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# ADVISOR SYMPOSIUM

***MARCH 12–14, 2018***

***THE ISLAND HOTEL***

***NEWPORT BEACH***

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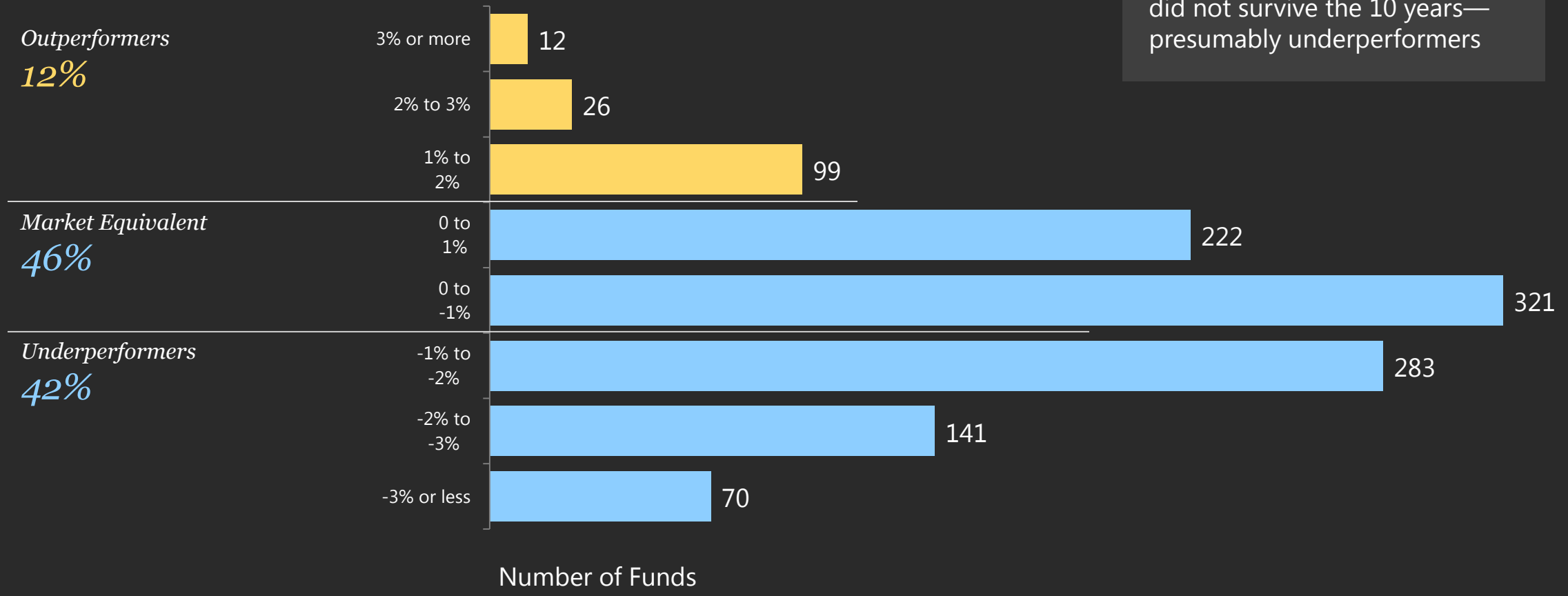
# Timing Poorly and Other Related Investment Sins

# Active Outperformance

**Excess Returns of Surviving US Large Cap Mutual Funds, 2005–2016**



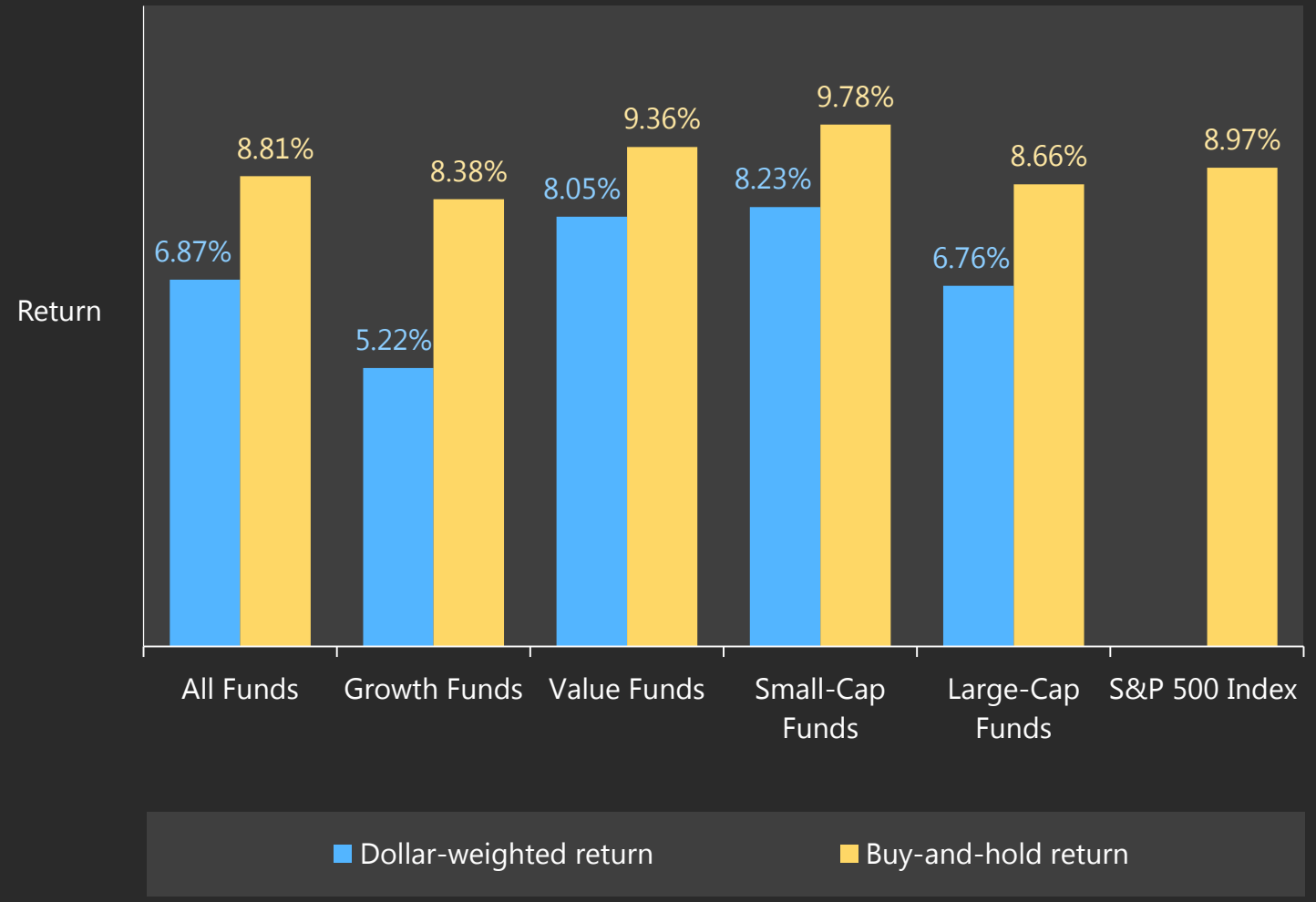

Excludes over 1,000 funds that did not survive the 10 years—presumably underperformers

Source: Research Affiliates, LLC, based on Lipper data for US large capitalization mutual funds. Mutual fund returns are net of fees. Chat has been recreated but based on Burton G. Malkiel, "Reflections on the Efficient Market Hypothesis: 30 Years Later," *The Financial Review*, February 2005, p.40.

