February 15, 2016

LOL Journal - Clear-Eyed Solutions to Willful Blindness

As I was finishing this piece, I got dizzy and almost fell off my soap box. That got me thinking, I should probably run this one by our editorial board, lest I end up sounding like Frank Burns of the old MASH television series. (Millennials: ask your parents to explain…) After some good feedback from the likes of Charley Ellis, Paul Smith (CFA CEO), James Montier and a few others, I've reworked this piece to where I don't appear to be barfing all over my chosen industry. Montier said it well in his feedback note: "We should be stewards of capital with a noble duty to our clients." Amen. And indeed FCG has experienced this with countless clients.

That said, the investment industry does present brilliant examples of what Margaret Heffernan calls, "Willful Blindness." In her fine book[1], Heffernan writes, "We turn a blind eye in order to feel safe, to avoid conflict, to reduce anxiety, and to protect prestige." And to make money. (As to our position on making money, FCG is for it.) Two recent pieces by Sir Bogle suggest that "willful blindness" is alive and well in the investment industry. In short, the investment industry exploits the naïve amateur investor. Bogle shows this powerfully in his analysis of two 30 year periods of returns for average equity mutual funds vs. the S&P 500 Index. The annualized returns for each are given below:

Time Period	Average Equity Fund	S&P 500 Index
1945-1975	9.7%	11.3%
1985-2015	9.6%	11.2%

Bogle, yet again, makes his case for the average investor to simply index his retirement funds: "With miniscule all-in costs, nominal portfolio turnover, tiny (if any) transaction costs, and high tax efficiency; and designed to be held "forever" – remains the optimal way for investors to earn their fair share of whatever returns, good or bad, our stock market delivers."[2]

As if the case for index funds isn't strong enough, just by looking at the numbers over a 60 year period, Bogle then brings in three heavy weights from the financial world—Samuelson, Swensen, and Buffett—and shows how each has embraced indexing as the strategy for success with average investors. [3] (In reviewing this piece, Charley Ellis wrote, "Please include me with Warren and David as serious advocates of indexing for almost everyone.")

[1] Willful Blindness, Margaret Heffernan
[2] The Index Mutual Fund: 40 years of Growth, Change, and Challenge, FAJ, Jan/Feb. 2016, pg. 9
[3] Of course, as our Michael Falk comments, active managers could choose to be much more competitive if they simply lowered their fees and held their winning positions longer; retirement funds are largely tax efficient already.

So, what's the problem? Why have so few investors chosen indexing?[4] Let me play with several analogies or "mentalities" that may offer insights. All of them linked to willful blindness.

Casino Mentality. Millions of tourists go to Las Vegas each year to gamble at the casinos. Most of them realize they will not emerge as winners, but at least they will be entertained while losing. And, who knows, maybe they will be one of the lucky few winners? But, we all know who the consistent winners will be: the casinos.

If the tourists were seriously interested in winning money as a collective group—all of them together—then they would of course NOT bet at the casinos. They would lose as a collective, each and every time. The house wins.

The investment profession operates with a "casino-like" mentality in that they know perfectly well that investors collectively will lose by giving all their money over to active managers. These investment firms, like the casinos, will be the winners. Of course, some of the investors will happen to choose the "right" investment firms that win big through active management and will celebrate their good fortune. (Like lottery winners.) But overall investors will lose in this zero sum game, after fees.[5]

The major difference FCG sees between casinos and active managers is that tourists in Vegas understand the risks and are quite willing to "pay" for the entertainment value. Fine. But, there is no entertainment value in investing. (Ok, you could argue it's fun to watch stocks go up and down, and hear Jim Cramer rant about them.) But retirement is a serious business. It's very different from a trip to Vegas. The former should be a sober and thoughtful exercise which gives people the best shot at a decent retirement. Vegas is just fun.

To restate, the failing is in the investment industry's unwillingness to think collectively. All the drama, glamor and—of course—profits drain out of the investment game once we think collectively. Indexing which serves the collective because of the strong returns at a low cost is an extremely boring strategy. When your neighbor tells you that a certain Hedge fund just earned him a 35% return compared to the S&P Index return of 9%, you feel like a loser. The casino mentality is fed by greed and envy. And hope. So is speculative investing. Maybe I will pick the right fund and make a fortune. Again, in the aggregate this can never happen. The collective always loses in the casino framework.

