Are fund managers stupid or lazy?

FundExpert
Smart research. Better investing.

COPYRIGHT

Our own research highlights that 92% of all funds consistently fail to beat an undemanding benchmark.

This begs the awkward question, are fund managers stupid or lazy? We answer that here, and also uncover encouraging pointers for private investors as they strive for consistent success.

One noisy cohort of fund manager critics will tell you that these fund managers cannot possibly outperform the markets because we are all rational, markets prices always reflect all information, and therefore there is no undervaluation to exploit (AKA the Efficient Market Hypothesis).

If this theory were true there would be no point buying anything other than index trackers.

But this theory is daft, and this has been illustrated many times.

If we were rational we would not get panics and crashes, manias and bubbles. Share prices would not have many multiples more volatility than underlying company profits. And you would not go in to a City trading room and see people watching Bloomberg TV (which would be like visiting your GP with Casualty on a TV in the background!).

If rational markets are not the reason why the great majority of fund managers consistently fail, what is?

Sound processes to achieve consistently outstanding returns have been understood for decades. For example, the famous 1934 Graham and Dodd book on the tendency of investors to under-value companies that were out of favour: "Security Analysis".

Even more comprehensive and accessible is modern day research such as *"What works on Wall Street"* by James O'Shaughnessy. First produced in 1996, and regularly updated since, it forensically identifies strategies which have consistently generated superior investment returns since early last century.

That such processes are well known and understood makes the dismal performance of so many funds even more puzzling.

Performance pressures aren't helpful. Don't ask the sales team why your fund isn't selling if you can't illustrate superior performance. This encourages too much focus on short term (relative) performance.

It also means fund managers have to spend too much time in meetings explaining why they are "special" (irrespective of current performance limitations) rather than being given the time and space to focus on running their funds.

There are myriad regulations and restrictions. The regulations seem to continually expand, creating a new layer of distractions. And many restrictions are created by house rules and investment committees.

An extraordinary volume of information, vastly more in the internet age, means more distractions but no greater knowledge.

Last but not least, the very nature of markets is a distraction. Frenzied in the short term, and always highly complex.

All these leave managers with a shortage of time to make key strategic decisions as well as better understand the stock-level analysis which they are being fed. There are just too many distractions for all but the most emotionally detached.

The way many managers are paid doesn't help, which tends to be based more on assets under management than investment success. If their pay varied dramatically dependent on their investing success, it would surely focus the mind somewhat.

Let's not forget where career risk meets behavioural problems

It is not easy (emotionally or commercially) to act against the consensus. Acting against the crowd draws attention to you and, when you aren't firing on all cylinders, risks making you look stupid AND losing your job. The risk of mistakes encourages conservative behaviour, and generates mediocre performance.

The clues to the solution are inherent in why index trackers succeed:

A simple strategy (buy the index constituents!)

No personal or emotional judgments required

Goethe said *"in the real world all rests on perseverance"*. And O'Shaughnessy and others make absolutely clear what works, and what could work for fund managers.

But we "investors" are all a bundle of inconsistencies and emotions.

Ask a number of people whether they consider themselves below, average or above average drivers and the majority will opt for "above average". We all tend to think we are above-average but that isn't statistically possible! Similarly, most investors are prone to be both over confident and over optimistic.

Expert fund managers are even more inclined to these problems, as are all "experts" (a worrying trend that has been empirically illustrated many times). Fund managers tend to believe they have superior insights and intelligence, and even if the fund has stated process, they will too frequently over-ride this by over-thinking.

Intellectual snootiness (not necessarily overt) makes it difficult for managers to embrace simpler solutions which are empirically proven, because they aren't intellectually challenging – but they do challenge behavioural frailties which they struggle to acknowledge!

Most fund managers aren't stupid or lazy but are often overwhelmed by these human frailties (which we all share to some degree). This goes to the heart of why most fund managers fail to beat undemanding benchmarks.

We know many fund managers who express a clear strategy. But either there is no empirical reason to believe it will work OR it is simply not consistently applied over time, for all the reasons set out above.

And therein lies the key to the success of private investors – discipline (or perseverance as Goethe put it).

In particular, disciplined and consistent application of a process which can be simply applied and which has a very clear and long track record of success.

Important Information

FundExpert is an Appointed Representative of Dennehy Weller & Co, who are authorised and regulated by the Financial Conduct Authority.

Funds reviewed in this guide (whether you hold them in ISAs, SIPPs, or otherwise) are risk investments and are intended as long-term investments (5-10 years at least). If you withdraw from these investments in the early years you may not get back the full amount invested. The value of risk investments can go down as well as up.

Risk investments are not suitable for everyone and you should obtain expert advice if you have any doubt about whether they are suitable for your particular circumstances. Levels and bases of, and reliefs from taxation are subject to change. The past is not necessarily a guide to future performance.

Although we have taken reasonable care to ensure that statements of fact and opinion contained within this document are fair and accurate in all material respects, such accuracy cannot be guaranteed. While reports contained within this document may make generic investment recommendations, nothing in this guide is an invitation to purchase shares or other securities. It does not seek to provide advice and recommendations in respect of the suitability of any fund or product listed. The use of this information by any party for any purpose whatsoever shall be entirely at such party's risk.

Dennehy Weller & Co Ltd don't accept any liability whatsoever for such use and no claims for loss or damage arising from reliance on the information by any party shall be entertained.

Important note on recommendations: The information contained in this document is based on Dennehy Weller & Co Ltd's research into a number of factors, including past performance and charges and whilst Dennehy Weller & Co Ltd accepts responsibility for this research. These investments may not be suitable for everyone, if a reader requires advice on his or her personal position or circumstances or is unsure as to whether a particular product is appropriate for them personally, he or she should seek further independent advice.

This document is intended for use by U.K. investors only and the investments referred to are available only in the U.K.