From the Foot's Mouth – October 2014

Mind the return gap

The importance of using the correct measure of success

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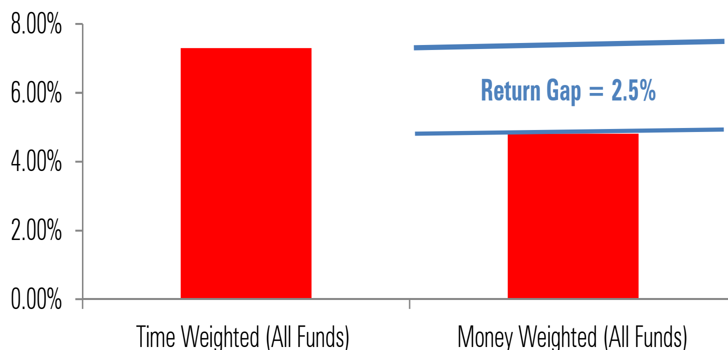
Experienced planners will know that left unchecked poor investor behaviour can be responsible for significant wealth destruction through actions like buying high and selling low. The problem can become particularly pronounced during market extremes when emotions such as fear and greed are prominent. Perpetuating the problem is the way in which investment success is measured by the industry and reported in the media.

In this edition of the FTFM, we highlight some research undertaken by Morningstar in the USA which shows the difference between the average return quoted by funds and the average return actually received by investors. This is known as the 'return gap' and takes each fund's stated return and then adjusts for inflows and outflows to get a measure of how the typical investor really fared. In technical terms Morningstar measures the difference between time-weighted and money-weighted returns, also making an adjustment for the different size of funds. Time-weighted returns are those shown in the performance tables and assume an investor buys at the beginning of a period and holds the investment to the end. Money-weighted returns factor in when the funds are actually bought and sold. The chart below shows the return gap in the USA during the decade ending 2013 was 2.5% per annum.

The Return Gap: 10 years to 31 December 2013 (US Mutual Funds)



Source: Morningstar

How this impacts fund manager behaviour

Knowing how investors react to short term performance many fund managers mistakenly place an undue focus on their ranking within the league tables (and forget that investors are actually loss averse and do not like losing money). Peer awareness is insidious, because this fear of underperformance leads to benchmark hugging. Not wanting to "stray too far from the pack" also increases the likelihood of holding expensive or inappropriate assets, simply because those assets are prominent within the peer group or market benchmark. The whole process encourages herding and inhibits the pursuit of attractive assets that are out of favour. This is unfortunate because it is the unpopular assets that often have the highest expected future returns, and are therefore more likely to provide long term outperformance and less downside.

Goal based investing

A better approach for investors, financial planners and asset managers involves aligning the investment strategy with the goals of the investors and then tracking outcomes on the same basis. Success then becomes a function of the consistency with which the stated objectives are achieved, rather than whether the strategy is top of the league tables. It would be unusual for an investor to have an objective that requires performance to be top of the peer group, because as they say "you can't eat relative returns". Defining success in a way that is consistent with client objectives means they are less likely to engage in value destroying behaviour, and more likely to focus on outcomes that are actually relevant to their circumstances.

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