So, when does the collective win? If they simply invest in index funds and then largely forget about them.[6] In this scenario, they have hitched their wagon to the power of compound interest, which has a powerful effect over time. The 11% return mentioned above would double your money in just under 7 years. In two decades, you could see your money increase 8-fold.

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[4] "Note that industry flows make the "few" seem much more like the "many" in the last several years." M. Falk.
[5] FCG has worked with and written about a number of excellent active managers, whom we call the "Focus Elite." See our website for the white paper called, "Linking Culture to Success" for a detailed description. www.focuscgroup.com
[6] M. Falk: Rebalancing and shifting asset allocations over time based on needs requires some attention.

Plantation Mentality. Sometimes we use this analogy internally at FCG because we feel a bit like abolitionists visiting the Southern Plantations in the 1840's. Specifically, the message we are delivering to the plantation owners—in modern terms, the asset management owners—directly challenges their business practice. The message threatens their livelihood. Upton Sinclair put it so well when he wrote:

> *"It is difficult to get a man to understand something when his salary depend~~s~~ upon him not understanding it."*[7]

The moral infraction is of course different in each case. The plantation owners were getting free labor by exploiting a whole race of people. Some—not all—active asset managers are making huge profits at the expense of a different "race" of people: the uninformed citizen. David Swensen, at Yale, put it this way:

> *"The fundamental market failure in the mutual-fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual-fund industry overwhelms the concept of fiduciary responsibility. The powerful financial services industry exploits vulnerable individual investors."*

There you have it, two forms of exploitation. Neither one ethical. But one of them still legal in today's world. FCG occasionally sees this ethical breech up close and personal. And it's not pretty. We've sat in rooms with Partners of asset management firms who have lost money for clients over ten year periods, never reduced their active fees, or offered discounts, and showed no signs of remorse. Let's be clear. If an active manager can consistently produce excess returns, then FCG has no qualms about that person making a very good living.[8] The real crime is that many active managers have not provided added value and have profited handsomely. That's just not right. Most investment professionals believe in meritocracy: top performance gets top pay. And yet, many are complete hypocrites when it comes to their own underperformance. Willful blindness and another point for Upton Sinclair…☺

Friedman Mentality. FCG believes much of the inappropriate mindset is the result of the "shareholder value maximizing" principle taught be business schools and advocated by Nobel Prize winner, Milton Friedman: "there is one and only one social responsibility of business—to use its resources and engage in activities to increase its profits."[9] Oh, the damage this mindset has done. James Montier calls it the "World's Dumbest Idea" and writes, "Shareholder Value Maximization has pretty well laid the kingdom

[7] The Investment Challenge by FCG, 2015, pg. 8

[8] One of our Focus Elite CEO's wrote this feedback: "I think you have to be careful not to dump too much on we price discovery managers. While it is true that we generally think too highly of ourselves, we are front line soldiers. We are continually at odds with the prevailing orthodoxy; we can never allow ourselves to become arrogant or complacent. We have to quell our envy when we see other investment firms expand too much and hose their clients while their owners become richer than we could ever dream. So, throw a little love our way, please!"

[9] Wikipedia quote

to waste." I have had several good chats with Paul Smith, CEO of the CFA Institute, on this topic, and he has similar views: business schools have used game theory and other abstractions to obscure actual problems: real people have real issues that should be addressed. In the asset management world, there is a whole population of people who are unprepared for retirement. And yet the industry that is responsible for designing retirement solutions is profiting mightily. How is that fair?! (Teetering on my soap box again…) Jim Valentine, author of "Best Practices in Equity Research" says, "If the auto industry made a product that only worked about ¼ of the time, they'd be out of business." But when only a quarter of active managers outperform the index that is seen as acceptable. Willful blindness.

