MILLEN CAPITAL

Your Adviser's role as your investment coach

Summary

It is always tempting to judge the value of your adviser on the recent performance of your investment portfolio. That is unfair as it fails to understand the true value that a good adviser delivers (leaving aside the valuable financial planning advice that they also provide) and the fact that no manager can control the returns that the market delivers. Their true value lies not just in the robust structuring of a portfolio, but as a foil to avoid the truly dangerous combination of investor emotions and bad, yet often tempting, investment ideas. A good adviser can earn their ongoing fee several times over, simply by helping clients to have patience, fortitude and discipline in their investing.

Client Communication 5

30 January 2015

Your adviser's role as your investment coach

> "If I have learned anything from my 52 years in this marvellous field, it is that, for a given individual or institution, the emotions of investing have destroyed far more potential investment returns than the economics of investing have ever dreamed of destroying."
>
> John Bogle, Founder, Vanguard Group

Investing: simple, but not easy

It is, without doubt, hard to be an investor. The dreams that we all hold – perhaps of a comfortable retirement, providing financial assistance to our family or community, or to pursue philanthropic works - are to a lesser, or greater, extent funded by the returns that an investment portfolio provides. No-one likes to see losses on their portfolio, but short-term losses are part and parcel of investing for anyone trying to protect or grow the long-term purchasing power of their assets. It's always a case of two steps forwards and one step back. When investors truly understand that investment returns never come in a straight line, but are made up of the ups and downs of the returns that the markets – not advisers - deliver from one short-term period (e.g. the year between valuation reports) then investing becomes easier, but not easy.

In this short paper we will explore the true value that a good adviser will bring to the client's investment programme.

Value level 1: Building a robust portfolio for all seasons

The first step in the investment process is to decide what to invest in. The choice is vast, but the solution – provided you have an astute adviser at the helm – can be reduced down to an elegantly simple set of risk choices, where the returns that these risks should deliver are captured using institutional quality, low cost 'passive' funds that try and deliver the return of each market risk as effectively as possible (rather than trying to beat the market, which is a futile pursuit according to the evidence). The first and primary decision to make is to decide how much to invest in growth assets, such as equities, and how much to invest in defensive assets, such as high quality bonds that will offer protection from large falls in the value of the growth assets the investor owns. The overall mix of investments is known in the industry jargon as 'asset allocation'. The Sandler Review commissioned by HM Government entitled 'Medium and Long-Term Retail Savings in the UK (2002)' concluded:

'For the individual investor, the asset allocation decision is by far the most important factor in determining returns.'

A good adviser will have a disciplined screening programme that will ensure that each type of investment (asset class) is worthy of its place in the portfolio. As David Swensen, who, as CIO of the Yale University Endowment, is one of the most highly regarded institutional investors in the world, states:

'By understanding and articulating the role played by each asset class, investors avoid making allocations based on the fashion of the day.'

The thing to remember is that in investing there is no single perfect solution to building a portfolio. Success lies in a sensible structure with the long-term attributes of each portfolio building block contributing positively to the overall portfolio, and the recognition that in the short-term, some elements of the portfolio will do well and other elements less so. It is always important to remember that the markets will do what they do and no investor can control them. The advice provided by William Bernstein, who is a prolific author on investing and an adviser, is as follows:

'Since the future cannot be predicted, it is impossible to specify in advance what the best asset allocation will be. Rather, our job is to find an allocation that will do reasonably well over a wide range of circumstances.'

These days, building a robust portfolio structure and populating it with high quality, low cost products that capture the rewards for the risks taken on, is perhaps the easiest part of the investment process.

Value level 2: Maintaining the efficacy of the portfolio and avoiding fads

Once a portfolio has been established, the next level of value that an adviser delivers is often hidden from sight. Given that a long-term portfolio structure has been put in place, and best-in-class funds have been selected to execute the strategy, it is quite usual that from one period to the next, nothing much changes on the portfolio. It appears that nothing is going on from the adviser's side. Some investors may even begin to feel that their adviser is not doing much for their money.

Nothing could be further from reality. Behind the scenes a good advisery firm will have an Investment Committee that meets regularly to monitor how each fund is performing, look at any new funds that might compete for best-in-class status, review new asset classes and investment ideas using the same rigorous and disciplined process used to select the incumbent investments in the portfolio, challenge the low cost 'passive' fund approach by reviewing the latest empirical research, and finally reaffirm or propose changes to the portfolio's structure or funds recommended.