# The Real Issue

# Empirical Evidence of Bad Investor Outcome

# Investor Outcome Is Ubiquitously Poor



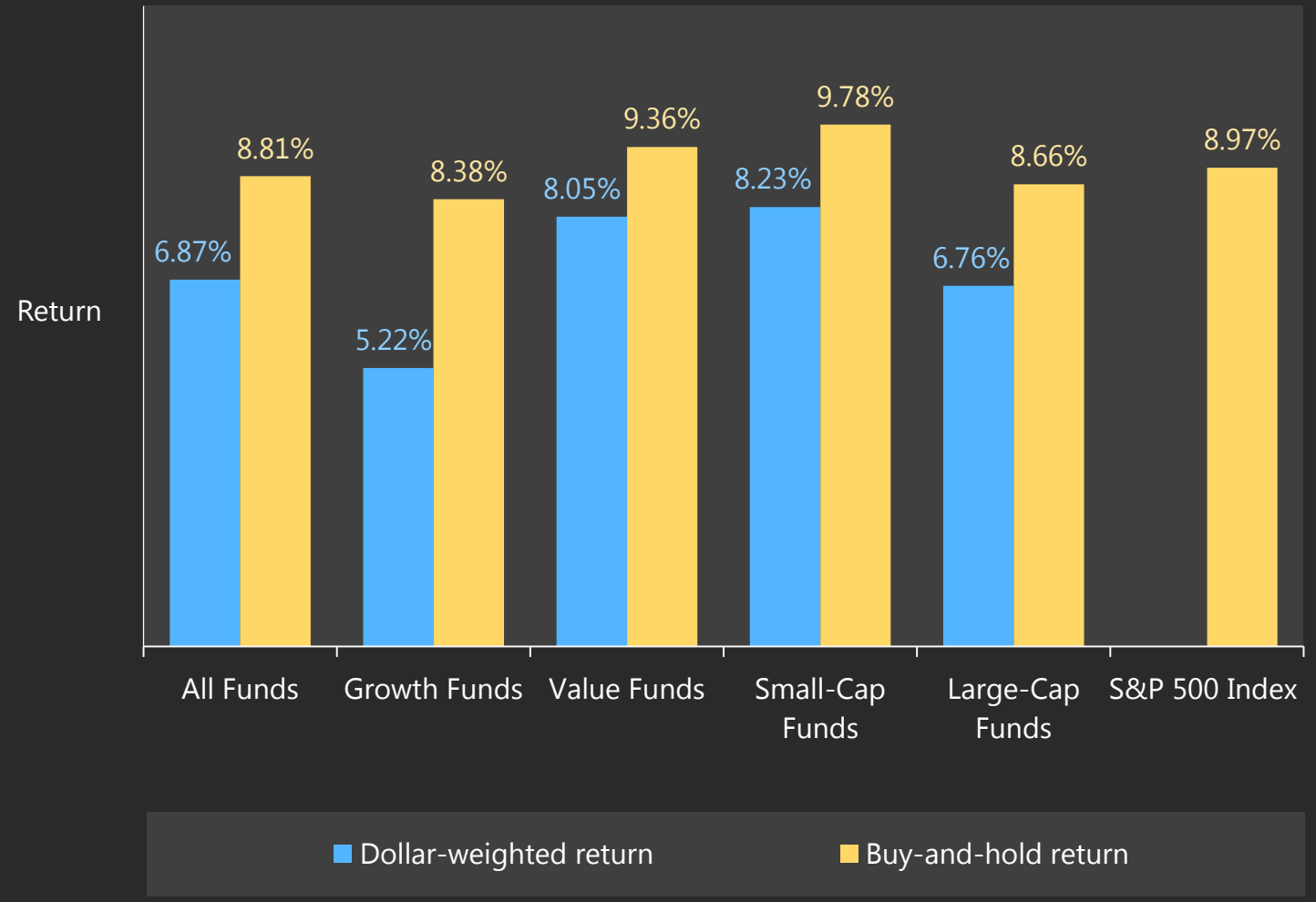

Source: Jason Hsu, Brett Myers, and Ryan Whitby, "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," *Journal of Portfolio Management*, Winter 2016.

# Computing Investor Success

» Dollar-weighted vs. Time-weighted returns
  – Time-weighted: manager performance
  – Dollar-weighted: investor outcome

» Return gap = Dollar-weighted – Time-weighted returns
  – Driven by timing of investor flow

# Investor Outcome Is Ubiquitously Poor




Source: Jason Hsu, Brett Myers, and Ryan Whitby, "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," *Journal of Portfolio Management*, Winter 2016.

# Value of Standard Financial Advice?

» Morningstar 3-star funds outperform 4 & 5-star funds (M* whitepaper)

» Institutional managers selected by pension consultants underperform those they recommend against (Goyal & Wahal)

Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *Journal of Finance*, August 2008.

