McLEAN ASSET MANAGEMENT CORPORATION

Occam's Razor

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WHAT IS OCCAM'S RAZOR?

Occam's Razor is a principle attributed to William Occam, a 14th century philosopher. He stressed that explanations must not be multiplied beyond what is necessary. Thus, Occam's Razor is a term used to "shave off" or dismiss superfluous explanations for a given event. This concept is largely ignored within the investment management landscape. This newsletter will "shave off " popular investment misinformation and present what is important for achieving long-term investment success.

THE (NOT) SURE THING

We all know there is no such thing as a sure thing when it comes to economic, business and market performance. However, can we rule out what does not work?

The evidence is mounting as to what drives poor investment performance. Every day investors entrust their life savings to active managers of various stripes. They use brokers to pick stocks and bonds and time the market or invest directly with fund families that selectively feature returns of some of their funds that have "beaten the markets" in the recent past. The message is clear: "We did so for the last five years and we can repeat this stellar performance in the future." Don't fall for it.

Do Winners Keep Winning?

The competitive landscape makes the search for future winners a formidable challenge. Confronted with so many fund choices—and lacking an investment philosophy to inform their search—some investors may resort to using track records as a guide to selecting funds, reasoning that a manager's past outperformance is likely to continue in the future. Does this assumption pay off? The research offers strong evidence to the contrary. The following charts illustrate the lack of persistence in outperformance (Equity funds on page 1 and Fixed Income Funds on page 2). Three, five, and seven-year mutual fund track records are evaluated through the end of 2010, and funds that beat their respective benchmarks are re-evaluated in the subsequent three-year period ending December 2013. Less than a third of the beginning funds outperformed in the initial periods—and subsequent performance was not much better. Track records for fixed income funds paint a similar picture.

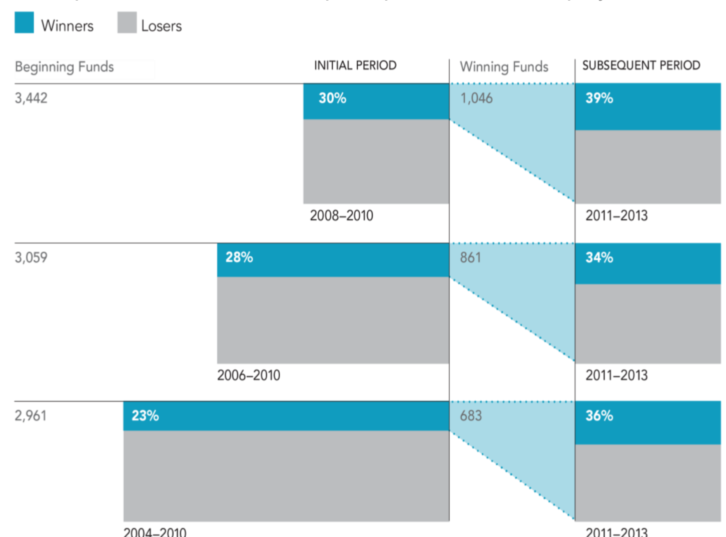
The results for both winning equity and fixed income funds show that past outperformance is no guarantee of future outperformance. Many equity and bond funds, even those with good track records, are actually more likely to *underperform* their benchmarks. This lack of persistence among winners suggests that gaining a consistent informational advantage is extremely difficult. Many smart professionals are striving to gather morsels of information to help them identify pricing mistakes. But this competition means that public information is quickly reflected in market prices, leaving few opportunities to exploit the knowledge for profit.

As important is the role of luck. Some managers are simply lucky for a period of time, but the luck will not persist. In a 2009 study, Eugene Fama, recent Nobel Prize winner in economics, confirmed that luck is almost always the driver of mutual fund outperformance of benchmarks. The assumption that past outperformance will continue clearly is mistaken, and if followed, will lead to many disappointed investors.

A "Phony" Debate?

In a study financial writer Daniel Solin completed in 2012, he began a search for an easy litmus test to be used to determine whether a financial institution really has the investment expertise needed to "beat the markets." He noted that many brokers sell proprietary mutual funds, which are funds sponsored by their firm. They typically have the name of the sponsoring institution in the name of the fund. Some examples of proprietary funds are: JPMorgan Mid Cap Core A (JMRAX), Goldman Sachs Korea Equity A (GWIAX), and Morgan Stanley European Equity B (EUGBX).

Solin thought that before a major brokerage firm would attach its name to a fund sold through its vast distribution network, it would want to be sure the managers of those funds were best of class.



