Fees and Gimmicks Are Squandering Your Investment Returns

April 23, 2019

by Dejan Ilijevski

Advisor Perspectives *welcomes guest contributions. The views presented here do not necessarily represent those of* Advisor Perspectives*.*

The following article is intended for retail investors. However, our editors believe it merits use by financial advisors for their clients.

Why do we invest? Most of us need to invest in order to fulfill our financial and retirement goals. By taking risks in capital markets, we expect a return on our investment that will at least outpace inflation. Inflation determines how much the purchasing power of our wealth will erode over time. Although investing means taking risks, not investing also means taking risks.

Unfortunately, most investors still don't know which actions will help their odds of investment success. There is just too much noise and nonsense that confuses, scares and nudges us into making the wrong decisions.

For example, when you tune in to any financial news channel, you are persuaded with sensationalized market information. The flashing visuals about stock price movements, the conveyor belt of talking heads and the broadcasts from the chaotic, noisy floors of the exchanges enforce viewers' anxiety about being left out of the game. It seems that every day is full of opportunities for making profits and avoiding losses. Indeed, the financial media and the investment industry want you to think that you need their knowledge. Otherwise, why would you watch? And, the more confusing investing in the markets seem, the more you are willing to pay the experts for their advice.

Investing based on the evidence

What if decades of data, peer-reviewed research and real-world evidence suggest that forecasting is a losing investment strategy? This would then say that market-timing, stock-picking and other conventional strategies that try to outguess or outwit the markets are cost-generating gimmicks. It would argue that the talking heads and the so-called market "gurus" have no more insight about where the markets are headed than you do. And it would mean that financial news and headlines have no impact on your long-term investment success. It would contradict everything that you've been taught about investing.

©2019 Advisor Perspectives, Inc. All rights reserved.

Well, that happens to be the case, and academics and many professionals have known this for a long time.

In 1933, Aldred Cowles III published in the journal *Econometrica* a paper entitled Can Stock Market Forecasters Forecast? He found that the financial institutions produced returns that were 1.20% worse a year than the DJIA; and media forecasters trailed the index by a massive 4% a year. We can even go back further to 1900, when the French mathematician Louis Bachelier, in his PhD thesis, The Theory of Speculation, demonstrated that security prices move in such a random fashion that, “the mathematical expectation of a speculator is zero.”

John Bogle, founder of Vanguard, knew that fees chewed up returns and that most investment managers underperformed the market. In 1976, he introduced the first index fund, the Vanguard 500 Index Fund, which instead of trying to beat the market, simply matched the market (in this case, the S&P 500 index). It didn’t require much overhead, there was no active manager and he kept the fees to a minimum, far lower than the rest of the industry. When he died on January 16, 2019, investors who stuck with his philosophy by investing in the first index fund have had a cumulative total return of 8,559%. Warren Buffett once said, “If a statue is ever erected to honor the person who has done the most for American investors, the hands-down choice should be Jack Bogle.” Vanguard continues to be among the best options for low management fee index funds.

There happens to be a simple, yet powerful idea that helps explains why forecasting is difficult – an idea that should convince you to embrace the markets, rather than trying to beat or outwit them.

Markets are efficient information-processing machines

Think of the markets as an efficient information-processing machine. Millions of participants quickly incorporate the latest news, information and expectations into security prices. It doesn’t mean that prices are always right; it means that prices are fair, the best estimate for what a security value should be at any one time because millions of participants can better estimate the fair value of a security than can an individual.

This theory that asset prices fully reflect all available information is referred to as the efficient market hypothesis. It was developed in the 1960s by Eugene Fama, an economist and professor of finance at the University of Chicago Booth School of Business. He won the Nobel Prize in 2013.

If markets are efficient, then the only way to predict what tomorrow will bring is to know tomorrow’s news. It’s the news that will drive securities prices tomorrow. If news, by definition, is information not previously known, then how do you predict it? Well, you need a crystal ball or some magical powers.

Does your advisor have magical powers?

Brokers and advisors sometimes try to persuade you that their technical analysis is akin to having a crystal ball. Unfortunately, charts tell you nothing about the future. When I was a yield-curve trader at the Chicago Board of Trade, I routinely transacted over $1 billion dollars per day. I was a technical analysis expert, monitoring multiple screens devoted to more than 30 charts. Yet I was good at trading

©2019 Advisor Perspectives, Inc. All rights reserved.

because I could swing trades around market volatility, not because I knew where the markets were headed. Of course, even the most mindless of technical analyses will work sometimes and even for a short while due to sheer luck. The most basic of these systems include moving averages and mean reversion, which happen to be popular with brokers and some advisors. You might as well make your next investment decision by throwing a dart at a board.

If not with technical analysis, then what about relying on fundamentals to make investment decisions? Because markets are so efficient, fundamentals are already “priced in,” as are expectations about the fundamentals. Notice how quickly the markets react to the latest economic indicators as soon as they are released (like GDP, the unemployment figures and the Fed funds rate announcements). Even a good result (e.g., the economy added 200,000 jobs) can lead to a downturn in the markets because it wasn’t as good as what the market participants expected. Unfortunately, fundamentals turn out to be useless indicators for market predictions.