In fact a good rule of thumb is that the more complex a portfolio, the greater the number of funds used and the higher the level of activity that you see, the lower the chances of a successful outcome. Less is often more in investing and a longer-term view is preferable to short-termism. As the renowned investment consultant and author Charlie Ellis states:

'In investing activity is almost always in surplus.'

It is the discipline of the Investment Committee that stops clients getting sucked into investment fads and flavour of the month investment ideas: these might range from the more esoteric investments in Ecuadorian rain forests and traded life settlement funds that are now deemed unsuitable for retail clients, to gold and low quality (high yield) bonds. As Donald Trump is reputed to have stated:

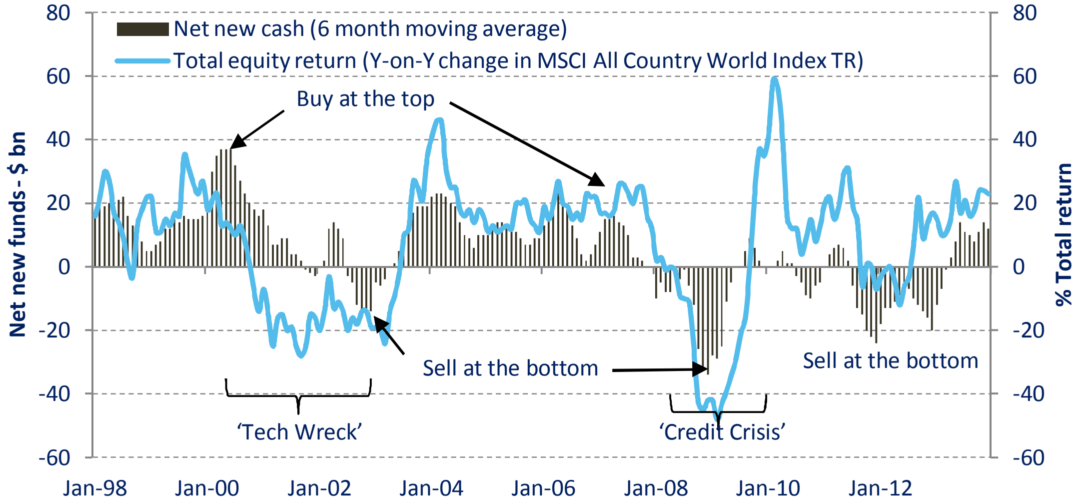
'Sometimes your best investments are the ones you don't make'

Value level 3: Providing support and guidance along the way

In a relative sense, building and maintaining a portfolio is the logical, straightforward part of investing. The harder part is having the confidence and emotional fortitude to stick with the programme through thick and thin. A good adviser will take every client through a disciplined risk assessment process which takes into account both the emotional and financial consequences of the trade-off between hoped-for returns and possible losses. They will also take time to explain the role of each of the assets plays in the portfolio. Even so, when markets – particularly equities - are either going up or down with great magnitude, as they inevitably do from time to time, an investor's emotions will kick in either in the form of greed or fear. As human beings, we simply can't help it. Given that investors feel the pain of losses twice as much as the pleasure of gains, they are most vulnerable at times of market falls. A good adviser needs to act as an emotional counter-weight at these times and reinforce in the client's mind (engaging the logical side of their brain) that the portfolio is structured as it is for a specific reason and knee-jerk reactions should be avoided at all costs.

Whilst most investors probably acknowledge these feelings, recent evidence reveals that we are, collectively, truly hopeless at stopping ourselves from engaging in wealth destroying investment decisions that result in buying at the top of markets and selling out at the bottom. Take a look at the chart below, which compares the flow of money into and out of equity mutual funds in the US to the year-on-year performance of the global equity markets. Everyone logically knows that to make money one must buy something at a low price and sell it at a higher price. But the consequences of greed and fear result in exactly the opposite behaviour. Investors load up on equities at the top of the market and sell when the markets crash, time and time again. The largest ever inflows into equity funds occurred almost exactly at the top of the tech boom in early 2000. The biggest outflows occurred at the lowest point of both the 'Tech Wreck' and the 'Credit Crisis.' In short, positive market returns result in investors buying equities and negative market returns result in investors selling equities!

