

# EVIDENCE BASED INVESTING STRATEGIES

## -The way to business success-

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**An investment group formed to promote good investment practice has found a synergy. It seems their successful investment strategies also result in business success stories.**

### *The search for reliable investments*

The majority of financial advisers study the results of active fund managers, comparing past performance statistics in their systems and carefully building client portfolios filled with highly rated five star funds. However, regardless of their energetic research, they are disappointed when they lose clients during difficult trading conditions.

The eight member firms of Evidence Based Investment Strategies (EBIS) are not at all surprised as they say active management will always disappoint clients in the end. The group believes it is the first organisation of independent advisers in the UK dedicated to educating investors about the benefits of passive investment strategies. They say that when you look at the evidence, there is absolutely no room for active management and they believe you cannot beat the markets consistently. This is not groundbreaking news but the point becomes compelling when we observe EBIS firms winning lots of new clients.

EBIS firms have researched carefully and observed that investors are looking for consistent investment performance, not a spectacular year followed by one of failure.

### *Clients come in a one way door*

IFA's aren't the only ones losing clients to EBIS firms. "Over the last two years all of our new clients have come to us from IFA's, stockbrokers and banks' specialist investment services. They invest client money in overpriced and inconsistent funds," say EBIS principals Graham Fidoie and James Martineau of Morton-Wilson. They concur, "Clients come to us after they have been disappointed. New arrivals come in through a one way door. We do not lose clients but we do turn those away who have been burnt once and are still convinced a speculative investment strategy can work."

When markets are good and portfolios show double digit returns, IFA's, banks and stockbrokers often bask in the glory, although the fund managers have not added any value at all.

Unfortunately for them, recent times have been difficult and their ability to outperform has come under question again. It makes it hard for them to justify their high fees which typically cost a client an extra 1% to 3% a year.

### *Clients open up to logic*

The active fund industry's failures are predictable using basic logic. In "The Arithmetic of Active Management," published in the January/February 1991 issue of The Financial Analysts' Journal, Nobel-prize winning economist William Sharpe noted that "if 'active' and 'passive' management styles are defined in sensible ways, it must be the case that (1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and (2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar. These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required."

Increasingly, today's investors are open to Sharpe's logic. When educated they can see that fees and turnover rates in active funds are far too high and the investment returns are too low. This has been a major factor leading to the success of the EBIS member firms who since 2005 have doubled funds under management.

"Our referrals, and the interest in our funds has increased significantly since we went passive", says Craig Burgess of Blackstone in Birmingham. "When I make presentations, in my capacity as Chairman of EBIS, you can see a light switch on". Although what he discusses with clients is evidence that has been around for a long time, all this is new to prospective clients who have only ever seen marketing hype before.

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Burgess's enthusiasm continues with a quote from a new client "I knew the returns weren't what they were supposed to be and now I know why!"

### *Keeping up standards*

EBIS founding members offer coverage throughout England, Scotland and Northern Ireland. Other firms are interested but the objective is to consolidate the group and perhaps consider admitting one or two new firms a year. Academic standards are high and it is unlikely many firms would have the experience required to add any value to the group.

Alan Dick, EBIS Glasgow, says a firm must be willing to 'get naked'. This refers to the eight member firms being totally open when sharing investment information, research, software

and the methods they develop to help educate clients. A full and open disclosure is necessary between firms because they support each other by sharing resources. There are no planning institutions that represent the group's evidenced based philosophy.

"When our firm decided the only way to maximise value for our clients was to move over to passive management strategies, we know there was a ton of academic research supporting us, but a total lack of client friendly material to show clients the principles," explains Dick. "In the industry an adviser will usually show a prospective client marketing material with a story line about how a fund manager's activities can beat the markets. However, there isn't really an easy way to break down our proposition into two-minute sound bites."

### ***A strong desire to educate***

It was this need for support that brought together the EBIS firms, and the strong desire to focus on educating clients and the media.

The firms originally met each other at the 'Elite Advisor Forums' based in London, and supported by DFA. DFA has tremendous resources and academic support, and EBIS wanted to take this further into a totally independent body of advisers with no restraints. As the firms are geographically dispersed in England, Scotland, and Northern Ireland, there is no competition with each other - in fact the opposite with a real team spirit to see everyone in the group continuing to succeed.

All of the members had previously experienced problems looking for peer to peer support in their businesses. "None of us fits into any of the industry groups," notes Martin Strutt, EBIS London. "We are all either Institute of Financial Planning or Personal Finance Society members, and although these professional organisations believe the client comes first, they do not take a stance on our active v passive core beliefs."

### ***Client costs reduced***

EBIS will represent a single substantial voice in the industry, and it can see people sitting up and taking notice.

Strutt says that "As the group grows, the EBIS investment decisions will have an impact and when it is known that we do business with certain firms this will influence their decision on fund expense ratios".

This has happened already as members of the EBIS group were instrumental in negotiating a reduction of Transact's administration fee for large cases, encouraging a fund provider to make an institutional fund available to clients, and another fund available with reduced annual management fees.

"We will not be demanding anything from investment companies," Strutt says. "We want a good conversation. If we meet with an investment firm and we say it would be really helpful if you did this or that or started a fund, or looked at its fees, this would be useful. We now know we will be heard as we are not lone voices anymore."

### ***Plenty to shout about***

Although EBS members have been quiet about their achievements there is plenty of research to shout about. The group has collected an abundance of charts, graphs and studies to provide good ammunition in their argument against active management. One example is the result of Gary Brinson's famous study, 'Determinants of Portfolio Performance' (published in the Financial Analyst's Journal in 1986). Asset class selection is 92% of the pie while market timing and security selection are only tiny slices being 2% and 5% respectively.

