GLASS JACOBSON
FINANCIAL GROUP

FIVE TIME-TESTED CONCLUSIONS ABOUT THE FINANCIAL MARKETS

The Virtual Impossibility of Beating the Markets

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September 2017

FIVE CONCLUSIONS

Reflecting on my 40 year career in the financial services industry prompts me to share some personal observations of the best kept secrets for managing money. A simple touch of the keyboard reveals an overwhelming body of academic research and evidence of secrets hiding in plain sight among millions of web postings on finance. Numbered below are references from the web, the content of which mirrors our firm's beliefs. These references can help you adopt a system for managing your wealth that is wise and delivers returns that will accomplish your goals.

I began my career in the banking industry, honing my money management skills in audit, comptrollership, and trust functions. Transitioning into investment management and counseling wealthier clients, I also began to take an interest in working with our institutional clients, as the investment principals used are virtually identical.

My approach is to help our clients achieve long-term success with their financial goals. The large quantities of financial data that cross my desk can be challenging to assimilate and comprehend, but the search for answers while traveling the path of discovery is what creates the solutions we seek. And it's this mindset that has resulted in the development of the processes we use with our clients at Glass Jacobson Financial Group. What I've learned through years of hard work is that it is virtually impossible to beat the financial markets.

THE FIVE CONCLUSIONS

Here are my **five fundamental conclusions** learned from 40+ years of investing experience:

1. Relatively few mutual funds or managers deliver index-beating returns.
2. Manager outperformance is not a reliable indicator of future performance.
3. Strong track records fail to persist among high cost funds.
4. High cost funds and excessive trading costs contribute to underperformance.
5. Developing a long term process to consistently select managers who outperform index benchmarks is extremely difficult ... and statistically improbable.

In the following pages, I will present the research and rationale which influenced my conclusions.

THE RESEARCH

THE IMPACT OF INDUSTRY SIZE

Peter Kraus, the former CEO of AllianceBernstein, was interviewed by the *Financial Times*. In his May 10, 2016 interview with Robin Wigglesworth, Kraus is quoted as saying "The asset management industry has grown too bloated to consistently produce market-beating returns."

https://www.ft.com/content/2981fb46-1610-11e6-b197-a4af20d5575e

ASSET ALLOCATION ON PERFORMANCE

In 1986, Gary P. Brinson, CFA, Randolph Hood, and Gilbert L. Beebower sought to explain the effects of asset allocation policy on pension plan returns. First published in the *Financial Analysts Journal*, their seminal work, "Determinants of Portfolio Performance," asserted that this decision alone accounted for up to 93.7% of the performance experienced by the plan. Other factors such as market timing and security selection actually cost investors money due to bad decisions by managers.

https://www.cfainstitute.org/learning/products/publications/faj/Pages/faj.v42.n4.39.aspx

ASSET ALLOCATION BEATS ACTIVE MANAGEMENT

Vanguard has prepared a condensed version of the Brinson study, titled "The Asset Allocation Debate: Provocative Questions, Enduring Realities." A downloadable PDF of this paper is available at *http://www.vanguard.com/pdf/icradd.pdf*.

The most significant conclusions of this paper are:

- On average, active management has reduced a portfolio's returns and increased its volatility when compared with a static index implementation of the portfolio's asset allocation policy.
- The influence of security selection and market timing on returns can be more significant. However, active strategies tend to have a high skill hurdle, less stable and less predictable relative returns over time, and higher costs.
- Investors' focus should be on the asset allocation choice and its implementation using broadly diversified, low cost portfolios with limited market timing.
- Active management creates an opportunity for the portfolio to outperform — along with the risk to underperform — appropriate market benchmarks.

What I have observed:

- On average, active management will cost investors over 1% (before fees) due to faulty decisions of market timing and security selection.
- As an investor, you are not compensated for taking speculative risks when selecting individual stocks or when trying to time market cycles.
- Professional active managers seemingly provide marginal benefit while still incurring the same added risks.

THE RESEARCH

ACTIVE MANAGER SUCCESS RARELY CONTINUES

Biannually, S&P Dow Jones Indices publishes the "SPIVA U.S. Scorecard." The scorecard tabulates current manager data, comparing performance to appropriate benchmarks. Very powerful conclusions can be drawn from the statistics presented. For instance, during the first half of 2016, up to 91% of all United States managers failed to outperform in their relative benchmarks for 1, 3, 5, and 10 year periods. Additionally, the underperformance factor runs over 1.3% for all large cap funds and 2.2% for all small cap funds. In particular, US growth funds are outperformed by benchmarks 95% to 99% of the time.