# Modern Manager Selection Process Sucks

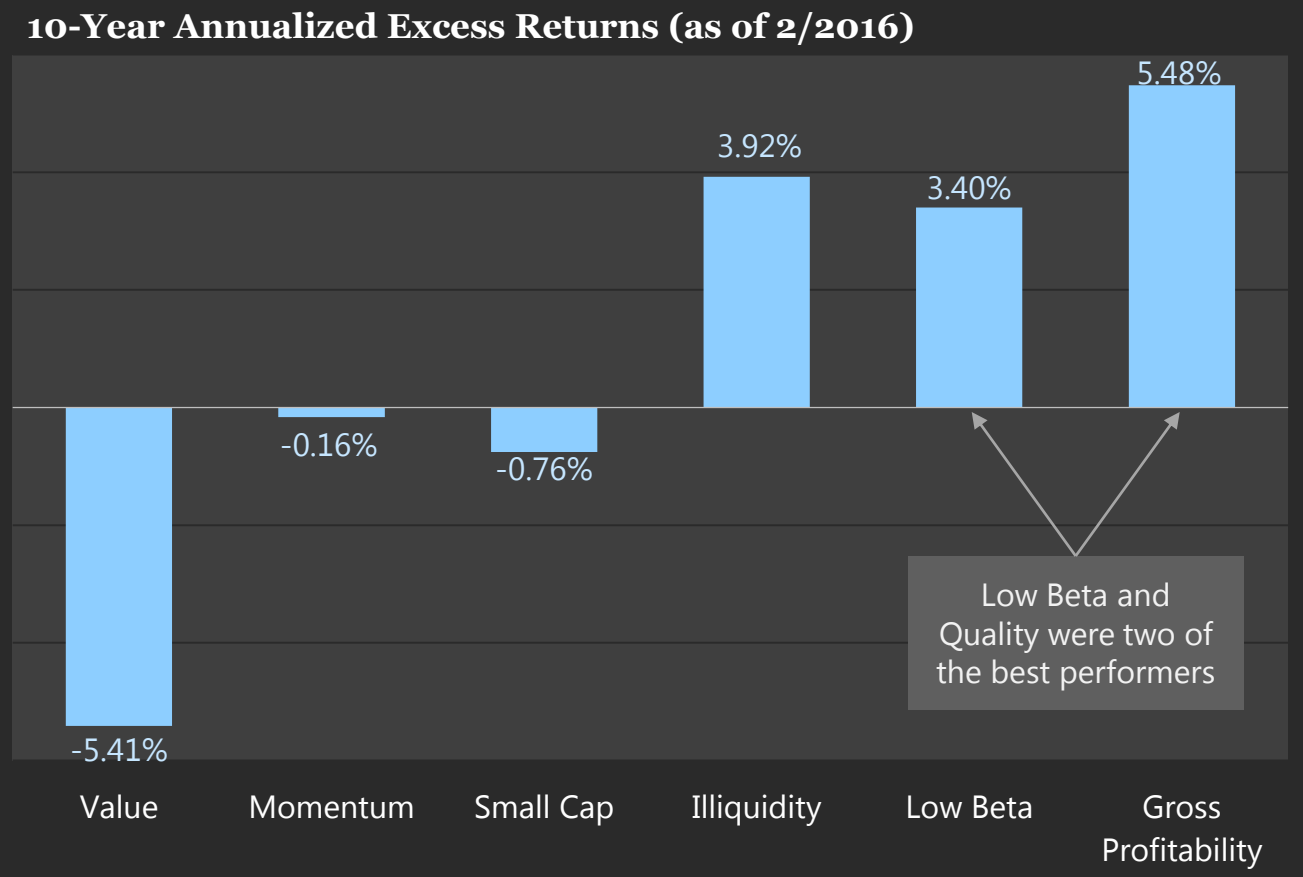
| | Winner Strategy | Median Strategy | Loser Strategy |
|---|---|---|---|
| Raw Return | 7.43% | 8.89% | 10.04% |
| Sharpe Ratio | 0.25 | 0.42 | 0.48 |
| CAPM Alpha | -3.61% | -0.85% | 0.40% |
| Carhart Four-Factor Model Alpha | -3.19% | -1.16% | -0.17% |

Input data: January 1994 to December 2015. Data source: Morningstar Direct.

Source: Bradford Cornell, Jason Hsu, and David Nanigian, "The Harm in Selecting Funds That Have Recently Outperformed," 2016.

# We Are All Bad at Market Timing

# Recent Factor Returns




Source: Research Affiliates, LLC. For more information, see full paper at:
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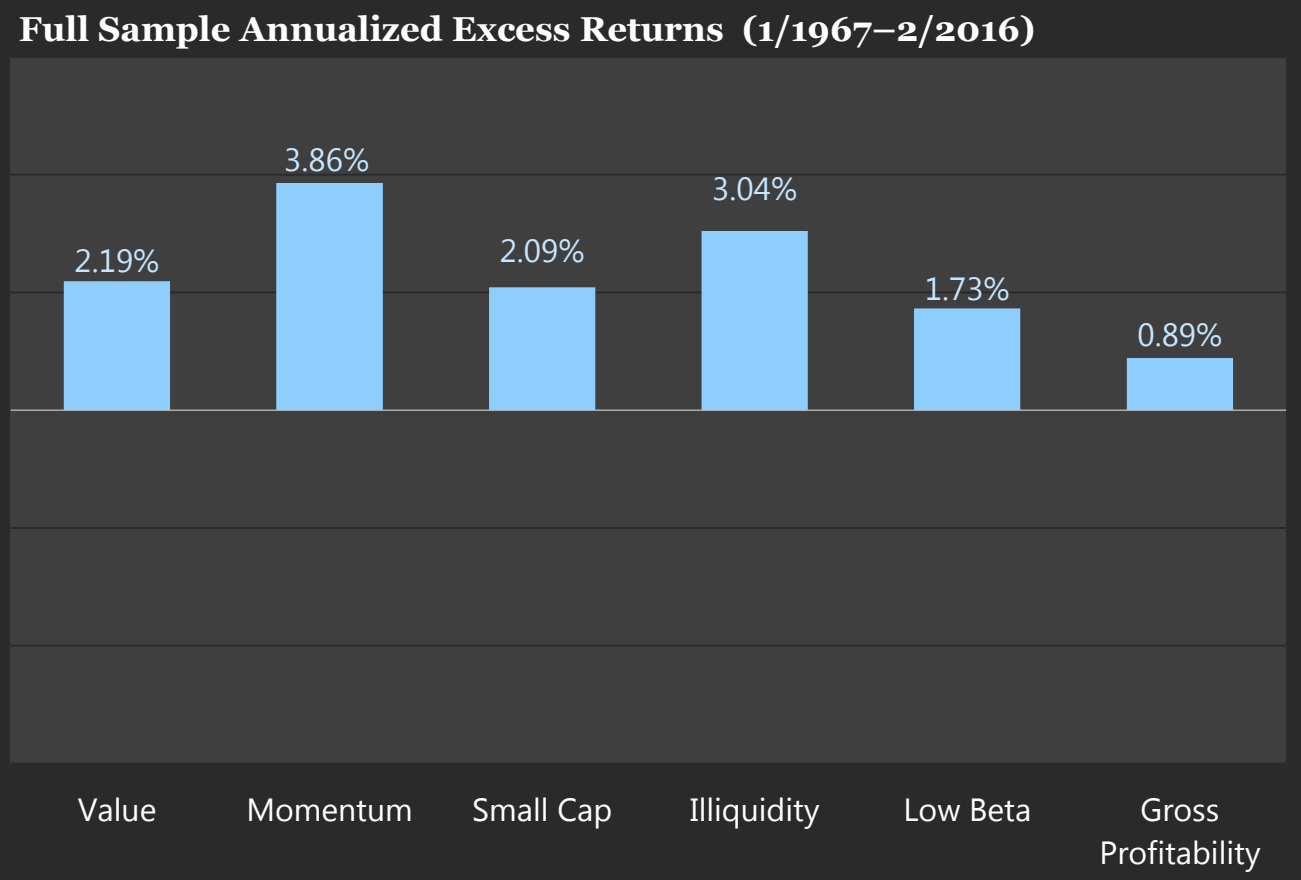
# Full Sample Factor Returns

