

MARTIAL CAPITAL WHITEPAPER: TRADITIONALLY-MANAGED ACCOUNTS: A FAILURE IN SPITE OF GOOD INTENTIONS



MARTIAL CAPITAL
www.martialcapital.com

The vast majority of managed investment accounts do worse than market averages over the long term. S&P reports¹ that over the five-year period ending September 30, 2006:

- ▶ More than 85% of actively-managed US Equity funds underperformed the S&P 500.
- ▶ More than 90% of actively-managed Canadian Equity funds underperformed the TSX.

The result has been an explosion of index funds globally. While investing in an index fund you are likely to outperform the vast majority of mutual funds or actively-managed accounts, unfortunately, you are guaranteed never to outperform the index.

Common Sense Explanation for this Failure

Unless one were to employ an army of thousands of analysts, it would not be humanly possible to be an 'expert' on each and every listed security. And if you did have 1,000 analysts, there would be no consistency from one to the next. In reality, even the largest firms truly cover only a small subset of the market.

Investment managers are human. They typically read voraciously – the web, opinions from other managers and analysts, newspapers, magazines – and are thus bombarded by contradictory advice and counsel. They react to good news with hope and to bad news with dread. They are, like all of us, subject to irrational fears and hopes.

This focus on a few stocks and a few market factors makes it possible for human investment managers to overlook something quite obvious. Reporting on the CFA Institute's June 2007 conference in Boston on The Efficient Market & Behavioral Finance, Pensions & Investments Magazine reported: "Attendees confident of their own lack of biases were tested by a short video shown by MIT's Mr. Lo.

¹ S&P's SPIVA Scorecard, Q3 2006 www.spiva.standardandpoors.com



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He got the audience to focus so intently on the number of times students dressed in white threw a basketball to one another that more than half failed to notice when another student, dressed in a gorilla suit, sauntered to center screen, beat his chest, and then walked off. 'You were focused on counting and so your brains told you to filter out anything that wasn't white,' said Mr. Lo, adding that the same myopic focus makes it tough to argue that the average investor is always rational."²

We would add, "or the average investment manager."

In some organizations the recommendation is often shaped by the reaction from other parts of the company: "We can't recommend selling that stock, we told them to buy it only last quarter," says the SVP of Retail Sales, "We can't recommend that stock. They're the chief competitor of our biggest client," says the SVP of Institutional Sales.

The resulting recommendations are published well after the discussions began. But today's markets react in a matter of minutes. An action taken any later has already missed the market.

Superior performance today requires a far faster and more comprehensive process than traditional investing. The results, as reported by S&P, speak for themselves

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² <http://www.pionline.com/apps/pbcs.dll/article?AID=/20070625/REG/70622028/1030/TOC>