SPIVA further notes that funds continue to disappear at meaningful rates. Nearly 21% of all domestic equity funds were merged or liquidated out of existence for the past five year period. This finding highlights the importance of addressing survivorship bias in mutual fund research. Also style consistency is an important metric for making asset allocation decisions and assessing proper benchmarks.

https://us.spindices.com/documents/spiva/spiva-us-mid-year-2016.pdf

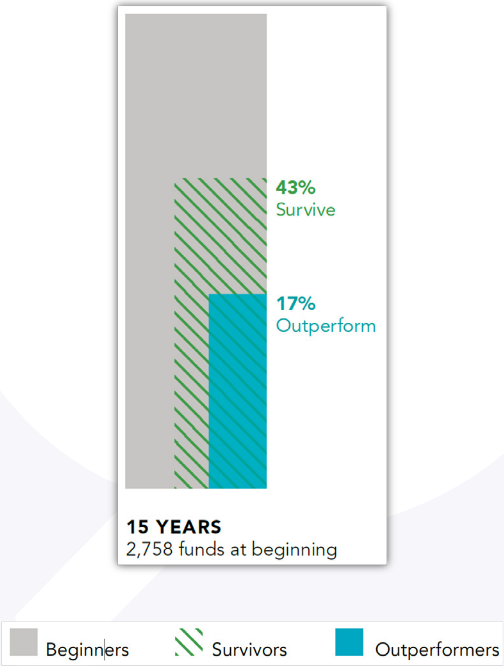
INVESTMENT COSTS ARE INCREDIBLY SIGNIFICANT

In "Dimensional Fund Advisors 2016 Mutual Fund Landscape Study," we see further corroborating evidence as well as additional information demonstrating that manager outperformance is not a reliable indicator of future performance.

From the original study group of 2,758 funds, adjusted for survivorship bias, only 1,186 funds survived. (See chart #1) This data shows the absurdity of marketing active management results to the general public. I liken this to overfilling shelves in a local grocery store, hoping to overwhelm the buyer with a variety of confusing brands.

CHART #1

Percentage of funds that survived and beat benchmark over 15 years



Performance periods ending December 31, 2015

THE RESEARCH

But what are the characteristics of outperformers?

- We find that low cost funds, based on expense ratio, have significantly higher odds of achieving outperformance versus high cost funds. (26% of low cost funds outperformed benchmarks versus 7% of high cost funds - see chart #2)
- Research has indicated that high turnover funds can cost investors as much as 3% to 5% of their investment return. In this study we see that 29% of low turnover funds outperformed, while only 8% of the high turnover quartile outperformed. (See chart #3)

CHART #2
Winners and losers based on expense ratios (%)

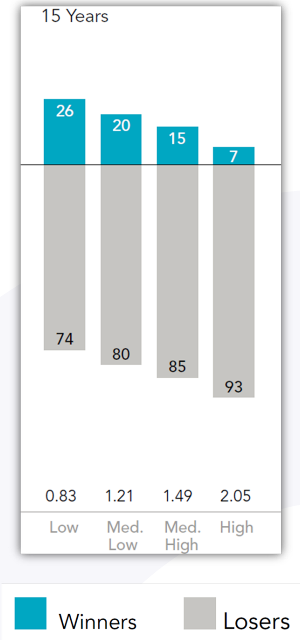
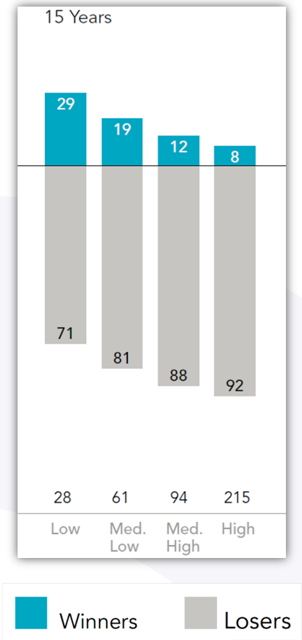


CHART #3
Winners and losers based on turnover (%)



Evidence further shows that past winners do not keep winning. This is a mistake that I see most investors make, investing with a manager who has a great track record. However, this is where gravity usually takes over. In the study we see that only 7% of active managers continue to outperform. This is consistent with Brinson's findings from 30 years ago that I mentioned under "Asset Allocation Beats Active Management."

When using a prudent process to conduct a manager search for high performance, one of the primary objectives is to exclude high cost, high turnover managers from the search data base. Doing so further reduces the odds of successfully finding an outperformer because the number of candidates in the manager pool has been reduced. So for argument's sake, let's say your odds of picking a manager are now 1 in 20. I have seen better odds at the racetrack or in Las Vegas, and those are destinations I avoid.

IN SUMMARY

In summary, these five time-tested conclusions show the fact that it is virtually impossible to beat the market. Relatively few mutual funds deliver index-beating returns. Manager outperformance is not a reliable indicator of future performance. Strong track records fail to persist among high cost funds. High cost funds and excessive trading costs contribute to under performance. Developing a long term process to consistently select managers who outperform index benchmarks is extremely difficult . . . and statistically improbable. I encourage all investors to pursue an academic-based solution to managing their portfolio and enjoy the power of the market over the long term.

CONTACT US

We hope you find this article helpful as you think through your portfolio strategy. If you have questions about this article, please feel free to reach out to Jon.

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