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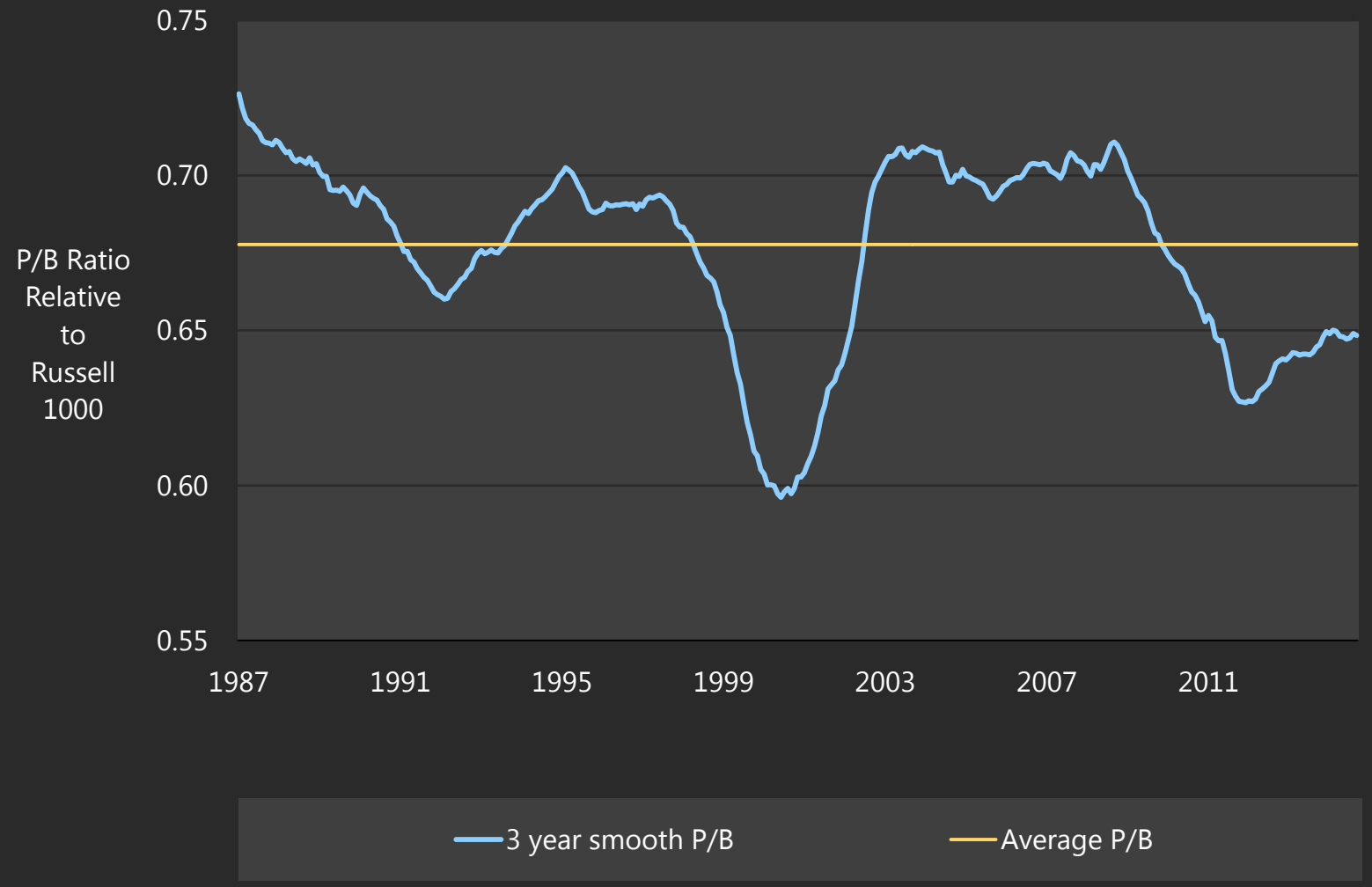
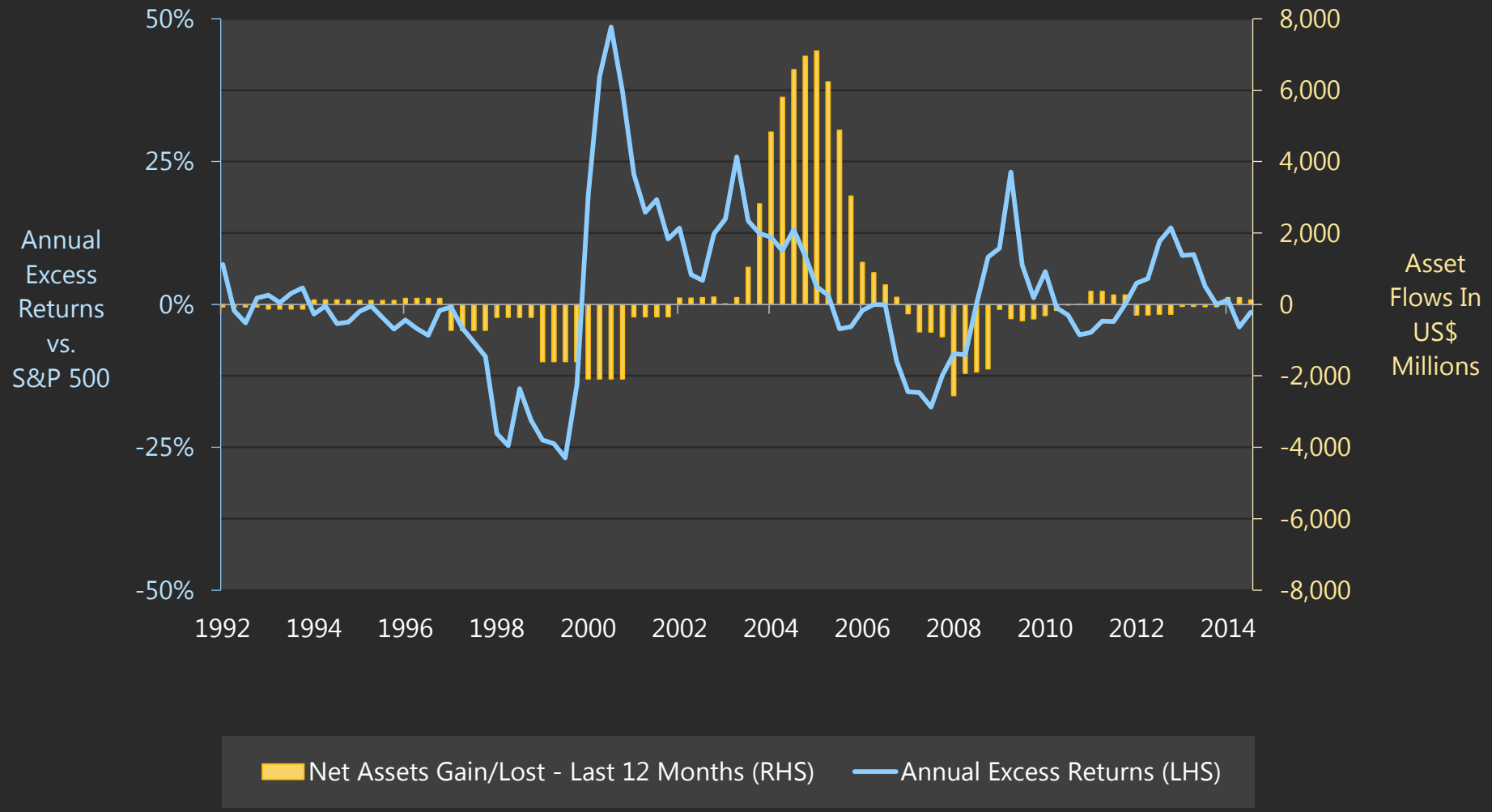
# Why Investors Do So Poorly?