Another recent piece of research was published in the New York Times (9th March 2008), which was headlined "Can you beat the Market? It's a Billion Dollar Question." The author of the research was Kenneth French a professor of finance at the University of Chicago. It is estimated that \$100 Billion a year is spent by managers just trying to beat the markets.

The observation was that a typical investor can increase their investment returns if they eliminate these high costs. In other words, they should use low-cost index funds.

### ***A little humour helps***

To help educate clients and to lighten up discussions, EBIS members often employ metaphors and introduce humour to explain concepts in a client friendly way.

One example is the sponsorship of an Orang-utan as an honorary fund manager – a metaphor to highlight two serious messages- the randomness of stock selection and excessive manager fees.

### ***No unpleasant surprises***

Darren Baker, EBIS South West, likens the investment process to building a house.

"The house plan and building regulations represent your asset allocation strategy, and your funds are the bricks, mortar and other raw materials.

Someone builds a house and they think they have a sound property with good insulation. However, it turns out they have an inferior build, so the end result is a property with high running costs. Also, when the bad weather arrives the house will risk extreme damage. In the same way, if you think you have good investments and it turns out an active manager used poor judgement and invested in hedge funds and high risk bonds just before the credit crisis, you've got a big problem. But with a genuinely diversified index portfolio you don't have these concerns at all, just lower running costs and no unpleasant surprises."

Baker continues, "If you know you've got a good structure available why do you need an EBIS member to buy it? There are passive funds available that track the All Share Index and the FTSE100, without paying an adviser's fee, but this really misses the point. We are in the business of helping clients to achieve their financial goals. We build portfolios that protect capital and secure long term growth. The evidence tells us that the most efficient tool to achieve this is an index fund."

## ***Educating the media***

One of the problems EBIS has is educating the media to understand that passive investing is not simply buying an FTSE100 Index fund. The firms would not be in business very long if this was a solution. What's usually lost in the discussion is that there are a number of passively managed funds available that provide exposure to a large number of asset classes, these diversify and reduce portfolio risk, and a number of them are not readily available to the investing public.

Anyone who has a thought that indexing and passive strategies are a lazy way out of doing research is fooling themselves, Anita Gatehouse, EBIS Midlands says. "When you look at EBIS members these are professionals who have done more meaningful research than anyone else in the business. And this is why EBIS members have independently come to the same conclusions as the academic world."

"With the annual fees of passive funds ranging from 0.20 to 0.50%, EBIS clients are not going to be complaining. The overall management costs of our proposition are less than if a client tries to buy active funds or went with another adviser," confirms Gatehouse, "Importantly, a client can expect a better return for a given level of risk and the expenses are very much lower."

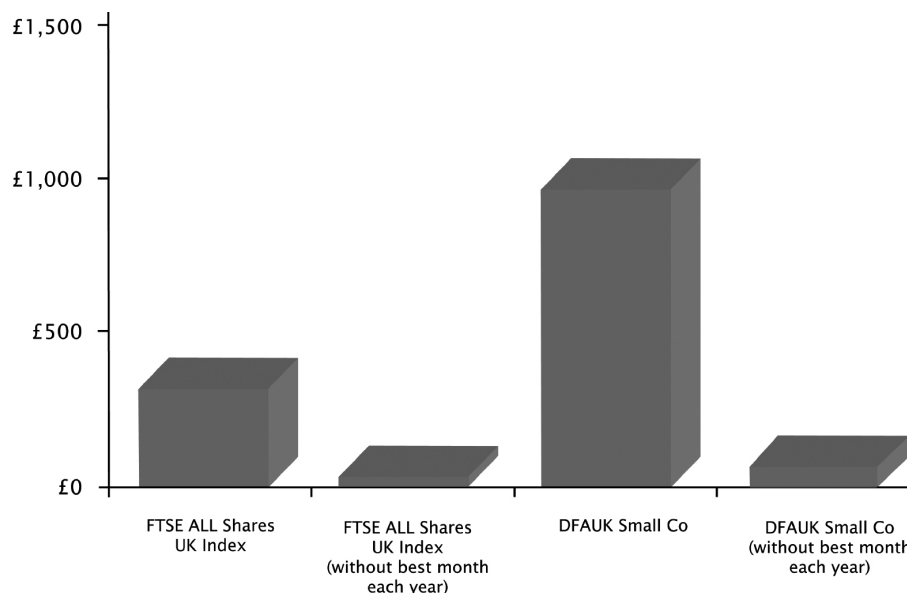
## ***Market timing***

One of the arguments put out by active managers is that they can beat index funds in a bear market, because unlike index funds they could theoretically move into cash during a bear market. Unfortunately for them, the evidence shows people rarely do a good job of market timing; in fact the end result is usually a disaster.

The only certainty is more expense for the client and a portfolio that fails to earn the market return a client deserves.

For example, taking the best month out of each calendar year, over the past 53 years, would have resulted in dramatically lower returns compared to those who were fully invested throughout the period.

*Right: Graph showing The Market Timing Problem*



One pound invested on 1st March 1955 in the FTSE All-Share UK Index would have accumulated to £591.32 by 31st December 2007. If you had missed the best month out of each calendar year, your investment would have grown to only £7.09 over 53 years.

The opportunities were more dramatic with UK small companies. As a result of this and other evidence, EBIS members spend a lot of time helping clients to 'behave well' and to avoid making mistakes, which they say is half of the battle.

## ***Past performance***

Perhaps the best advert for managing client wealth the EBIS way can be found in the literature of every active managed fund: "Past performance is no indication of future results."

The Financial Authority's own occasional paper concludes

"Information on past performance would not, in general, be useful to retail investors."

It could be said that trying to identify a good active manager in advance is like driving a car and only looking in the rear-view mirror. If you rely on historical track records, inevitably you are going to crash.

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