should still rely on the main game plan to deliver the vast majority of their investment outcomes.

It may be instructive to consider the effects of prior sharp selloffs. Driven by specific events, fear can feed on fear to produce an oversold situation. For example, the so-called 'taper tantrum' of 2013 took the Australian market from above 5,100 to 4,600. As it turns out, it was the start of a significant market rally. But who's willing to take a punt on this market correction?



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Use the past and the present to clarify your future expectations by all means, but stick to your plan. Let's say you have decided to take 5% of your portfolio to chase tactical opportunities. Plan ahead so that you know what your reaction will be should it go against you. Therefore, before making the tactical trade, ask yourself the question: "What loss can I take before I have to pull up stumps?" and write it down. As required, reconstruct your portfolio on the basis of your findings.

*70/30 refers to a multi-asset balanced fund with 70% growth assets and 30% defensive assets. Defensive assets are generally fixed interest securities and cash. Growth assets are everything else.

Martyn Wild is Head of Diversified Strategies at BT Investment Management. This article is for general education and does not consider the circumstances of any person. Investors should take professional advice before acting on any information.

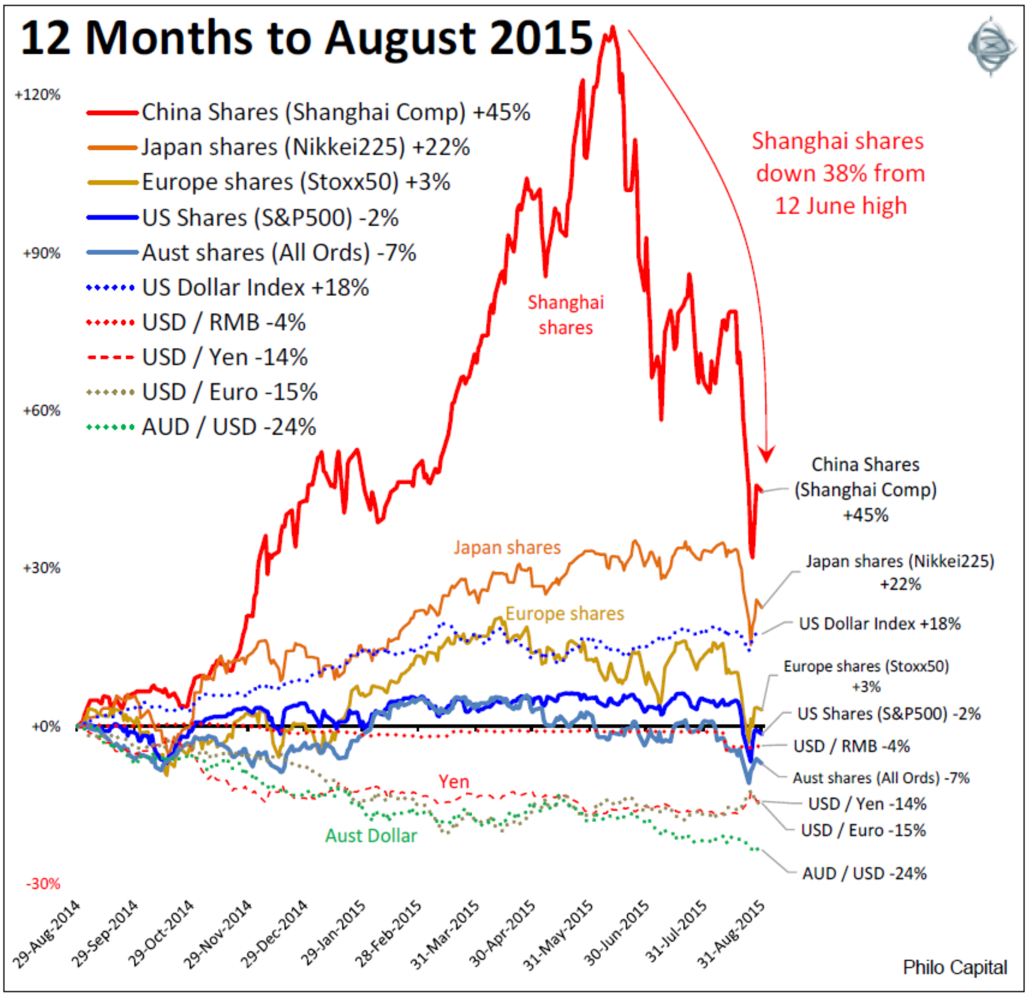
Chinese shares and currency red herrings

Ashley Owen

The main headline stories over the past month have been the sudden crash of the Chinese stock market bubble, the devaluation of the Chinese currency, and how they sparked a sell-off in global shares.

