CIBC Private Wealth Blog

Investors Beware… Of Investors

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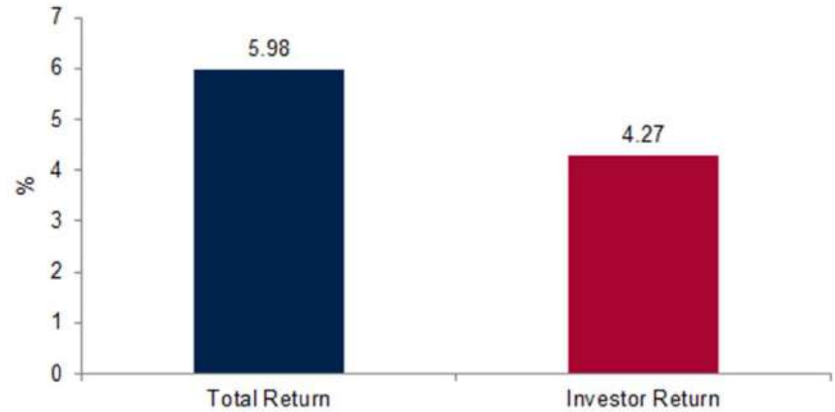
Last month's investment article highlighted the debate surrounding active vs. passive investment, framed by the notion that most professionally managed funds have struggled to keep up with indices in recent years. This month, we continue our discussion, but with a different dimension of active management, looking at whether individual investors are successful in moving in and out of particular investment strategies at the right time. Unfortunately, the evidence is somewhat sobering.

A straightforward way to analyze this issue is to differentiate between a mutual fund's stated return and the actual return a particular investor earns while invested in that same fund. The investor's return is affected not just by the fund's results but by the decisions he or she makes on when to buy (or add) and sell (or trim) units of the fund.

Morningstar Direct, one of the many analytical tools used by the CIBC Atlantic Trust Multi-Manager Investment Committee, is able to perform this analysis by incorporating the cash flows in and out of mutual funds over time. The chart below illustrates large-cap funds' total return vs. investors' actual return for the last 10 years. We're using the peer group, as it represents the average of funds available for purchase in that style; therefore, we make the assumption that an investor is purchasing an average fund for the period. It is important to note that these are both absolute return measures, not relative to a benchmark. Additionally, they are net of any fund fees. In other words, issues like how the fund in question performed relative to an index or whether management fees affected the results have been neutralized.

Exhibit 1: Morningstar Large-Cap Peers' 10-Year Return

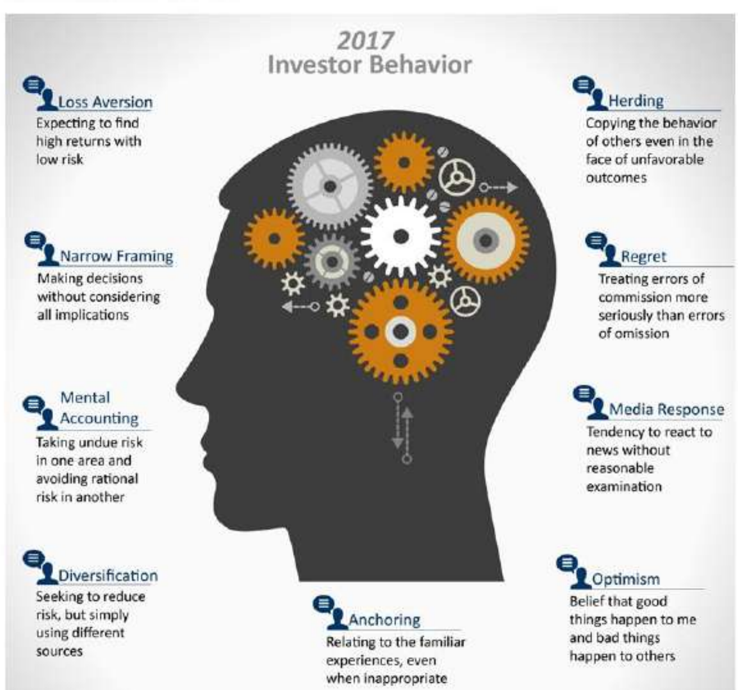


Source: Morningstar. Data as of 05.31.2017.

As you can see, the individual investor's return falls short of the fund's stated total return over the time period. If an investor had bought and held an investment in the fund for the entire period, he or she would have earned almost a 6.0% annualized return. However, the investor return was only about 4.3%. This 1.7% gap in annualized performance on a $1 million investment would mean a difference of roughly $189,000 over a 10-year time period.

What is the source of this significant amount of money left on the table by investors? It could be stated in very general terms as "doing the wrong thing at the wrong time." Investor actions and decisions tend to be driven by various biases. An entire field of research—behavioral finance—has developed to learn more about how human nature can be self-defeating when it comes to investment decision-making. Nine of the most common biases are listed below.

Exhibit 2: Nine Investor Biases



Source: Dalbar, 2017.

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The first step to avoid succumbing to these biases is to acknowledge that they exist. The second step is to develop a methodology—a discipline—that pushes these sometimes-unhealthy tendencies to the background. A long-term investment horizon holds great importance once we realize the significant amount of "noise" baked into short-term results. By expanding the investment time period, hopefully, a greater understanding can be achieved regarding the true drivers of returns.

At CIBC Atlantic Trust, we take a long-term view across our various areas of focus, including asset allocation, manager selection and, most important, constructing clients' accounts. Our Asset Allocation Committee follows a core set of principles when assessing both strategic and tactical allocations. The Multi-Manager Due Diligence Team performs rigorous analysis on money managers, with a focus on their ability to deliver strong risk-adjusted returns over a full market cycle. We have found in all aspects of our investment discipline that tuning out the short-term noise is perhaps the single best way to avoid many of the biases discussed, any of which can have negative implications for portfolios.

Scott Burg is a senior investment analyst with more than 19 years of industry experience. He is responsible for investment manager due diligence and selection within the Multi-Manager Investment Program's traditional investments team.