Figure 1: US investors – net new cash flows vs. equity market returns (1998 to 2013)



Source: Investment Company Institute. Copyright. All rights reserved 2013

More evidence and quantification of the wealth destroying impact of emotion is revealed by looking at the difference between the returns that funds deliver (where the impact of investor flow, into and out of the funds, are ignored) and the returns that investors in funds actually achieve (which take into account the timing of when they get in or out). The former returns are known as time-weighted returns and the latter as money weighted - or investor - returns. Research by Morningstar[1], who provide fund performance data to investors around the world, reveals that across a number of different categories of funds in the 10 years to December 2013, the average difference on an annual basis between the returns of a fund and those that the average investor receives is -2.5% per annum to the detriment of investors, on account of their poor entry and exit timing. Given that most advisers charge 1% as an ongoing fee, which should also include comprehensive financial planning and regular goal tracking, it is easy to see the value of employing a steady hand to guide an investor through choppy waters.

Value level 4: Instilling the fortitude and discipline to rebalance

At the outset of a portfolio, the appropriate level of portfolio risk is established. Over time, and accentuated by rapid market rises or falls, the balance between riskier growth assets and defensive assets can drift away from the desired balance. The Credit Crisis, that began in late 2007 and reached its nadir in early 2009, provides a good example of this drift. A portfolio with 60% in UK equities and 40% in short-dated UK gilts would have ended up with around 44% in equities and 56% in bonds between the November 2007 and the end of February 2009. Given the emotional pressures at the time, on the evidence above, many would have been tempted to sell even more equities and reduce this balance further. In reality investors should actually have been selling down their now overweight position in bonds and buying equities, in order to return the portfolio to the level of risk that they originally set out to achieve. In the industry, returning the portfolio structure to the original plan is known as rebalancing.

David Swensen describes the value and challenges of rebalancing as follows:

[1] Mind the Gap 2014 by Russell Kinnel, Morningstar. http://news.morningstar.com/articlenet/article.aspx?id=637022

'The fundamental purpose of rebalancing lies in controlling risk, not enhancing return. Rebalancing trades keep portfolios at long-term policy targets by reversing deviations resulting from asset class performance differentials. Disciplined rebalancing activity requires a strong stomach and serious staying power.'

Investors who don't rebalance their portfolios might theoretically end up with more money (as equities are likely to deliver higher returns than bonds over longer time periods), but they will suffer worse falls than portfolios that are rebalanced. These falls may end up being too large to stomach resulting in bailing out of the strategy. Rebalancing forces investors to sell assets that have done well and to buy assets that have done less well. As the legendary investor Warren Buffett says about his investment strategy at Berkshire Hathaway:

'We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful'.

Those who rebalance their portfolios are in good company! Good advisers will have the discipline, process and stomach to make sure that their clients rebalance just at a time when they think that this is the last thing they want to do.

Value level 5: Doing the boring stuff

The final level of value that an adviser delivers is undertaking some of the menial, yet highly valuable, administrative functions such as ensuring that ISA allocations are made use of and that capital gains are taken in a controlled manner, avoiding as little time out of the market as possible. We all hate paperwork, so let someone else take care of it!

In conclusion

Whilst the structuring of a robust 'portfolio for all seasons' is the primary step in the investment process, the true value of the adviser, goes way beyond this. It is highly likely that if an investor took the portfolio that the adviser set up and decided to manage it themselves, they would end up with a less favourable outcome in the long run; new, better funds might be available that would be missed, the portfolio might need to be refined over time, all sorts of new investment fads and ideas might tempt them without the proper due diligence to understand what the risks and rewards are likely to be, and when markets crash, it is unlikely that they will have the fortitude to rebalance and may bail out altogether. Making use of ISA allowances and managing capital gains is also an important administrative function that matters, which takes knowledge and discipline to execute. Failing to do so would be costly. Investing is never easy, but a good adviser will make it easier and the chances of success are higher than going it alone.

Other notes and risk warnings

This article is distributed for educational purposes and should not be considered investment advice or an offer of any product for sale. This article contains the opinions of the author but not necessarily the Firm and does not represent a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed.

Past performance is not indicative of future results and no representation is made that the stated results will be replicated.

Errors and omissions excepted.

About us

Millen Capital Partners LLP is authorised and regulated in the United Kingdom by the Financial Conduct Authority (FCA) (FRN: 518934), is registered in England and Wales under Company No. (OC351596).

The registered office address of the Firm is: 10th Floor, Horton House, Exchange Flags, Liverpool, L2 3YL.

Contact us

Please contact us on +44(0) 151 236 4988 or via email:

Angus Millen, Chartered MCSI

Chartered Wealth Manager & Founding Partner

E: angus@millencapital.com

Gareth Lyttle BA (Hons), Chartered FCSI

Chartered Wealth Manager

E: gareth@millencapital.com