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Managing uncertainty: a question of weighting?

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Surprisingly there have been 563 bank failures in the US since 2001[1], far more than I think most would have guessed. Less than a third of those occurred during the worst of the Global Financial Crisis (GFC) in 2007-2009. Nonetheless, the two most recent collapses, Silicon Valley Bank and Signature Bank, have led to much concern, not least because they represent the second and third largest US bank failures over that period based on total assets ($209bn and $100bn respectively). But what's motivated investors and moved markets most has been the question: What comes next? The immediate answer of course was Credit Suisse's collapse and controversial rescue; an entirely separate and unrelated event on a different continent. However, with three very large bank failures in a week, it is natural to draw comparisons to the GFC which resulted in huge, and in some cases, permanent losses in risky assets. We think the circumstances today are very different and that those truly systemic risks are largely absent (discussed in our recent note[2]) but amidst such uncertainty, the common response for many end-investors is so often the wrong one; de-risking their portfolio after the event. Helping to keep clients invested during times like these is arguably the most valuable service our industry provides.

The legendary investor Peter Lynch said "Far more money has been lost by investors trying to anticipate corrections than has been lost in all the corrections combined. One of the worst mistakes you can make is to switch in and out of stocks or stock mutual funds hoping to avoid the upcoming correction." Surely wise words, but the track record of his investors provides much more powerful support for his suggested approach. As manager of the Magellan Fund at Fidelity Investments between 1977 and 1990, he delivered a 29% annual return, double that of the S&P 500 equity index and making it the best performing mutual fund globally[3]. However, studies suggest that the average investor in that fund actually lost money during their holding period![4] Part of the explanation is that on average, investors bought after periods of good performance (prior to periods of poor performance), and vice versa. The 700-fold increase in asset size from when Peter took the helm to when he stopped running the fund is also a key factor in explaining a very different outcome for the average dollar invested.

A more recent and similar example comes from Cathie Wood's ARK Innovation Exchange Traded Fund (ETF). As the poster child of the boom in US speculative growth stocks, her actively managed strategy delivered phenomenal returns up until mid-2021 around the turn in the US monetary policy cycle, since when the fund is down by over 75% in US dollar terms. Despite an impressive since inception return of 114% or 9.5% per annum, the average dollar is estimated to have lost 27% because most investors piled in late, after the best returns had been generated[5].

What these examples highlight is how extreme the differences can be between time-weighted and money-weighted returns. End-investors should only worry about the latter for themselves, because it takes account of cash flows into or out of the portfolio which changes the amount of capital invested. If for example one only adds to a portfolio when markets are low ahead of a rebound, then the money-weighted return would exceed the time-weighted return. However, most people focus on time weighted returns, because that is what gets reported in market news and by professional fund managers; rightly so given they often cannot control the timing of cash flows in or out of their strategy, nor realistically track the money-weighted return for each individual investor. Time-weighted returns reflect the average compound growth rate of a strategy over time, so unless assets under management change so much as to force fundamental changes in that strategy, it's a good yardstick to evaluate a manager by, based on the factors they can control.

While the Magellan and ARK funds are high profile and more extreme examples, they are by no means isolated. The persistent tendency through time for the masses to buy high and sell low should give all investors serious pause for thought when reacting to short-term events.

But beyond just recognising how much value destruction happens due to short-term behaviour, asset managers and financial advisers must focus on helping clients narrow the gap between time-weighted and money-weighted returns. As Peter Lynch pointed out, market timing (specifically de-risking through periods like now) is the biggest factor explaining that gap and so helping clients avoid that should be the priority. That can be achieved in many ways, including through a combination of careful fund selection and portfolio construction (thereby reducing the need for forced portfolio turnover and creating less volatile returns) and through communication and education to encourage better behaviour (thereby avoid those usually damaging attempts at market timing).

These parts of the value proposition are particularly relevant today, given the huge uncertainty in markets, but even more so in the UK during a year when much of the industry is grappling with new Consumer Duty regulation[6]. An overarching focus of this regulation is the need to contribute towards better customer outcomes, as far as possible across the entire value chain, as well as measuring and evidencing the value of services provided. While it's encouraging that this regulation focuses on value rather than simply cost, the tendency is still to only include that which can be measured easily. Keeping clients invested and delivering better money-weighted returns is not as easy to quantify as fund performance or costs from a factsheet, but it's far more relevant and perhaps one of the best ways to evidence the value of good advice. We recognise the significant risks facing the global economy and markets presently, and wouldn't discount further challenges and volatility ahead, but in the long sweep of history these periods have usually proved the time to be buying rather than selling.

Sources

1 Deutsche Bank, March 2023
2 https://momentum.co.uk/media/8265/silicon-valley-bank-collapse_march-2023.pdf
3 Wikipedia, https://en.wikipedia.org/wiki/Fidelity_Magellan_Fund
4 Forbes, Fidelity Investments
5 Financial Times, Factset
6 FCA, https://www.fca.org.uk/firms/consumer-duty

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