The bursting of the Chinese stock market bubble should not have been a surprise, as [we wrote about it in May](). The market is little more than a casino driven mainly by first time gamblers using borrowed money, and share prices have little to do with company fundamentals or the underlying economy.

The Chinese market fell by 26% midmonth but recovered partially to end down 12% for the month. To date the Chinese crash has wiped out just six months of gains, so the only people who lost money were those who panic bought in the frenzy earlier this year (many first-timers and many using borrowed money), and then panic sold in the crash.



Investors who had bought shares prior to March this year are still ahead. At the end of August the Shanghai Composite closed down 38% from its 12th June high. Fearing the crash would have wider implications for the Chinese economy the central bank cut interest rates and reduced bank reserve ratio requirements, increasing the amount banks can lend. It also suspended most listed shares from trading so shareholders were unable to sell shares. The main risk in emerging markets is the likely impact of a rising US dollar and US interest rates on US dollar borrowers.

Turning to recent currency moves, the real story of the past year has been the rise of the US dollar as the Fed prepares to raise interest rates with the improving US economy while other major markets are slowing, cutting rates and printing money. The Chinese have been remarkably patient watching the RMB being dragged upward by the US dollar peg. Over the past 12 months the RMB has fallen a tiny 4% against the US dollar, including the 3% "shock" devaluation on 11-12 August 2015. In contrast the Euro has fallen by 15% and the Yen has fallen by 14% over the same period.

Japanese and European company earnings and share prices have benefited from the falling Yen and Euro but US shares have struggled against the rising dollar and fears of higher US interest rates. Australian shares have also been flat, held back by the collapses in commodities prices and also by the big banks' scramble to raise capital to reduce their leverage.

What else is happening in China?

The Chinese economy is probably growing at a rate much lower than the official 7%. Growth has been propped up since 2009 by debt-funded state-directed infrastructure spending. As the economy is slowing even further this year, the latest plan is to grow Beijing into a mega city of 300 million people that spills over into neighbouring Tianjin, Hebei and Shandong provinces. It has already started relocating government departments. The official unemployment rate is being kept low at around 4% by mega projects like these and also by keeping factories over-producing and then exporting the surpluses to the rest of the world, which has kept global inflation low.

Aside from the stock market fall the main market event in August was the sudden 3% devaluation of the RMB against the US dollar to help exporters. However by month end the central bank was having to intervene to prevent further declines, amid accusations from the US that China was enflaming a currency war.

Military tension also rose between China and Japan in the lead-up to the 70th anniversary of the end of World War 2. Nationalist pride directed against China is Japan PM Shinzo Abe's 'fourth arrow' in his national revival plan. Also North Korea stepped up its war preparations against South Korea after a heated artillery exchange.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general educational only, not personal financial advice.

Superannuation engagement better than expected

Susan Thorp

In mandatory retirement savings systems like Australia's Superannuation Guarantee, default options are critical. A 'default' is where the investment is chosen on behalf of the investor, such as by their employer. In other words, the investor accepts the default option. International research and experience show that 'passive' regulatory settings like defaults are far more important than those relying on active decisions like tax concessions. Super fund members face two key defaults: the fund itself and then the investment strategy.

The recent introduction of MySuper gave the superannuation sector a reason to review and renew default settings. And with the support of the Centre for International Finance and Regulation, the research paper, *Delegation, trust and defaulting in retirement savings: Perspectives from plan executives and members*, was commissioned to find out how well the refurbished MySuper defaults fit the people they are designed for. We interviewed superannuation fund executives and collected their impressions of member needs and characteristics, and the goals of MySuper defaults. Then we surveyed over 1000 members on their default behaviour, reasons for defaulting or opting out, and their superannuation goals.

More active choices than expected

More members described themselves as active choosers than we expected. The diagram below shows the proportion of members who stayed with the default fund and default investment option. Only 36% of our sample defaulted at both stages, meaning that 64% made at least one active choice. Also, around one-quarter of members in the default fund and 9% of investment defaulters chose the default options deliberately. So the proportion of completely passive defaulters in our sample is probably below one-third. Clearly, not all defaulters are completely disengaged or uninformed, and conversely non-default choices are not a simple proxy for member interest and engagement.

