Fiduciary Focus: The Catch-22 of Investment Return

W. Scott Simon | 08-04-04 |

In his war novel *Catch-22*, author Joseph Heller, who served as a bombardier in the U.S. Twelfth Air Force on Corsica from 1942 to 1945, explains:

> "There was only one catch and that was Catch-22.... [Bomber pilot] Orr was crazy and could be grounded [and thus avoid flying bombing missions over Nazi-occupied Europe]. All he had to do was ask; and as soon as he did, he would no longer be crazy and would have to fly more missions.... If he flew them he was crazy and didn't have to; but if he didn't want to he was sane and had to. Yossarian was moved very deeply by the absolute simplicity of this clause of Catch-22 and let out a respectful whistle. 'That's some catch, that Catch-22,' he observed. 'It's the best there is,' Doc Daneeka agreed."

Many participants in the investment advisory profession today may not realize it, but they could find themselves caught in the same kind of Catch-22 circular reasoning. That behavior can, in my opinion, lead to imprudent fiduciary conduct.

Nobel Laureate Harry Markowitz, the father of Modern Portfolio Theory, identifies the fundamental problem faced by all investors: Selections of portfolio investments involve making decisions under uncertainty. This leads to the observation that risk (i.e., uncertainty) is the central factor at work in financial markets. The Prefatory Note to the Uniform Prudent Investor Act observes that the "central consideration" of a fiduciary when investing and managing assets is to determine the tradeoff between portfolio risk and return. Taken together, these mutually reinforcing notions tell us that risk is something that we should actually be serious about as investment advisors.

Yet many advisors simply ignore the existence of investment risk. The primary reason is obvious: In the sales-oriented advisory profession through which most financial products are distributed, the "good news" of an investment product's superior return sells while the "bad news" of that product's risk doesn't. High return is easy to understand; risk is much hazier. As a result, many investment advisors focus solely on investment return and ignore risk. This undue emphasis on return characterizes much of what passes for acceptable money management in America today.

There are a few problems, though, with a system that extols above all else the virtues of marketing investment return: those that obey the rules of that system risk 1) appearing foolish and 2) being imprudent. Here is what I mean by that.

Probability theory describes certain laws of nature that random variables are observed to obey. A random variable has values associated with it, which are both measurable and subject to unpredictable change. In the investment world, for example, the values of an individual stock are measurable (e.g., a $20 stock) and subject to unpredictable change (e.g., the $20 stock becomes a $12 stock, then a $34 stock, and so on). In short, then, the return generated by any given stock over any given period of time is a random variable.

A bit more expansive explanation is that the return (gain or loss) of an individual stock at the end of any period of time is a product of all the changes (positive and negative) in the values (i.e., market prices) of the stock from the beginning to the end of the period. These many changes in the prices of a stock can be depicted as the stock's "pricing path." For example, suppose that the first step taken on the pricing path of a stock begins on Jan. 1, when the stock is priced at $20, and the last step on that path is taken on Dec. 31, when the stock is priced at $34.

On Jan. 1, the content, magnitude, and sequence of information (both accurate and inaccurate) flowing through financial (and non-financial) markets that will have an impact on the pricing path of the stock (and thus determine the stock's return) over the ensuing year are *unknown*. From the vantage of Dec. 31 looking back in time, though, the pricing path followed by the stock appears *inevitable*. As a result, many investors will assign to the future the same pricing path experienced in the past.

While this is understandable, it is also wrong. In fact, at the end of Dec. 31, the pricing path actually taken by a stock for the year was merely one path--out of an infinite number of possible pricing paths--that could have been taken starting the preceding Jan. 1. In this light, the historical pricing path of an individual stock cannot be predestined; it must be random.

Here's another example of the unpredictably--the randomness--of investment return: Do you really (honestly) believe that any member of any group of money managers who assembles on the starting line of the investment racetrack each year actually knows which stock, which portfolio, which manager, which mutual fund, which investment strategy, which asset class, which anything will end up winning the race? Of course not! They all know that one of them will win--they just don't know which one. In fact, there is no way for anyone--before the race is finished--to know.

It is indeed a curious thing, then, that the one factor upon which so many investment advisory firms hope to differentiate themselves from each other--achieving superior investment returns--is, on closer examination, usually nothing more than a random occurrence, as unpredictable as a game of coin-flipping. This cold hard fact has a number of implications for investment advisors and their clients. Two of these implications involve the identification of investment skill on the basis of track records and the identification of investment skill itself.

"Track record investing" occurs when an investor identifies some investment such as a mutual fund with an outstanding track record and invests in it because the investor thinks that its historical performance will continue into the future.

A number of sources, though, tell us that identification of investment skill on the basis of track records is not a reliable basis on which to invest and manage portfolios. One source is the Securities and Exchange Commission: "Past performance is no guarantee of future results." Another source is virtually every reputable study of mutual fund performance over the past 40 years, which finds that there's no reliable way to predict when, or which or even if, winners from the past will win again in the future. A third source, Reporter's General Note on Restatement 3rd of Trusts Section 227, reflects this finding: "Evidence shows that there is little correlation between fund managers' earlier successes and their ability to produce above market returns in subsequent periods."

The plain truth--for those willing to face it--is that any investment (or investment manager) that has performed well over a certain period in the past is just as likely to perform poorly in the future as it is to continue doing well. In fact, data show the perverse tendency for many superior track records to be followed by inferior track records. It seems, then, that many investment advisory firms engage in an activity--marketing the random variable of return in the form of track records--over which they have little control!

If identification of investment skill on the basis of track records isn't a reliable basis on which to invest and manage portfolios, what about the identification of investment skill itself? Investment management consultants, for example, maintain with great confidence that they can discover "skillful" money managers. These searches for the "best," conducted among their vast proprietary databases that classify money managers by their investment style, are undertaken at the behest of certain fiduciaries responsible for investing and managing, for example, ERISA and nonprofit portfolios.

But these searches nearly always have the same ending. A fact well documented is that at the conclusion of an investment management consultant's (long and expensive) search for the "best," the manager that is hired invariably has a superior track record (i.e., one in the top quartile) over a relatively short time period (i.e., the past three to five years). In short, the winning money manager is deemed "skillful" only if it has a superior track record.

Captain Yossarian no doubt would be "moved very deeply by the absolute simplicity" of the circular reasoning used by investment management consultants and others that pin their hopes on the random variable of return: Track records are virtually useless in helping predict future winners; but the typical way of identifying investment skill itself is through track records.

Let's see: "If he flew them he was crazy and didn't have to; but if he didn't want to he was sane and had to."

Those placing undue marketing emphasis on investment return chance being seen as foolish because return is a random variable over which there is little control. They also chance being found imprudent: Focusing solely on return defines investment prudence in terms of portfolio performance not fiduciary conduct, which is directly opposite of how the Uniform Prudent Investor Act defines prudence, in terms of fiduciary conduct not portfolio performance.

It would be much more useful for advisors to keep costs and taxes low, and consciously manage risk to achieve broad portfolio diversification. After all, the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule) place great emphasis on such virtues and the critical role they play in assessing fiduciary conduct. This approach may better serve clients as well as advance the cause of prudent fiduciary investing than getting caught in the Catch-22 of investment return.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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