Seed Weekly

Investment Complexity by Tawanda Mushore

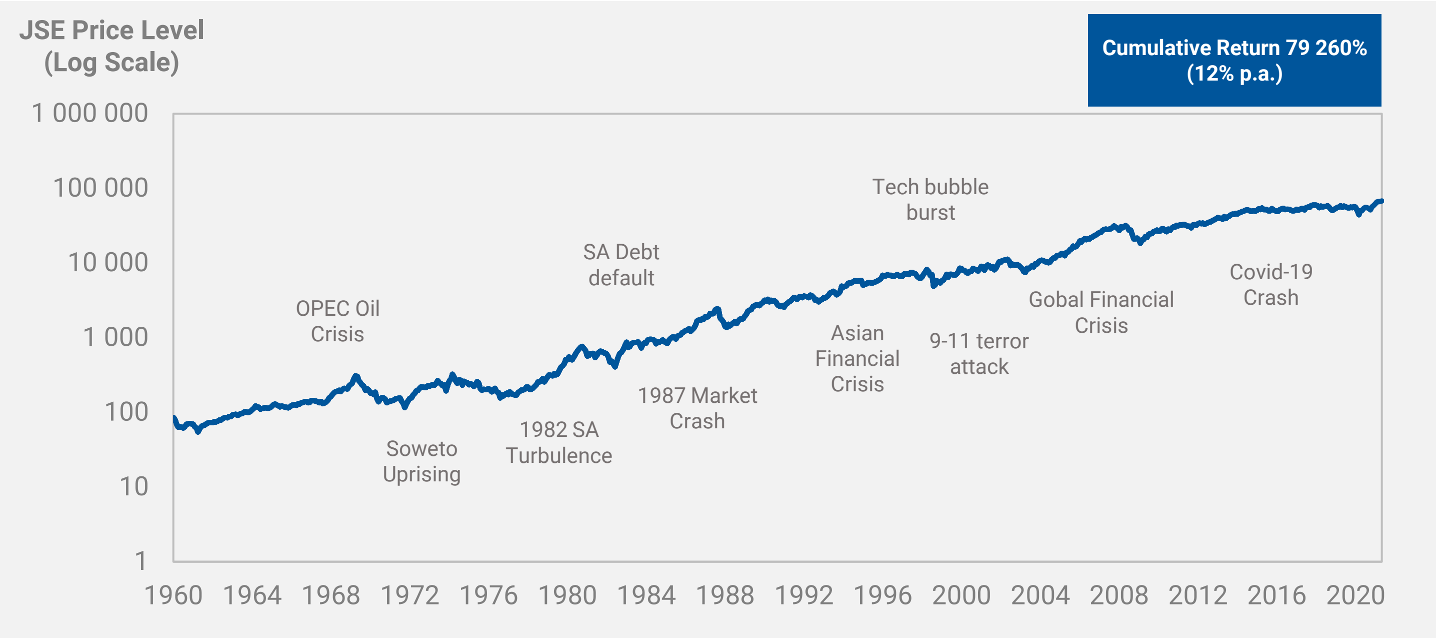
Part 1 - Long Term, Fees and Performance

"In investing, what is comfortable is rarely profitable." Robert Arnott

Many consider investing to be one of the more complex processes when it comes to personal finance management. Investors are constantly trying to find answers to questions such as: Is it a good time to buy shares? Which is the best fund to invest in? Which manager will outperform? What asset allocation works best? The amount of jargon one encounters adds to the complexity.

It is often said that to reap the full benefits of investing, one needs to investment long term. This means having to experience inevitable volatility and cyclicality. Market crashes are hardly comfortable but as illustrated in Chart 1, through several crashes, the South African market has trended upwards over the long term. The price level of the JSE All Share Index has gone up roughly 12% per annum since 1960, through several crises.

Chart 1: Growth of FTSE/JSE All Share Price Level Through Various Shocks Log Chart (1960 - 2021)



Source: Seed Research, Morningstar Direct (31 May 2021)

A relaxing retirement is a great reward for a lifetime of work, but current conditions make it feel like one must pass an entrance exam for it, and the exam is almost impossible to pass. Advisors and other investment professionals have a huge role to play to ensure that readiness for retirement is a reality for clients.

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Selecting the right investment options is part of this. This process has generally become a case of just looking for the latest top performer and/or the lowest cost option. I explore how targeting measures like (low) fees and (out)performance can have unintended consequences, which is why in addition to looking at these, deeper analysis is necessary.

Goodhart's Law

British economist Charles Goodhart came up with a theory suggesting that all metrics of scientific evaluation are bound to be abused. Anthropologist Marilyn Strathern broadly simplified the law as follows:

"When a measure becomes a target, it ceases to be a good measure."

This is because it is human nature to try and optimise for specific targets. When people know the target, they refine their behaviour to optimise for the specific data point, that it ends up not being as useful as it was before.

Our education system is a good example of this. An improving pass rate is indicative of a progressing education system. However, targeting the pass rate as a measure of progress has resulted in lowering of standards to achieve higher pass rates. Furthermore, students optimise for higher grades in a system that does little to promote creativity and critical thinking. Politicians optimise for votes through short-term targets at the expense of long-term progress. These examples show the human mind's propensity to game the system when a measure becomes a target.

Source: Scott Adams (1999). Accessed on https://dilbert.com/strip/1999-08-04 on 4 June 2021.

Fees

Lower fees add to an investor's performance. Overall, what is most important is the value added to a client's portfolio, that is, it should be commensurate the fee being paid. With fees becoming a target as investors look for the lowest cost investments, not enough work is done on the potential future value creation for clients (only assumed to be reflected in the fee).

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With market participants aware investors are targeting low fees, unintended consequences include:

- Hidden costs,
- Inaccurate reporting,
- Misleading or insufficient disclosure, and
- General transparency issues which make it difficult to understand the full costs picture.

Therefore, what is presented may not always be the full picture and is not enough on its own to gauge the future value add for clients.

Performance

Clients want exposure to the best performers while managers want to outperform their peers. What should however be primary, is achieving the client's investment objectives. Purely targeting outperformance can have the following unintended consequences:

- Managers taking undue risks,
- Focus on short-term gains at the expense of long-term objectives,
- Fraudulent reporting including inflated returns or artificially smoothed returns to reflect low volatility, and
- Securities fraud like insider trading.

We have seen clients losing money in schemes which promise high returns but are misrepresented. While performance and fees are important measures to consider, given that targeted measures can have unintended consequences, it is important for investors to carefully consider all factors affecting risks and expected returns. We assist with this process at Seed. Focusing on the purpose of the measure is much more important than the measure.

Kind regards,

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Head of Research

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