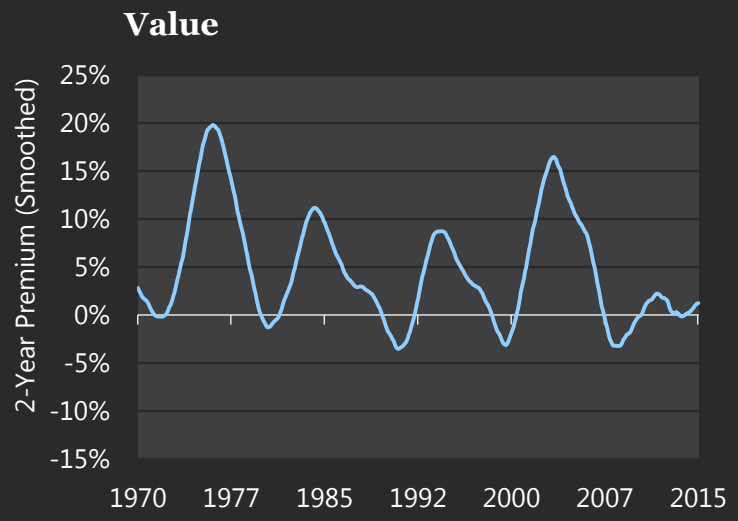

Source: Research Affiliates, LLC, from CRSP/Compustat from 11/30/1984 to 6/30/2015.

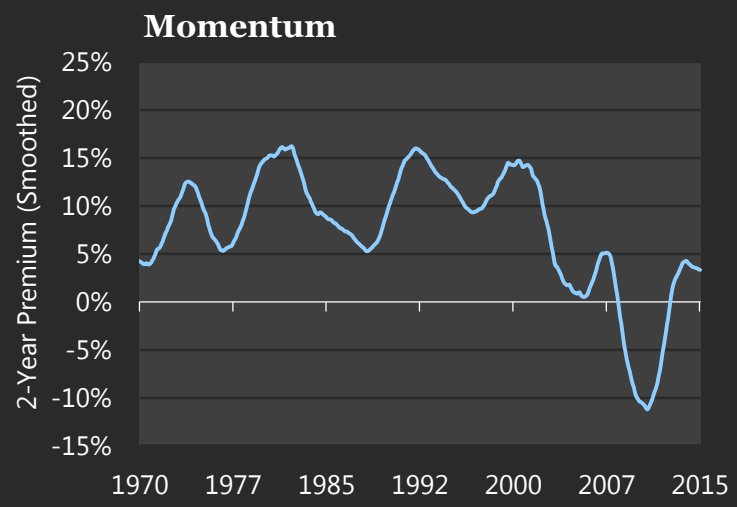
# Underperformance Is Due to Trend Chasing

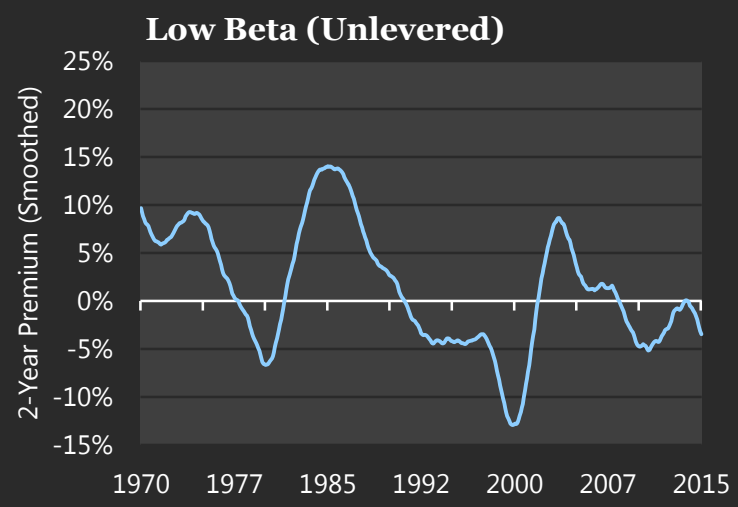


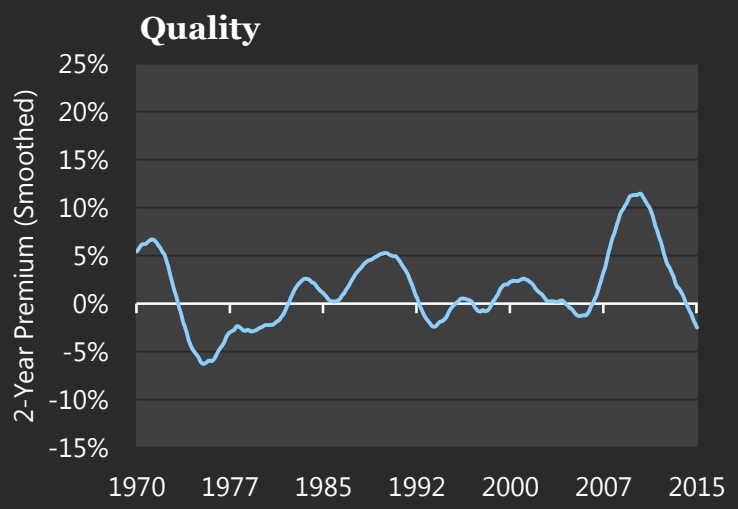

Source: Research Affiliates, LLC based on data from eVestment Alliance.

