By Ainsley To

FINANCIAL ADVISERS

Chronocentricity - Will this time really be different?

Ainsley To acknowledges that the most dangerous phrase in finance is "this time is *never* different". But he explains that although it is necessary to constantly adapt our processes and theories to innovation, it is equally important to do so with a healthy dose of scepticism.

"A worldwide communications network that spans continents and oceans, it has revolutionised the business practice, giving rise to new forms of frauds and crime, and inundated its users with a deluge of information. Romances blossom over the wires, secret codes are devised by some and cracked by others. Huge fortunes have been amassed and lost again as the network takes shape. Attitudes towards everything, from news flows to diplomacy, to prospects for world peace are being completely rethought."

- *The Victorian Internet* by Tom Standage

The excerpt above was written in the mid-1800s about the electric telegraph.

Chronocentricity is the human tendency to believe our generation is the one that sits on the cusp of history; that the changes of our time are unique and will result in a quantum leap in the way we live. The reality is that we are no more special than the generations that came before us and change is a permanent feature of human history. The internet today is the same tool refined from its guise as the telegraph 150 years ago.

Here are examples from asset management, wealth management, and economic theory that illustrate how our chronocentric brains may be overly optimistic at this point in time.

Smart Beta

The marketing concept that Towers Watson named "Smart Beta" has been a disruptive force for traditional active and passive managers of late, seeing widespread adoption by investment consultants and some of the largest pension funds globally. Unfortunately, unlike communications technology (we are never going back to telegraphs), financial markets put a winner's curse on any "smart" strategy – it either gathers too many assets and reaches capacity or other market participants adapt to compete away its edge. Something smart is rarely permanent.

The industry's answer to this has been "innovation", however there may be signs that new products are beginning to stray from the original merits of the approach (low cost, diversified and robust long-term evidence).

Professor Campbell Harvey, of Duke University, has documented an exponential rise in academic papers published on different risk factors – from 20 per year in the early 2000s to over 50 per year currently. Unfortunately many of the factors are looking less robust – some aren't statistically significant when adjusted for the number of backtests*, and in some cases the results of the paper can't even be reproduced using their own data! The icing on the cake is that the Smart Beta products these research papers have spawned are charging fees on par with traditional active managers.

Whilst there are some decent strategies in this space, investors who are blindly adopting strategies on the basis that they are "innovative" may be in for a nasty surprise when out-of-sample results fail to live up to promises made on the back of simulations.

Robo-advisers

Claims of an imminent technological "singularity" for investment advice are probably somewhat exaggerated. Having access to an additional lower-cost option for investors is unarguably beneficial, however it is difficult for an entire industry to be fully displaced by automation when human interaction is itself part of the value proposition.

This is where it is important to distinguish between the provision of a service (a wealth manager) and the sale of financial products (an asset manager).

Trust

Tradesmen in many industries continue to thrive purely through word-of-mouth, despite lower-cost options available at the click of a button. The value a client places on trust (whether misplaced or not) can't be quantified in basis points. This value will vary greatly between people, but individuals whose utility function for trust is such that they will prefer a builder, lawyer or financial adviser they know on a personal level, will always remain.

Education and comfort

There are many self-starters who are comfortable teaching themselves purely through textbooks and Wikipedia.

But there are always those who respond better to human explanation, particularly for something as complex as financial markets. Teachers have the capacity to explain a problem in as many ways as needed and can reassure a student.

Given the long-only bias of their portfolios, the big litmus test for robo-advisers is how they can prevent panic selling in the next financial crisis.

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Unbounded irrationality

At its most basic, automated advice is similar to a doctor who gives out prescriptions based purely on patient age and income. Investors have their own preferences and sensitivities to risk – rightly or wrongly, they seldom want the optimal portfolio (and often unapologetically so). Risk is not a number, and a tailored portfolio a client is willing to stick to is more likely to keep them invested long enough to enjoy the wonders of compounding. There may come a day when machine learning enables the mathematical modelling of an infinite spectrum of client preferences – until then, human interaction will have to fill this gap.

Behavioural finance and market inefficiency

Since the collapse of 2008 there has been an exponential rise of interest in behavioural finance, at the expense of traditional finance theory such as the Efficient Markets Hypothesis (EMH). Whilst Fama and Shiller shared two thirds of the Nobel Prize in 2013, it is Shiller's followers who seem to have experienced a much greater rise in mainstream popularity more recently.

Is there a bubble in the word bubble?

When every investor and their grandmother have rising interest rates as their top concern, it seems inconsistent to presume that asset prices are in a bubble due to some irrational exuberance. If financial markets are totally inefficient and independent of fundamentals today, then it is cognitive dissonance to invest on the assumption that they will reflect intrinsic value some day in the future without assuming some degree of market efficiency. The persistence of mean reversion as an investment strategy is as much a vindication of EMH as it is of behavioural finance.

Similarly, a regular marketing pitch for active managers is that the rise in assets under management (AuM) of passive investments has led to more inefficiency and opportunities. The problem is that investing remains a zero-sum game: for an active manager to outperform, another active manager has to underperform. Passive investors cannot be their source of alpha since they simply follow the index, which represents the net views of all the market participants within that universe of securities. So as pro-cyclical fund flows leave underperforming managers in favour of passive, it is increasingly the best investors who remain to fight over the alpha. If it is a smaller number of more informed stock pickers who are allocating capital for the indexers to follow, one would argue the market is now more efficient, not less.

A natural reaction to any unforeseen event is to assume a theory is obsolete simply because it didn't predict with 100% accuracy. But whilst a world inhabited by human beings will never have fully efficient markets, they might still in fact be less inefficient than we think – particularly as we become increasingly aware of our biases. ■

*Source: *..and the Cross-Section of Expected Returns* – Harvey, Liu and Zhu (2015).

Ainsley To is an analyst for the multi-asset team at Credo capital, undertaking cross asset research in asset allocation as well as fund selection. Prior to Credo, he also worked at Stamford Associates, Fidelity and Bloomberg. Ainsley has been a CFA charterholder since 2014.