

The Paradox of Performance II: Disparate Investment Worlds

Why are there are two investment worlds? In the investment management world, account performance is calculated, adjusting for cash flows and fees, for every client report. People expect to see how their performance compares to applicable benchmarks. They would be suspicious of a failure to provide this information. Last month, we described how investors can hurt themselves by overemphasizing trailing performance. In the second investment world of brokerage accounts, however, overemphasis is not a problem. The problem is that there is *no* performance reporting.

Brokerage firms could report account performance – as Oscar said about Steve Austin in *The Six Million Dollar Man*, we have the technology. Brokers at some firms can pull up performance statistics on their internal computer network – it is just not shared with the customers. There are many honest, dedicated brokers (and recent news tells us there are many dishonest, grasping investment managers), but industry culture discourages telling brokerage customers how they are doing.

So why the two worlds? Why should there be obsessive and excessive focus on trailing performance in one category (mutual funds and investment management) while there is a strange determination to avoid noticing performance in the other category (brokerage, bank investment and insurance investment accounts)? Is there any real distinction between the two?

The answer is yes. Investment management and mutual fund accounts are discretionary – managers buy and sell investments without having to get client approval for each transaction. In contrast, most brokerage accounts are non-discretionary. The broker is supposed to get the customer's approval for purchase and sale. The result is that responsibility is not clearly defined. Does the broker get the credit or blame for presenting an idea, or the client for selecting the actual investment from among the alternatives presented? This fuzzy sharing of accountability is key – brokerage firms rationalize not reporting customer performance because the brokers are not the decision makers. So why don't they want to report performance?

Most of us are natural optimists – we remember happy events while forgetting the bad, a tendency that breeds overconfidence. Which is easier to remember, the best round of golf you’ve played, or the worst? Your most successful fishing trip, or the time you caught nothing? How much evidence would we have to provide for you to conclude that you are a below average driver? Brokerage firms know that by not reporting performance data, their customers are likely to overestimate how they are doing. The customers will also tend to take credit for investment successes while attributing the mistakes to their brokers. Despite the common kvetching about how they do all the work while their broker gets a commission, the customers need the broker to blame for the clunkers.

This dysfunctional, ambiguous division of responsibility is tenable only if you do not know how your account is actually doing. If you knew your account performance was terrible, you would make changes, regardless of whose fault it was. But brokerage customers, for the most part, do not want to make changes – they are happy with the system in which they can convince themselves they are clever. For a lot of people, being “right” (or at least claiming so) is more important than making money. If they had a discretionary management account, good performance might put money in their pocket, but it would eliminate their bragging rights.

“The slaying of a beautiful hypothesis by an ugly fact”
- T. H. Huxley

People often immodestly tell us how successful they are in their investments. (Do people insist on telling doctors about their successes in self-medication, or brag to lawyers about representing themselves in trials?) The war stories invariably begin with something like “Well, I don’t know the exact numbers, but I’ve done pretty well,” followed by a couple of anecdotes about particular investment successes or timing decisions. We are sure there are times they caught a lot of fish, too, but we cannot help but believe that this is an exercise in building self-esteem, not wealth. If brokerage customers demanded performance reporting, they would get it. The fact that they do not tells us that they do not really want it.

At the risk of sounding hard to please, we find fault with the handling of performance numbers in both investment worlds. Obsessing about trailing investment performance numbers leads to chasing performance, selecting investments on the basis of how they did in the previous period. This is a world described by the White Queen in Lewis Carroll’s *Through the Looking-Glass*: “The rule is, jam tomorrow and jam yesterday—but never jam today.” When you chase performance, the past numbers are always good, you expect great things in the future, but somehow your current performance always falls short. On the other hand, in the codependent world of brokerage accounts, the lack of performance data makes it impossible for either broker or customer to make a rational assessment of success or failure. This is exacerbated by the structural blurring of responsibility for the (unreported) performance.

The key to investing is to have a logical, thoughtful, consistent process. Trailing performance data is not an end in itself. Properly analyzed, however, it helps you assess your investment process. Account values will tend to rise in bull markets and decline in bear markets, but without an appropriate comparison of investment performance to applicable benchmarks, how else will you know if you are on the right track? If you would like to apply that kind of rational process to your portfolio, call us at (503) 419-3938.