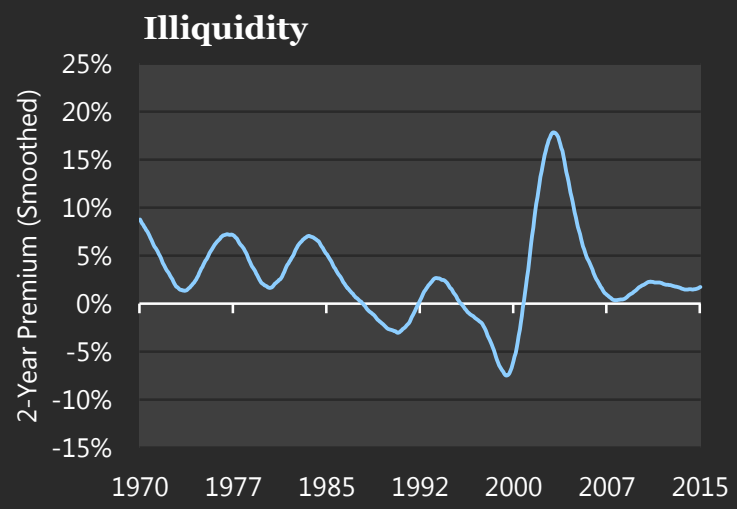
# The Style Premium Is Cyclical

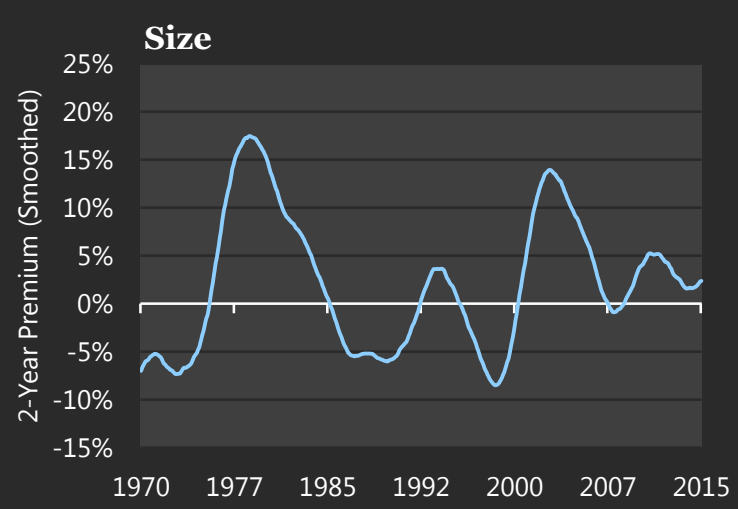


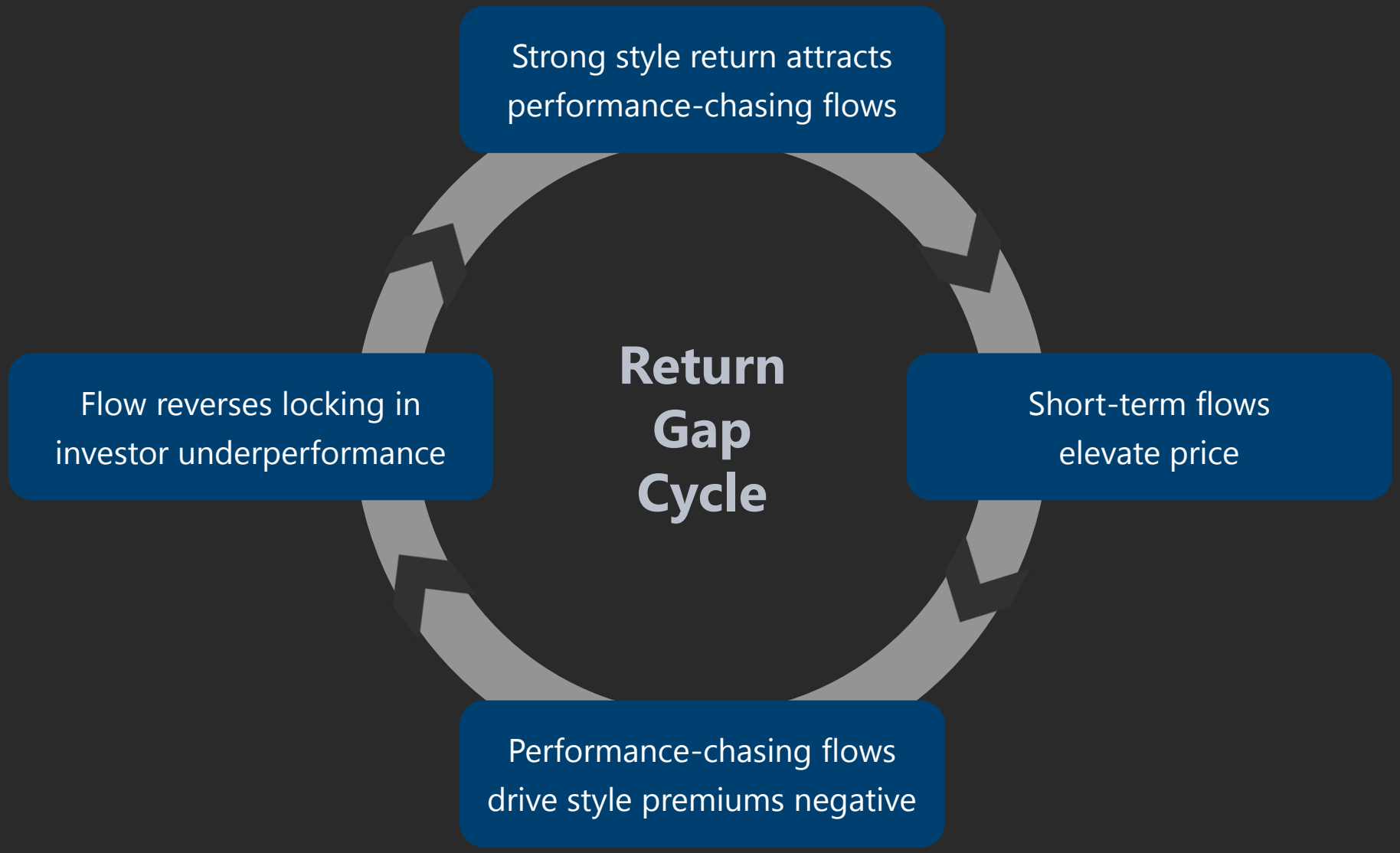



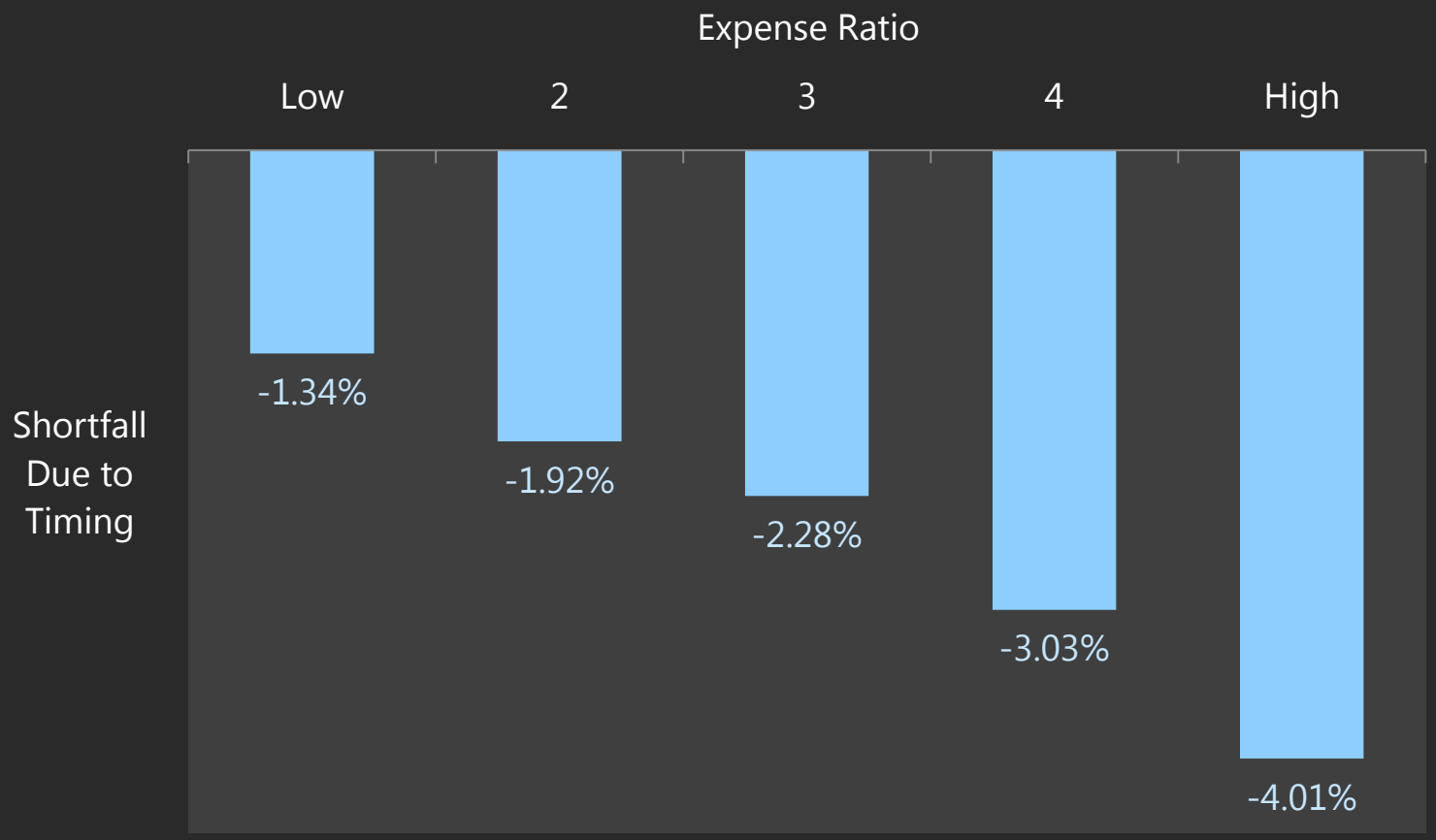




Source: Research Affiliates, LLC, from CRSP/Compustat from 1/1967 to 12/2014.

