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WEALTH & INVESTING

Picking stocks is a losers' game

Research shows that many professional investment managers disappoint clients. **By Wei Dai**

WHAT'S the best way to achieve long-term financial goals? Searching for mispriced stocks and putting money in them? Finding a smart fund manager to do so? These approaches are popular, but research suggests this is a losers' game.

Global financial markets process millions of trades worth hundreds of billions of dollars each day. The prices at which trades happen reflect the views of buyers and sellers around the world. Investors who attempt to outguess prices are pitting their knowledge against the collective wisdom of all market participants.

Dimensional Fund Advisors' annual study of thousands of US-registered funds – which invest in stocks and bonds all over the world – illustrates how hard it is to beat that collective wisdom.

The study shows how most fund managers fail to outperform the market; how funds that won in the past fail to win later; and how high fees and costs associated with selecting "mispriced" stocks may contribute to underperformance.

Lost funds, high fees

One challenge in any study of investment funds' long-term performance is how much the landscape changes over time. Hundreds of new funds are launched, merged and closed every year. Dimensional's study tracks these as well as funds that were open for the whole period.

It's rare for a fund manager to close a successful fund, so it's important to include all the ones that closed in the period under analysis, in addition to all the ones that made it from start to finish.

You might be surprised how few funds both survive and outperform.

In equity funds, out of 3,000 funds available in December 2013, only 67 per cent were open 10 years later at end-2023, and only 25 per cent had outperformed their benchmark.

These figures fall further over a longer time period.

Looking further back to 2003, only 45 per cent of funds survived over the next 20 years and just 18 per cent both survived and outperformed.

Our research also finds that underperformance is associated with higher fund fees and expenses. For example, just 13 per cent of equity funds in the highest quartile of expense ratios survived and outperformed over the latest 10 years.

Considering other costs, trading costs are difficult to analyse, because funds do not publish data on things like brokerage fees and the price at which stocks were traded. But a rough proxy for trading costs is turnover – an indicator of how much trading is done in a portfolio each year.

Higher turnover indicates higher trading costs – and, just like expense ratios, trading costs drag on performance. Only 19 per cent of



In a study by Dimensional Fund Advisors, few investment funds managed to both survive over time and outperform.

PHOTO: PIXABAY

equity funds in the highest turnover quartile survived and outperformed over the latest 10 years.

Passive-aggressive

We believe our research demonstrates the uphill struggle faced by investors who set out to beat the market by outguessing it. The obvious alternative to the traditional active investment approach is to go "passive" and buy an index fund. But this approach also has drawbacks.

Purely passive investing, where an asset manager aims to match the performance of an index minus fees, has its merits. It's generally a low-fee and low-turnover approach – but to think of it as entirely passive can be a mistake.

Which stocks are in the index and which are not? When and how often does this change? Lots of decisions by index providers will influence performance, and not all of them are optimal from the investor's point of view.

These decisions can make a big difference to investment performance. Imagine only styling your hair once a year. How bad would it look after 364 days? This is the approach to rebalancing that some index managers are forced to take, when the index they are tracking only changes its constituents once a year.

Rather than competing against the market's collective wisdom, it is better to take a research-based approach to design investment strategies that are systematic and flexible.



And what would happen if hairdressers only opened once a year to administer everyone's annual haircut? They could charge whatever they want, because people have no choice but to wait in line for their one chance of the year.

This is the challenge that index funds face when their priority is to match the index. The so-called "style drift" means that investors' portfolios can quickly get out of shape.

When the periodic rebalancing occurs, the demand and volume to trade the same thing at the same time as everyone else can result in high trading costs, negatively affecting performance.

If there are weaknesses in both active and passive investing, what is the alternative? Ideally, an investment strategy would offer the best of both worlds. It would be low-cost, transparent and diversified like indexing, but with the flexibility and potential to beat the market that active managers aim for.

Rather than competing against the market's collective wisdom, it is better to take a research-based approach to design investment strategies that are systematic and flexible.

The writer is head of investment research at Dimensional Fund Advisors

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