CREDO
WEALTH

# Against the Gods

## Lessons from the first 5 years of Multi-Asset Portfolios - Part I

*Ainsley To, Head of Multi-Asset - 13 September 2019*

This summer marks five years since the start of the Credo Multi-Asset Portfolios (MAP). The journey resembles a discreet social experiment that can be summarised in the following way – could a diminutive, young investment professional (whose face looked another decade younger still), armed only with publicly available academic literature and a Bloomberg terminal, construct "evidence-based" portfolios that would survive the chest thumping egos and dogmatic certainty of traditional active management. There have been many tough conversations and philosophical lessons learnt along the way - it is fair to say that *if it weren't for my superior physical size and strength, I would have been torn to pieces long ago.* But against all odds, MAP have thus far survived and continued to grow. In what was originally a twelve-page tirade but has since sensibly been reformatted into four more digestible mini-rants, I share some reflections on a few of the lessons learnt, with some obligatory marketing (subtly) sprinkled in.

### Part 1 - Rocket Science

***"If you're so smart, why aren't you rich?"*** *- a money manager asked Professor Paul Cootner, at a practitioners' conference in New York.*

The above question and Cootner's answer of ***"If you're so rich, why aren't you smart?"*** perhaps synthesizes the tension between finance academics and practitioners that still exists today. This has been apparent in my (infrequent) interactions with investors over the years, where I often get introduced as "the rocket scientist". The reality is that I'm certainly no rocket scientist (*as my B in secondary school Maths will attest to*). And the huge irony is that the most important financial theory for individual investors over the last century, the late Jack Bogle's "Cost Matters Hypothesis" (CMH), is far from rocket science. The fundamental equation in the CMH reads:

*Net Return = Gross Return minus Costs*

Sadly, knowledge does not equate to power (at least not immediately), as the late Jack Bogle found out the hard way when his index fund business struggled for survival during the early years – mutual funds seemed to behave like Giffen goods, where higher cost was associated with higher quality, even though there was no evidence to support this view.

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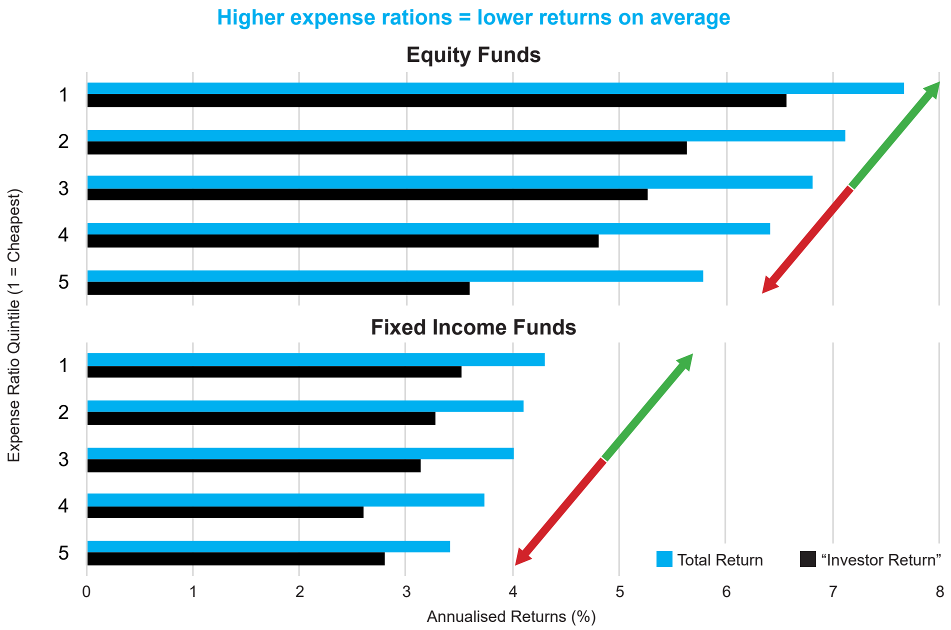
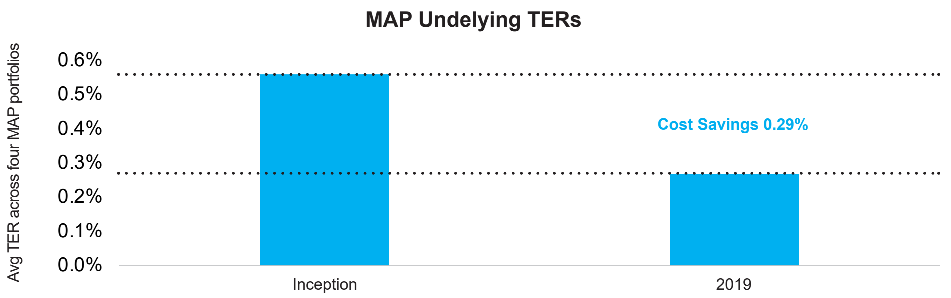



***Morningstar summarised the average performance for funds across different levels of expense ratios. More expensive funds had lower average returns both for the funds themselves and the investors in those funds (the dollar weighted return).***

A look at Vanguard's AuM today would suggest that investors' opinions have now shifted to becoming more cost conscious. Regardless of your own investment philosophy: whether you believe markets are inefficient and can be beaten, or that money managers are monkeys throwing darts at a dartboard on a random walk, or that managers have skill but *keep it for themselves in fees*, or you believe in some combination of the above (as I do), there is no escaping the negative impact of costs. No investment strategy is so good that high enough costs won't make it a bad one – whether it is fees, commissions, market impact, or otherwise. This is especially true for individual investors, who lack the economies of scale and bargaining power of larger asset owners.

And despite initial resistance as per Bogle's experience, cost has gone from totally unconsidered to being one of the primary self-imposed constraints in including new strategies in MAP. The focus on cost control has cut the underlying expense ratio since inception in half.




Before outraging any readers of an anti-indexing disposition, it is important to make the distinction in the difference between the CMH and the now tired "Active vs Passive" debate. The former represents a mathematical identity, whereas the latter is a bad mixture of binary thinking, misunderstanding, and identity politics. We fully acknowledge some of the imperfections with cap weighted indices (which in our view is the only truly "passive" investment). The fault line dividing the industry is no longer between active vs passive, it is now between what is evidence-based and what is not.

If you can only focus on one thing, it should be cost. However, cost is not the only input into building a portfolio – you also need inputs for risk and return. The challenge is that cost is often the most predictable of these three inputs and far less susceptible to estimation error. So in order to stray from a pure "Buy The Lowest Cost" approach, one must be able to trade-off the near-certain additional costs with the uncertain benefits of reduced risk or increased potential return, taking into account the level of confidence in one's assumptions. This is another key reason why low cost, cap weighted index products have been so popular – not only are they cheap, they are fully transparent in their process and thus require a minimal amount of trust between the investor and the manager (an example of which we will explore in Part II). And investors' trust in promises of higher returns has been in decreasing supply as empirical data on fund manager performance has become increasingly mainstream.



Sources: Mind The Gap 2019, Morningstar