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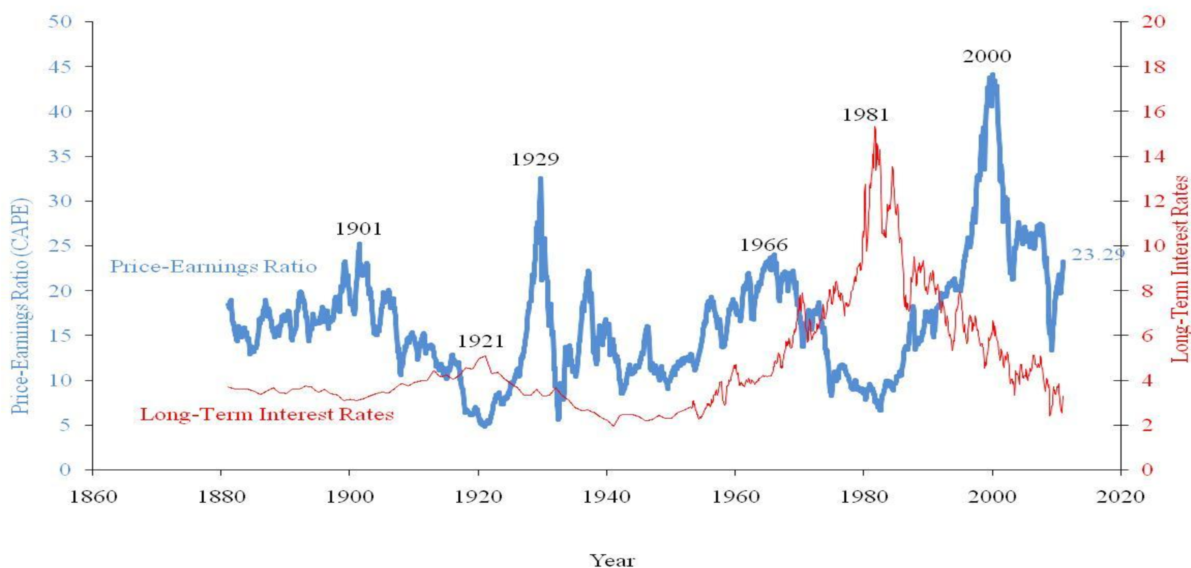
Wrong at the top of their voice

"I contend that we are both atheists. I just believe in one fewer god than you do. When you understand why you dismiss all the other gods, you will understand why I dismiss yours."

- Stephen Roberts.

Given their role in the financial crisis, taking investment advice from investment banks is a bit like taking marriage guidance advice from convicted rapists. Nevertheless, as The Economist's Buttonwood points out, Goldman Sachs and SocGen recently held investment strategy conferences that were poles apart. "In the Goldman world the forecast is for eternal sunshine; visitors to the SocGen world would need to carry an umbrella and a gas mask." Which nicely summarises the lack of conviction at large in the investment world – perhaps 2011 will be a muddle-through year after all. One common theme to all the SocGen presentations was apparently the use of CAPE, the cyclically adjusted price / earnings ratio for the US stock market, popularised by economist Robert Shiller. As his chart below shows, stocks look overvalued by roughly 40% on this measure, trading at a level that SocGen analyst Andrew Lapthorne suggests has previously delivered average real returns of just 1.4% per annum.

Cyclically adjusted stock prices / earnings, 1871 to date



Source: Robert Shiller

Buying the (US) stock market at current levels may deliver disappointing returns, then. But we are talking averages, of course, which hold little appeal or relevance to those of us who are focusing instead of bottom-up value, defensiveness and not least yield. And stocks, of course, are not the only game in town – but at a time when both cash and bonds have been effectively discredited as meaningful asset classes by central bank market manipulation, they represent the only traditional asset class with any hope of generating real returns if analysed selectively and with conviction.