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He expected the vast majority of them would be able to beat their analyst-assigned benchmark every year, and certainly over the long term. Otherwise, how could they possibly respond to clients to whom they sold these funds when those clients complain they would have achieved better returns by simply investing in the benchmark index?

Solin selected JP Morgan, Goldman Sachs, and Morgan Stanley for this analysis because they are three of the largest and best-known U.S. investment banks, according to Morningstar Direct. He looked at all of their proprietary funds with data for one-year, three-year, five-year, ten-year, and fifteen-year periods ending July 31, 2012. He found that roughly two-thirds to more than three-quarters of these proprietary funds did not achieve the returns of their benchmark index.

Solin concluded that if this is the best the largest U.S. investment banks can do with the funds that bear their name, why are you giving any credence to anything they may tell you about their "investment expertise"? Investing responsibly means paying less attention to the hype and more to the hard data.

A "Sure Thing"?

And there is much more to support the opening contention that active management does not work. This does not mean by any stretch that passive indexes will produce positive results in all periods; of course they won't. It also does not mean that passive indexes will always outperform active managers in all periods. They won't. But the preponderance of evidence indicates that market indexes outperform active managers the majority of the time. Analysis of U.S. mutual fund performance illustrates the obstacles confronting investors seeking outperforming funds. For the periods examined, the research shows that:

- Strong track records failed to persist
- Outperforming funds were in the minority

And we did not address the issue of how high costs and excessive turnover may have contributed to underperformance. That is an additional factor and topic for a future article.

These results are consistent with a market equilibrium view of investing. Intense market competition drives securities prices to fair value, making it difficult to persistently add value by identifying mispriced securities. Despite the best efforts of many professionals working in the industry, the vast majority of funds fail to outperform their benchmarks. Although the odds are stacked against them, many investors continue searching for winning mutual funds and look to past performance as the main criterion for evaluating a manager's future potential. In their pursuit of

returns, many investors surrender performance to high fees, high turnover, and other costs of owning the mutual funds.

The underperformance of most U.S. mutual funds highlights an important investment principle: The capital markets do a good job of pricing securities, which makes beating benchmarks (and other investors) quite difficult. Moreover, when fund managers charge high fees and trade frequently, they must overcome high cost barriers as they try to outperform the market.

Is choosing a mutual fund based on its past performance a "sure thing"? By no means. In fact, about the only "sure thing" associated with choosing such a fund is that those doing so will be statistically *less likely* to outperform going forward, statistically *more likely* to have paid higher costs, and thus *more likely* to be disappointed. We believe investors and advisors would be far better served if they redirected their time and resources away from ineffective active fund research and toward pursuits with a known return: tax planning, estate planning, allocation selection, rebalancing, and other proven wealth management strategies. These activities have a far more determinable positive impact than being pulled in by the siren song of the active manager, or that of the largest U.S. investment banks who try to direct you to their active managers, and your hard earned money, to their pockets.

So you know what not to do, however, this naturally leads to the question of what should I do? Our recommendation is that you develop a portfolio that adheres to an investment philosophy that is evidence based and has been proven successful over time, not just five years. Expect more on how to do this in the next Occam's.

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US-domiciled mutual fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago.

Certain types of equity and fixed income funds were excluded from the performance study. For equities, sector funds and funds with a narrow investment focus, such as real estate and gold, were excluded. Money market funds, municipal bond funds, and asset-backed security funds were excluded from fixed income.

Funds are identified using Lipper fund classification codes and are matched to their respective benchmarks at the beginning of the sample periods. Winner funds are those whose cumulative return over the period exceeded that of their respective benchmark. Loser funds are funds that did not survive the period or whose cumulative return did not exceed their respective benchmark.

Expense ratio ranges: The ranges of expense ratios for equity funds over the one-, five-, and 10-year periods are 0.02% to 4.93%, 0.01% to 4.74%, and 0.02% to 4.44%, respectively. For fixed income funds, ranges over the same periods are 0.02% to 3.27%, 0.01% to 2.53%, and 0.05% to 2.43%, respectively.

Portfolio turnover ranges: Ranges for equity fund turnover over the one-, five-, and 10-year periods are 1% to 1,315%, 1% to 3,452%, and 1% to 3,552%, respectively.

Benchmark data provided by Barclays, MSCI, and Russell. Barclays data provided by Barclays Bank PLC. MSCI data © MSCI 2014, all rights reserved. Russell data © Russell Investment Group 1995–2014, all rights reserved.

Benchmark indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

"The Phony Debate About Active and Index Funds", Daniel Solin, US News and World Report, August 30, 2012

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