The next time that your broker or advisor tries to impress you with a chart or a spiel about market conditions to explain the basis for their trading advice, remember that it’ll be tomorrow’s news and information that will drive the markets, not what happened today or yesterday. Without a crystal ball, your advisor is simply guessing in order to inflate their value or to justify their fees or commissions while you take all of the risk.

Professional traders use the latest in technology, co-located servers and real-time news aggregation services and rely on powerful automated strategies to compete in the milli- and microsecond high-frequency space. By some estimates, more than 90% of these professional traders can’t sustain a career. Turnover is high. What makes you so sure that it is your broker/advisor is that special one who can not only outwit the professional traders in the short run, but can also consistently beat the markets over longer time frames? Your odds are not very good.

What about paying financial professionals a premium for access to superior strategies? The only thing that higher costs guarantee is that more wealth will trickle up from your account to the pockets of your broker/advisor. Be wary of commissions, sales loads, high expense ratios, unreasonable AUM fees, frequent trading or high portfolio turnover, account maintenance fees, operating expenses, 12B-1 fees and other fees, some of which will be hidden. Minimizing your costs should be one of your main goals. It’s one of the few things that you can control when you invest.

Unfortunately, the financial industry continues to be entrenched with high costs and speculation gimmicks. If that’s the case, is there any good news? Actually, all of this turns out to be awesome news for every investor, regardless of age, income, wealth, or investment experience.

To improve your odds of investment success, shift your focus to the longer term. Invest (rather than speculate), embrace the markets (let them work for you, rather than trying to beat or outwit them) and minimize costs (keep more of your returns). You’ll no longer be anxious or confused about the current financial headlines. You won’t need to stress about chasing performance. And, you’ll avoid paying a broker/advisor a premium for their supposed trading skill (since the overwhelming likelihood is that they don’t have any).

©2019 Advisor Perspectives, Inc. All rights reserved.

Start with an investment plan

At the very least, your plan should define your portfolio asset allocation. If volatility makes you nervous, then you may be better off with more bonds than stocks. On the other hand, if you are relatively young and don't pay attention to the market dips and swings, tilt your portfolio to mostly stocks. Think of volatility as your payment for returns. Without volatility, there would be no risk, and without risk, there can't be an expectation for reward. The more risk you take, the higher will be your expected reward. To increase your expected returns, you'll have to endure more frequent and more turbulent portfolio swings. Remember, even when they seem out of control, the markets deliver returns over the long term.

The capital markets have rewarded disciplined, long-term investors. Only if you understand where returns come from will you more likely stay in your seat during the next market turmoil.

Diversify your portfolio

When you invest only in one stock, you are exposed to the uncompensated, unsystematic risk of that security. By diversifying with 100, 1,000, or even 10,000 securities, you minimize the risks for which you will not be compensated. It is the only "free lunch" when it comes to investing.

But diversifying only within your home market (e.g., U.S. stocks and bonds) may not be enough – the U.S. equity market rarely outperforms other developed markets on a consistent basis. Instead, global diversification will broaden your investment opportunity set. By holding a globally diversified portfolio, you'll be well positioned to seek returns wherever they occur.

Invest with index funds

Index funds not only help you diversify, but they also minimize costs. Some index funds even have expense ratios that are at or close to 0%.

You may have heard that index funds are boring and average. Well, yes, investing with index funds is indeed boring. Fortunately for you, boring is very good, it's what will help you succeed in the long run. You should look for boring when investing. If you want exciting, take your money to Vegas.

What about indexing being average? Well, there are still many myths about index investing that are meant to confuse you. As more investors continue to flock toward index funds, the less profitable big brokerage firms and your broker/advisor will be. Long-term, disciplined investors who rely on low management fee index funds have done better than most of their peers and the professionals. It's anything but average.

If you need help, find a fiduciary

If you need an advisor (even if it is someone to simply help you determine your risk tolerance), seek out a reputable, fee-only fiduciary advisor. Fiduciary advisors must work only in your best interest. This is in stark contrast to the "suitability" standard by which most brokers operate. This standard requires

©2019 Advisor Perspectives, Inc. All rights reserved.

that brokers sell you products that are “suitable” for your needs, even if owning those products is not in your best interest. Unfortunately, the investment industry has been slow to move toward a fiduciary standard of care in where all licensed financial professionals legally must give advice that is in their clients’ best interest only.

Fee-only means that the advisor is not working on commissions. A fee-only fiduciary charges you for advice, not for selling financial products. They are only compensated by you, their clients, not by some third party, which means that they minimize conflicts of interest.

To help your odds of investment success in the long term, avoid fees and gimmicks that squander your returns. Embrace the markets, invest for the long-term using low management fee index funds and ignore market headlines. You’ll be much more relaxed and rational about investing. Good luck.

Dejan Ilijevski, MS, MBA, is president of Sabela Capital Markets a fee-only, Indiana-based registered investment advisor (RIA).

 ©2019 Advisor Perspectives, Inc. All rights reserved.