That two large financial institutions can contemplate the same investment landscape and come to such radically different conclusions also acts as a reminder that institutional advice and management inevitably incorporates biases and conflicts. There may be other fundamental reasons to distrust institutional investment managers, as an excellent recent paper by Simon Wong of Northwestern University School of Law argues. Among the problems facing institutional investors that Wong highlights:

- Inappropriate performance metrics and financial arrangements that promote trading and the pursuit of short-term returns (see our commentary last week, 'A playground for robots', indicating that the average holding period for a US stock now stands at just 22 seconds);
- Excessive portfolio diversification that makes monitoring difficult (and outperformance harder to achieve);
- A lengthening chain of share ownership that weakens an 'owner' mindset;
- A misguided interpretation of fiduciary duty that accords excessive deference to quantifiable data at the expense of qualitative factors;
- A flawed business model and governance approach by passive funds.

Many of these problems can be summarised in two words: agency risk. Many institutional investors have little or no skin in the game; they are hired hands, working to a mandate dictating short-term outperformance relative to an index, who will jump ship – either between employers, or their own portfolio positions – at the drop of a hat. Any brief that rewards short-run outperformance versus an index is effectively incompatible with the pursuit of longer term value creation. Quite how and why index-relative benchmarking even entered the game to begin with is an intriguing question. Either way, too many institutional investors rent stocks rather than thinking like owners, which alone leaves them at the mercy of noise traders and quants. That reference to "quantifiable data" is particularly damning, and recalls the recent triumph of traditional 'scientific' economists over, say, the behaviouralists – a triumph which meant that no mainstream economist was able to foresee the financial crisis until it broke, and which means that even now there is precious little evidence of obvious brain activity, consensus or actionable advice from those same economists. That the models are obviously broken is not stopping traditional economists from using them.

But Wong's paper is not just a counsel of despair; it advocates remedies. One of the first: eliminate unnecessary intermediation and strengthen internal capabilities. He compares the chain of ownership between end investor and investee company with that linking a family office or entrepreneur and company, and that linking the retiree of a pension fund and company. In the first arrangement (family owners / entrepreneur) there is but one step from owner to company. In the second (pension fund arrangement) there can be at least five, including pension fund trustees; investment consultants; funds of funds; asset manager, and company. Another suggestion: reconsider performance metrics and reduce emphasis on relative returns. Having committed to a three year investment, one US public pension fund refused to meet the asset manager during the first year to discuss results, on the basis that a full review of performance should occur only after the second year. A third: consider reducing the number of portfolio holdings. Can there by anything in investment more absurd than the actively managed fund wherein the manager is

compelled to hold stocks even when he hates them because he otherwise runs the risk of tracking error ? Again, spurious science has won out over true art.

The storied David Swensen, manager of the Yale endowment, has written well (in 'Pioneering Portfolio Management') on the characteristics that investors should look for in fund management counterparties:

"Attractive investment management organisations encourage decisions directed toward creating investment returns, not toward generating fee income for the manager. Such principal-oriented advisers tend to be small, entrepreneurial and independent.. Entrepreneurial capitalism constitutes a behavioural process with three driving forces: innovation, ownership and adaptation. Each characteristic contributes to the core of successful money management organisations."

But the buy side is polarised between institutional heavyweights with heft in assets under management that can only be detrimental to longer term performance, and individuals in boutique firms:

"In selecting external managers, investors attempt to identify individuals committed to placing institutional goals ahead of personal self-interest. Alignment of interest occurs most frequently in independent investment management firms run in an entrepreneurial fashion by energetic, intelligent, ethical professionals."

Or you can choose to take your advice, and investment management, from the big boys. But the big boys may not have your best interests at heart, and they are likely to be pursuing ends (pursuit of asset scale that boosts fee income, for example) wholly at odds with yours. Full service investment houses are likely to be hopelessly conflicted. Invariably acting as both principal and agent, does any full service institution hold fundamental appeal for a rational investor – would you really want to be buying anything that they're selling ? (Anecdotal evidence from the subprime mortgage market alone would suggest that the answer is in the negative.) As John J. Macreedy (Spencer Tracy) declares in 'Bad Day at Black Rock':

"You're not only wrong. You're wrong at the top of your voice."

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