CONVENTIONAL WISDOM MEANS NOTHING IF NOT EMBRACED

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We do not lack for taglines in the investment industry. We throw these conventional wisdoms around in presentations and conversations and it sounds quite impressive. But can we manage the evidence that we embrace them? Does it affect or moderate our behaviours?

We all agree that your investment return is a function of time and that you only gain time through patience.

“The two most powerful warriors are patience and time.” - Leo Tolstoy

If we consider the ASISA fund flows of real investors (real money) through economic cycles, then we need to acknowledge that we cannot claim that investors are either patient or allow their selected funds the time required to deliver the expected returns.

“Time is still the best critic, and patience the best teacher.” - Frédéric Chopin

Even with the benefit of hindsight we still struggle to embrace these wisdoms and tend to default to old narratives and conversations. The conversations with clients are still dominated by the state of the world economy and the relative recent performance of their portfolio. Fund flows clearly show that recent performance chasing is still alive and well. “Best returns” on a relative basis still trump “good returns” on an absolute basis (relative personal client stated goals). Recent performance and fund flows have a near perfect correlation.

The client’s reasonable expectation is the only benchmark we should focus on, and our job should never be to “beat” anything. We need to meet the client objectives in the most risk conscious way. Our job is to narrow the gap between the clients expected return and the realised return over a relevant period. Why is an industry that professes to meet “client specific goals” so obsessed with beating relative benchmarks… or even the goal itself?

A sound decision framework and a long-term focus results in better outcomes for clients. Markets move through cycles and are unpredictable in the short term. No single investment style benefits at every point in this long-term cycle.

The long-term cycle evolves in different stages: early vs. late cycle risk factors are not the same. Some risk factors or themes benefit more in the early stages and others in the late stage of the cycle. Certain market conditions suit a particular investment managers style better than others. Different styles are rewarded at different stages of the normal market cycle. That is why even the regulator compels us to disclose to clients that past performance is no indication of future expectations. History shows that the winners of today tells us nothing about tomorrow as different themes are rewarded in different stages of the cycle. You just cannot harvest future returns based on yesterday's performance. The same themes do not persist.

The client's true risk is not being able to fund a future need - not having enough when they need it. That's it! Nothing more, nothing less. Why would you risk this by focussing your conversations on how well you are shaping up against a market or peer group that has nothing to do with the client's own goal and need?

How many times does history have to humble us to accept the fact that what happened recently does not necessarily repeat? Staying focused and disciplined within a sound decision-making framework gives you the highest probability to meet future objectives. Focusing on short term performance and market movements is both unproductive and dangerous.

Unfortunately, the financial media floods us with sensational news. What motivates them? Well, their business model works on advertising what benefits from attracting more attention. How do you get more attention? Through sensation and fear. The separation between "news" and "noise" is not important. If they can get your attention, then business is good. They are not accountable for how you react to it.

Why does this matter? Because clients are deeply affected by it. We understand that. The human brain processes information differently when it experiences stress. Bad news triggers this process. We cannot change the human condition. Your conscious brain (pre-frontal cortex) is immediately highjacked by your emotional brain (Amygdala) when you experience stress. When the Amygdala becomes active your body is instantly flooded with a hormonal cocktail that includes adrenaline and cortisol which primes your body for action - fight or flee. This prepares you for action. History has shown that inaction is usually the best policy when it concerns investing. We react when we should be responding. It's ok to feel the stress. But understand that acting on it will cause financial harm.

Reacting is emotional whereas responding is emotional intelligence. A reaction is a reverse movement or tendency. Reactions are done on impulse, without putting much thought into it or considering what the end result may be. Response can be defined as saying something in reply. Response is more thoughtful and done with reasoning. People who respond put their thoughts ahead of their actions. Advisors most important value is to help clients to respond to their changing environment and not react. This requires them to be mindful in making informed decisions and fully understanding the consequences.

How do you help clients make better decisions? Well, for starters, by not pretending that we can divine the future and implement our "knowledge" timeously. In the short-term reacting to news flow and noise has proven to be costly. In the long run sticking to a disciplined plan and investment strategy has increased your probability of meeting clients' objectives. Better outcomes are the result of better decisions.

As a discretionary investment manager, we are focussed only on delivering the expected long-term returns that will make the advisors planning process work. Structuring and managing long-term portfolios to a specified risk/return target is all that we do.

It demands all our experience, attention and discipline to be able to do this. We enhance the integrity of the advisors planning process and free them up to have meaningful conversations with their clients (real people) without having to worry about the daily noise of the markets. Our whole process is in service of the advisor who sees their own unique value in “advice as a service”.

Real advisors guide clients in their financial life decisions and coach them to ensure that their behaviours do not sabotage their own plans over time. For real advisors this is an ongoing collaborative process with their clients to adapt their plans as life unfolds. We collaborate with these advisors to ensure that the investment management offering measures up to the same fiduciary mindset and standard that they extend in the advice process to their clients. We ensure institutional quality research, discipline, experience and mindfulness permeates all investment decisions for the benefit of the client.

The above article was written by Marius Kilian, Director of 2IP.

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