A Different Kind of Investor: Ahead of the Curve

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In the tax free shop at the Heathrow airport, I bought some cosmetics duty free. When I pulled out my credit card, the saleswoman said, “Would you like to pay in dollars?” That sounded like a good idea and I said “yes” without giving it any thought. The salesclerk flashed 1.65 in front of me. Since I didn’t know the exchange rate of the day, I just nodded in the affirmative.

At the time I felt good because I knew I was avoiding the credit card charge of 2 1/2-3 percent plus whatever exchange rate they would use, possibly unfavorable for me. Later on, though, in the airport lounge, I looked up the dollar/pound exchange rate of the day. It was 1.58 dollars for one pound. Since I paid 1.65 dollars per pound in my transaction, I didn’t feel so great about it anymore.

My airport experience is similar to many investors that don’t pay attention to cost and therefore get bit in the butt when they invest. Specifically, that bite goes right for the cash in their back pocket wallet. Unlike me, however, most don’t feel any pain. The reason is this they aren’t aware of their loss.

Although studies show that low cost index funds do better on average than more costly managed mutual funds (and by proxy others paid to run people’s money), a lot of investors ignore this data. One reason is that they don’t know about it. Another is that they hoped, in face of evidence to the reverse, that their manager could magically help them. That hope is getting harder to maintain.

This piece is different than my previous message, the advantage of passive over active management, because it addresses this subject especially during a downturn. It is at this time that one might expect active managers to shine because they theoretically could provide intervention before/during a dive in equity prices. This is what they are paid to do to help their clients. The question is, did they?

In 2008, when the market dropped off a cliff, actively managed funds underperformed compared to appropriately matched index funds that were passively managed. This is according to data from Standard and Poor’s. Actively managed funds are those for which the clients pay higher fees than passive funds because they hope to attain better performance than the market. Active managers are supposed to protect clients in a down market. It didn’t work. Those clients who paid a manager by and large wasted their money.

The same perverse scenario took place during the 2003-2007 Bull Run. Again, active managers underperformed their less sexy, but better performing indices (Standard and Poor’s).

This suggests that paying for investment management diminishes rather than enhances investment returns in all markets including down. A lot of people are paying something for nothing, or worse, they are paying to lose their hard earned money compared to more passive strategies.

There is good news, however. Fewer investors are so unrealistic these days they think someone else can 'beat' the market for them. According to a survey by Watson Wyatt published in 2008, "*passive assets have risen from US$1.3 trillion to over US$6.0 trillion in the past ten years at a compound annual growth rate (CAGR) of over 16%, while the CAGR of the total 500 (active managers) was around 11% during the same period*." Still the majority of money is actively managed by a ratio of about eleven to one, though the margin is clearly narrowing because of a different kind of investor, one who is unique and ahead of the curve.