

The Sound Investor Series #46

Is Investing Difficult?

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Is investing difficult? Most people think that it is and a new study supports them. It also gives us insight into why so many investors wander down the garden path with unscrupulous salespeople.

Professors from Yale, Harvard and the University of Pennsylvania just published, “Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds.” A full copy of the paper is available at <http://www.som.yale.edu/faculty/jjc83/research.html>. The authors demonstrate that even our brightest college and graduate students fail to understand basic investment concepts. And perhaps more alarmingly, they show investors are greatly influenced by prominently displayed information, regardless of its relevance.

The study asked Harvard undergraduates and Wharton MBAs to invest a hypothetical \$10,000 in one or more of four S&P 500 index funds. The students were given the prospectus for each fund and the only differences among the four funds were fees and inception dates.

In both the undergraduate and MBA groups, only 19% of the money was invested in the fund with the lowest fee, the optimum choice of professionals. The MBAs showed slightly more insight by allocating only 18% of their money to the highest cost fund while undergraduates placed 27% there.

This is very disappointing, but not totally surprising. In real life, investors put billions of dollars into high-cost index funds. A good example is the Morgan Stanley S&P 500 index fund, which charges Class A shareholders a 5.25% load, and annual expenses 0.64%. The B shares have no front-end load and annual expenses of 1.46%. For comparison, Vanguard and Fidelity have no front-end loads and annual expenses of 0.18% and 0.10% respectively.

Why in the world have investors put almost \$1.5 billion in Morgan Stanley’s fund? From my experience, most high-cost products get “sold” rather than “bought.” Put a large enough commission on anything and salespeople will search out buyers, regardless of the product’s usefulness.

This brings me to the second part of the study, which shows how easy it is to manipulate investors. The investigators split the students into groups and gave some students sheets of paper that highlighted information contained in the prospectuses. One group received information comparing the fees of the four funds while another group was shown an evaluation of the funds’ performance since inception.

As you might expect, students in both groups relied heavily on this highlighted material to make their decisions. Students who received fee information were more likely to choose the lowest cost funds, but many still chose higher cost funds. The students given performance data were more likely to choose the fund with the best performance since inception, which is not a good idea..

To me these results are both encouraging and depressing. On the positive side, it shows that with even a little help, investors will make better decisions. In this case, fees were the only fundamental differences between the funds and should have been used for decision-making.

On the down side, the experiment shows how easily investors can be misled. A fund's performance since inception is irrelevant for comparison, unless they all started on the same date, which is highly unlikely. For example, if one fund started when the market was low, its performance would look good versus a fund that started when the market was higher.

This brings me around to the salespeople selling various investment products. Good quality salespeople discuss the pros and cons of different investments and make sure their clients understand their options before moving forward.

Low quality salespeople only discuss the positives and try to focus in on one or two points the client might consider important. For instance, salespeople who sell deferred annuities pound away at the fact investments grow tax-free. This is nice and who wouldn't want tax-free growth? However, that is not the whole story! Investments grow tax-free, but when the gains are taken, the income is taxed at ordinary tax rates as high as 35%. On the other hand, capital gains in a taxable account have a maximum rate of 15%. Add to these deferred annuities the huge commissions and onerous surrender charges and it is no wonder investors are not told the whole story. Most informed investors would never buy.

What is the solution? I'm not sure. Years ago, this question was mostly academic, but today it has real significance as the burden of investing is thrust on more and more individuals.

One lesson for investors is Follow the Money. Find out what percentage the broker, advisor or insurance salesperson is paid on the products they sell. The higher the percentage, the higher the need for caution.

There are also important lessons for regulators of advertising, sales literature and prospectuses. The first lesson is prospectuses don't work for individual investors.

If you want to learn more, please visit Farm Creek's website listed below and click on The Sound Investor Series. Finally, I promise to stop saying investing is fairly simple!

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