# Flow Responds to Recent Performance

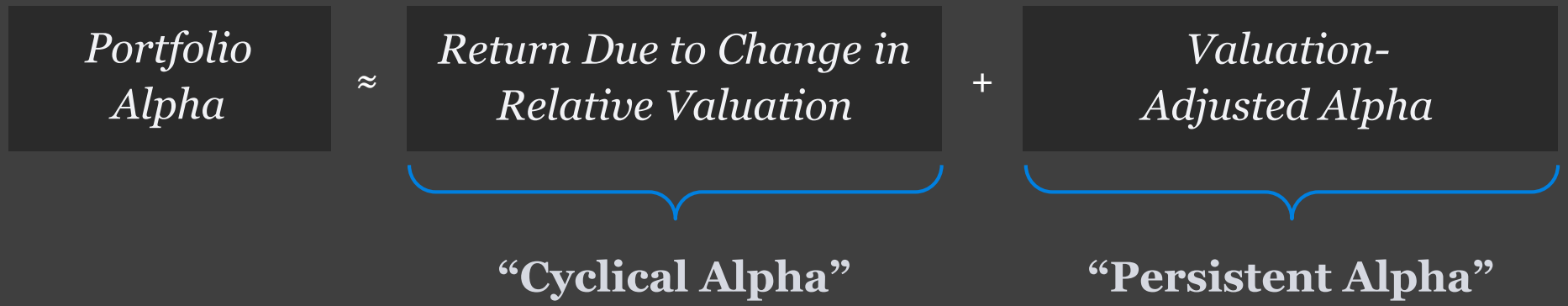


# Investor Shortfall by Expense Ratio



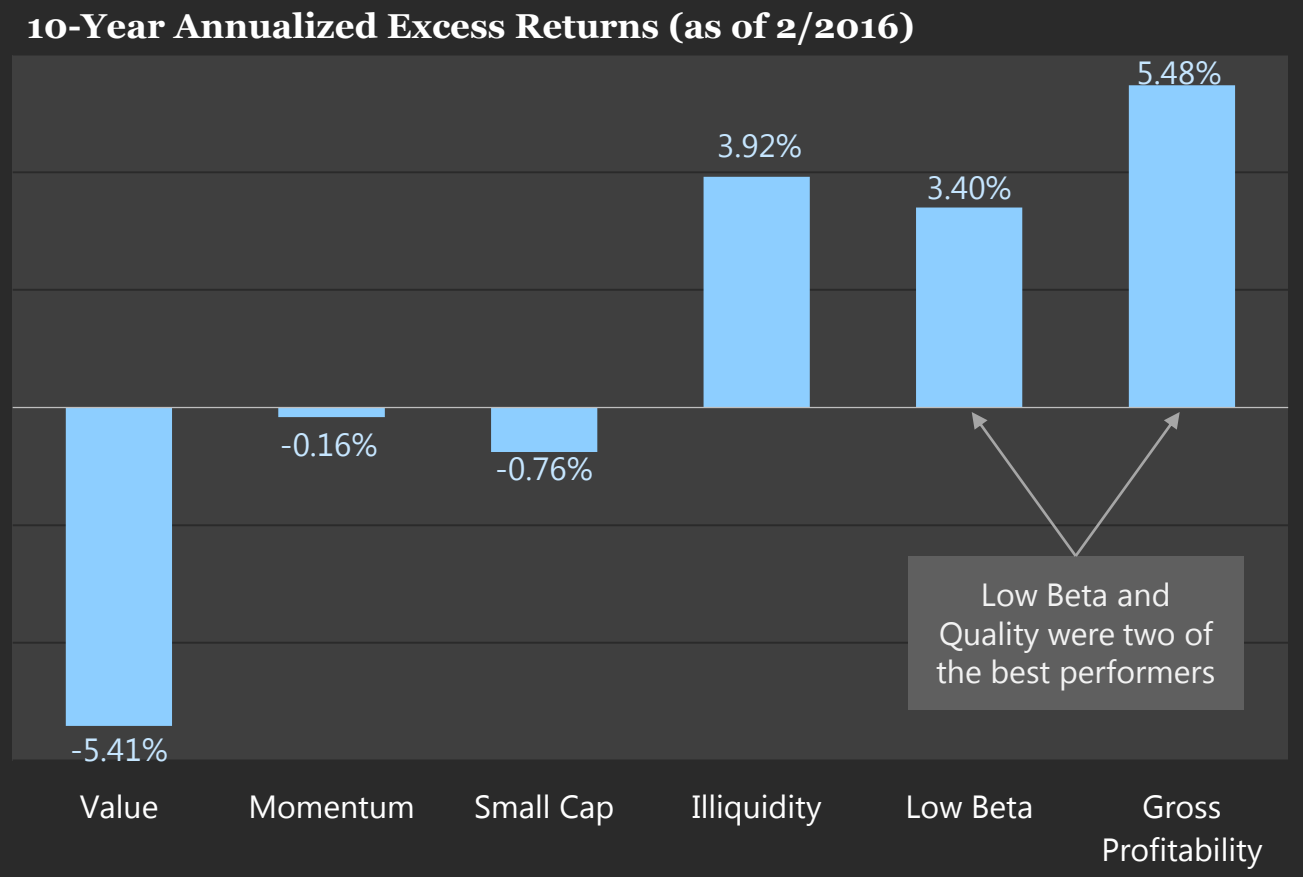
# How Should You Really Estimate Performance?

