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May The (Investment) Force Be With You!

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Inside this issue:

There is a powerful force in the investment world that is frequently ignored but when used properly, achieves good returns with reasonable risk. The force is called patience.

There is an economic rule that states that people will defer consumption and invest their excess funds only if they believe the funds will eventually grow to meet future spending requirements. While this rule tells us **what** to do (invest), it does not tell us **when or how to do it**.

A key tenant of finance says that to induce people to defer spending, investors must be sufficiently compensated for accepting risk. It means, the higher the risk an investment has, the higher the returns need to be.

To achieve higher returns, investors hire people with advanced education and special training. For a fee, these professionals work diligently to earn good results while containing risk. This belief ushered in the era of active management.

Early on, giving money to a single firm made sense. The "Balanced Fund" platform was thus born and remained the dominant investment vehicle until the 1970s. Then, computer costs dropped dramatically and a new industry was born; performance consulting using manager data. The data revealed that balanced funds excelled in some areas but were weak in others. Balanced funds were less than optimal.

By the mid-1980s, the specialist manager era had begun. Most specialists used an active investing style and tried to achieve top-quartile ranking. Researchers again looked at empirical data and discovered two new facts. First, specialized active managers produced inconsistent performance. These pro's might be great in one period but not in the next. So, manager selection proved highly difficult.

The second more damning revelation was the majority of active managers weren't able to beat a passive benchmark over time (academics had predicted this in the 1960s). Soon, active specialist managers were being replaced by cheaper passive indexers. In 1989, the first Exchange Traded Fund (ETF) was created in Canada. It heralded the advent of low-cost funds and democratized investment access by individuals.

But a significant problem arose. The best-known indices were capitalization weighted (eg., S&P500). These uneven weighted indices could produce risk fluctuations. So researchers began creating alternatives which eventually led to creation of Smart-Beta indices.

So in just one generation, there has been a major revolution in the field of investments and a myriad of new products. The challenge today isn't about products, but rather, **how to use them**. When is active or passive management better? Finance theory offers us clues.

In markets that are deemed efficient, index strategies make sense. In inefficient markets, active management works if the extra returns can exceed the fees.

Nonetheless, there is one constant that impacts all investors. Human heuristics is our dark side. It hinders our abilities and is an **significant negative destructive force.**

One example, overconfidence, leads to impatience, which leads to errors and much lower returns. Too quote Pogo, "I have met the enemy and he is us".

Many assets have natural long-term expected returns. Equities near 10%, real estate close to 7% and bonds around 5%. Can you beat these figures? Many people think so, but in fact, cannot.

As Ben Kenobi once said, "may the force be with you". In my universe (investing), that force is a patient approach to investments. ◻

ASI — What we do:

Alternativ Solution Inc. (ASI) offers consulting services on capital markets to institutional clients. We deal in topics ranging from investment strategy, risk management, asset allocation, manager selection and manager assessment.

Our recent engagements include development of investment policy, searches for money managers, investment strategy (active vs. passive), and alternatives such as infrastructure, real estate and smart beta.

ASI also offers Trustees and Board members with financial education or training.

Mr. Klar is a faculty member in the Finance area at the Schulich School of Business and is a senior advisor to York University's $2.1 billion pension plan.

....Cheers, GMK