Short and Sweet

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In fifth and sixth grades I played clarinet in the Sycamore Elementary School band. I suspect that those two years of dealing with me caused our band director to switch from teaching to school administration. I remember during one practice session, he stopped and looked down at me in frustration and exclaimed, "You are the only person I know who taps his foot in one time and plays in another time, and neither one of them is right."

That fact that I totally ignored his direction probably accelerated his decision to abandon teaching. To me, my job was to play every note and whether or not they were played at the right time made no difference to me. So if I got behind, instead of jumping to the appropriate place, I would just play faster until I caught up - which I rarely did. As a result, I usually had three or four notes left to play when he gave the signal to stop. And since everyone else obediently obeyed, I almost always ended every performance with a short solo.

While short, my solos produced sour notes, not sweet music. According to Sir James Jeans in *Science and Music*, "…the aim of music is to weave elementary sounds… into combinations and sequences which give pleasure to the brain…" As an investment advisor I have likewise learned that successful investing requires the arranging of appropriate financial instruments into prudent combinations that are bought and sold in the correct sequences. Curiously, if the process brings pleasure to the brain, it is being done wrong. As investment manager and finance professor Robert Arnott so aptly explained, "In investing, what is comfortable is rarely profitable."

Michael J. Mauboussin, the Head of Global Strategies for Credit Suisse, explains why good investing feels wrong. In the left hemisphere of the brain there is a part "…that neuroscience has dubbed 'the interpreter' [that] assigns a cause to every effect it sees." And while it is very effective most of the time, it "…stumbles when confronted by randomness [which] presents a problem [for] investors." This problem, which academics refer to as the "dumb money effect," manifests itself in two costly ways. First, investors buy actively managed funds and second, they trade on emotions -- they fearfully sell in down markets and greedily buy in up markets.

Unfortunately, like my tapping and playing, neither one of them is right. Mauboussin points out that "…the annual return for the average actively managed mutual fund was 1.0 to 1.5 percentage points less [than] the S&P 500 Index." And this bad product choice was made worse by the "bad timing" of buys and sells that causes investors "… to earn… another 1.0 to 2.0 percentage points less than that of the average actively managed fund… This means that the investor return [for the past 20 years] was roughly 60 to 80 percent that of the market."

Most investors underperform for the same reasons I underperformed as a musician: bad choices and bad timing. That's why investors need what I needed, good direction. Barbara Palmer, in the Stanford Report, wrote "A good conductor looks…to the composer and then convinces players to accept his vision." For investors, the composition to look to is the body of economic knowledge known as Modern Portfolio Theory. However, because these economic principles run contrary to our normal mode of thinking, most investors ignore them like I ignored my band director. So if investors don't want to fail, like I failed at music, they need to accept a vision about investing that is based on the often sour sounding notes of economic truths. But, Mary Poppins taught us "a spoonful of sugar helps the medicine go down." So, I write my newsletters short and sweet.

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