# Alpha Decomposition




- Alpha due to change in relative valuation
  - Is mean reverting and averages roughly zero in the long run
  - Contributes significantly to strategy performance in the "short run"
    - *"Short run" can mean decades!*
- Alpha adjusted for change in relative valuation is a good measure of unconditional expected return of a strategy

# Recent Factor Returns

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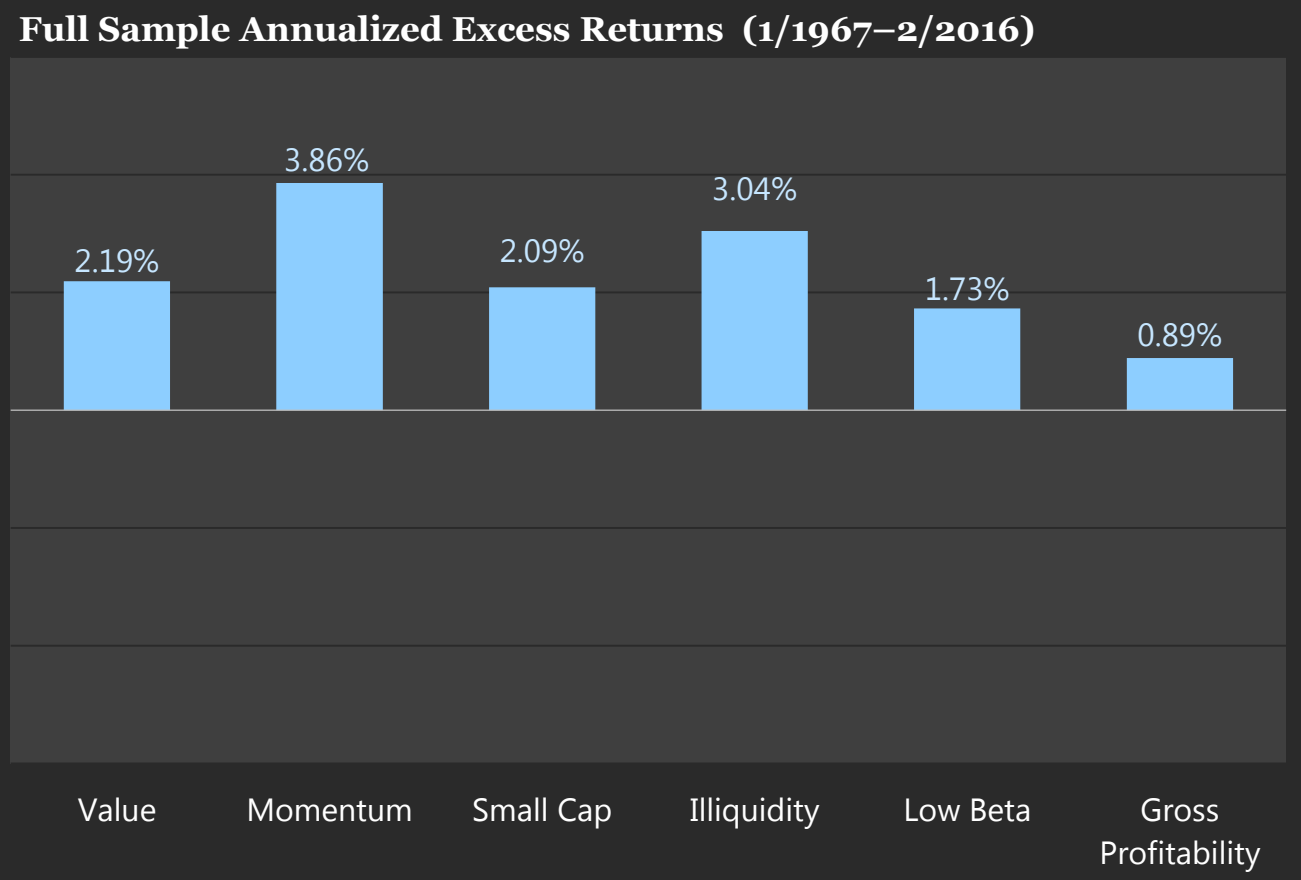
# Full Sample Factor Returns

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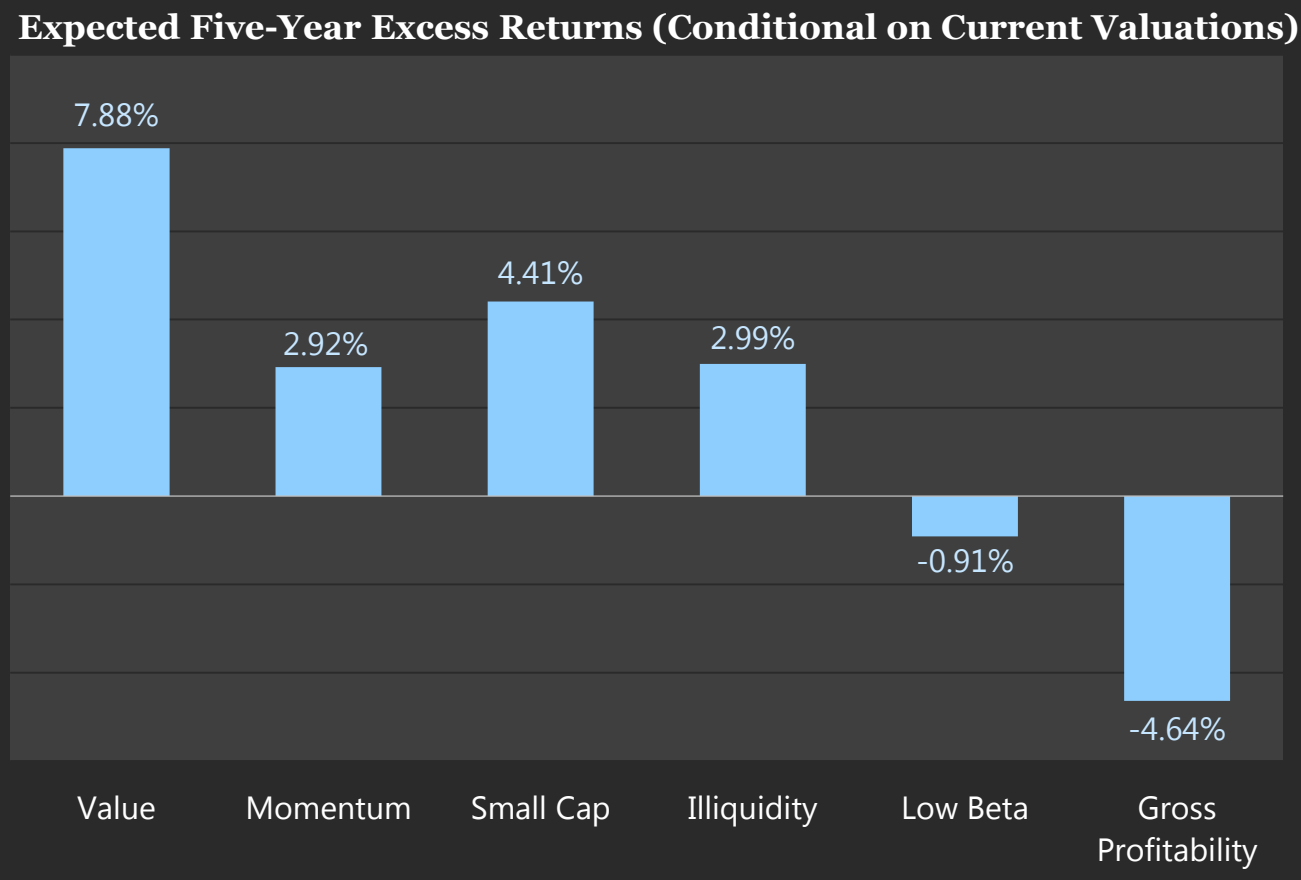
# The Journey Ahead

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# Summary

- Poor investor outcome is not driven by managers but by how the ecosystem sells products
- We time aggressively as a result of our manager/product selection, and we time very poorly
- We have a fundamentally flawed understanding about performance generation

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