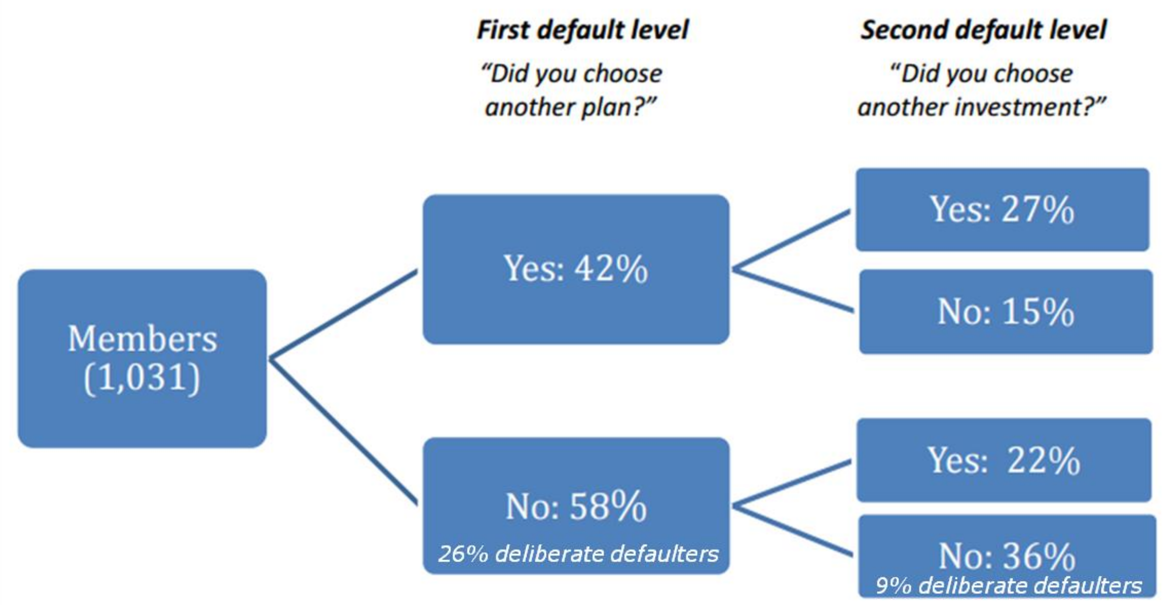
Defaulters are more likely to be younger, female and have lower incomes than non-defaulters. As account balances rise and retirement approaches, the costs of a non-optimal default become larger and are likely to prompt more members to make another choice. Interestingly the financial literacy of defaulters was only a little lower than that of choosers and the difference was not statistically significant.

Interest, trust and defaulting

We also asked members about their reasons for defaulting versus choosing. Most people said they do not want to relinquish control over their retirement savings, but they found the products suitable, and viewed the fund as trustworthy and accountable. Respondents in the default investment option emphasised more than others their own low skill and knowledge. Respondents in the default fund expressed more trust and belief that the system is well monitored. Time costs of active decision-making were rated high more often than money costs. These results are at odds with some industry commentary that characterises default members as *uninterested* in superannuation.

A lack of interest was not the main reason for delegating investment to the fund according to the survey (although it did have some impact), and neither is relinquishing control. However, interviews with fund executives suggested that trust is sometimes mistaken for disengagement. Trust,

Figure 1: How many people default? At what point?



Notes: This figure shows proportions of total sample (n=1,031) who defaulted or chose at two decision nodes. The first choice is whether to go with the provider (superannuation fund) chosen by the employer, or choose another plan for themselves. The second is whether to go with the default investment option of the provider, or choose another investment(s). Respondents who chose "don't know" at either node are counted as defaulters. Respondents who deliberately defaulted (i.e. actively chose the default) are also counted here as defaulters.

when combined with a self-conscious lack of financial skill, underlies both a low level of active choice and a low level of direct interaction with the fund.

Goals for superannuation

In terms of goals, members emphasised achieving a basic amount of wealth for retirement. This lines up with comments from interviews where executives framed default design in terms of retirement outcomes rather than short-term performance. However there is little agreement in the sector about what are the best strategies to reach this goal.

Members thought low fees were an important, but not the most important, aspect of a fund's goals. This also seems broadly consistent with executives, who acknowledge that fees matter but view them as constraints rather than objectives.

A noticeable area of difference between executives and surveyed members relates to risk tolerance. The clear skew towards low risk tolerance among default members stands in contrast with relative aggressive investment strategies, where growth asset exposure averages over 70%. While life cycle funds are designed to de-risk near retirement, many executives express the view that default members need strategies with high growth asset exposure in order to generate higher balances and retirement incomes.

Regulators and industry might improve member outcomes by developing smart defaults that allow for a variety of risk preferences and demographics. The study emphasises the dangers of misconstruing super fund members as uninterested: instead, many see themselves as low in skill but high in trust.

Susan Thorp of the University of Sydney co-authored the research paper with Adam Butt of the Australian National University, Scott Donald of UNSW, Doug Foster of the University of Sydney, and Geoff Warren of the Centre for International Finance and Regulation.