Competitive Mentality. Finally, the competitive mindset of most professional investors contributes to the willful blindness. The investment industry is filled with Type A, ambitious personalities.[10] In many ways competition serves the consumer in a free market. Adam Smith's invisible hand allows for healthy competition in which car makers battle it out to make a superior product. The consumer wins. The case is not so clear for the investment industry. Yes, competition serves the public with regard to the original purpose of financial markets: "to raise capital for companies that create jobs, build organizations, manufacture products, or provide services, with growing efficiency and lower costs to consumers."[11] But competition for price discovery among active managers has now reached the stage where it largely cancels itself out. In his FAJ article called "The Rise and Fall of Performance Investing" Charley Ellis makes this point, citing various studies, including one from Vanguard that examined mutual fund returns: "Results do not appear to be significantly different from random before costs."[12] In that same article, Ellis quotes Fama: "Active management in aggregate is a zero-sum game—before costs…After costs, only the top 3% of managers produce a return that indicates they have sufficient skill to just cover their costs, which means that going forward, and despite extraordinary past returns, even the top performers are expected to be only about as good as a low-cost passive index fund. The other 97% can be expected to do worse."[13] In this case, the competition does not serve the consumer. He does not get superior returns from it. The fierce competition does not contribute to a better product. In fact, all the competition makes index funds even tougher to beat.

The competitive mentality—rampant in the investment industry—keeps the participants focused on the fierce battle of outperforming benchmarks, rather than stepping back and seeing the bigger goal: client success. A different mentality—call it a "service mentality" (think Four Seasons)—is better able to step back and ask, "How is the customer faring in all of this?" And the answer is: not so well. In FCG's view, the customers would be far better served by investment leaders who are service minded rather than competitive minded. The notable exception would be a handful of exceptional active managers who are competing in price discovery to keep markets efficient. Yes, there IS a role for active managers. But

[10] M. Falk: "The profits of the industry "seduced" all these smart people; the real puzzle is that the profits have remained similar even in the face of the increased competition."
[11] Bogle, Putting Investors First, JPM, winter 2016, pg. 9
[12] Ellis, Rise and Fall of Performance, FAJ…pg. 17
[13] Ibid, pg. 18

Suzanne Duncan and others have written about the gross over-allocation of resources in the investment industry devoted to price discovery.[14] Service-minded leaders see the world in a fundamentally different way from competitive-minded leaders. Service-minded leaders see the world through collaborative-win/win lenses, as opposed to competitive-win/lose ones. The service mindset continually asks, "How do I provide the biggest wins for my clients? How do I partner with them?" FCG witnessed a classic example of the competitive mindset, when the Partner of a well-known investment shop stated boldly, "We don't care about the clients, we care about the partners." (Gasp.) When we challenged this statement, the partner only partially backed down. Small wonder the financial industry ranks at the bottom of the Edelman Trust Barometer. (I am taking a few deep breaths now…)

A Clear-eyed Solution

Heffernan writes that the only way to overcome willful blindness is by "challenging our biases, encouraging debate, discouraging conformity, and not backing away from difficult or complicated problems. Then, we can be more mindful of what's going on around us and be proactive instead of reactive." The purpose of this piece is to do just that: encourage the debate. Industry legends like Bogle and Ellis are writing and speaking on this topic, and we applaud their willingness to challenge the "blindness."

Meantime, FCG will continue to challenge our clients with the basic question: are you putting clients first? And when we get the response, "Well, we put both owners and clients first" (which we did recently), we'll push them: Only one can come first. Which is it? Sometimes this challenge causes an awkward silence in the room…and makes us less than popular. But that's the nature of exposing willful blindness. It's a risk. And it's seldom comfortable.

Finally, the good news. FCG works with hundreds of investment leaders who are decent and service-minded in their work.[15] We're not starting this crusade from ground level zero. We have critical mass to apply sufficient peer pressure on the bad apples, so that they move beyond their blindness and reclaim their moral compasses. So just as plantations died off in the South, we look forward to the day when the same will be true of exploitive investment firms. And hopefully it won't involve a civil war or "I have a dream" rallies at the Lincoln Memorial. One CEO of a major publicly-traded investment firm recently said to his executive team, "We are experiencing a secular decline in the margins of this industry." FCG applauds his honesty. And his courage in accepting the realities of the new era for investment professionals. Clear-eyed vision is the antidote for willful blindness.

Curiously yours,

JW

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[14] See Duncan's piece, "the Influential Investor"
[15] Tossing a little love to the successful active mangers! ☺