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Indexing: A cure for investor self-sabotage

By John Heinzl

Chris Turnbull left a big bank-owned investing firm to become an advocate of passive index investing

Earlier this year, I wrote a column[1] about the tactics that some unscrupulous advisers use to extract more money from clients.

Well, that column only told half the story. The truth is that clients themselves often bear part of the responsibility when their portfolios underperform.

This thought occurred to me as I was reading Chris Turnbull's book *Your Portfolio is Broken: Who's to Blame and How to Fix It.* A former broker with one of the big bank-owned firms, Mr. Turnbull built a client base with more than $100-million in total assets before he left the company and became an advocate of passive index investing.

In his book, Mr. Turnbull – now a portfolio manager with the Index House in Edmonton – lifts the curtain on the practices that contribute to subpar investor returns. Although he pulls no punches when criticizing the industry, he also makes it clear that clients are often part of the problem.

"Over the 17 years I worked at a brokerage firm, I saw first-hand how investors make decisions," he writes. "On very little and often oversimplified information, investors willingly sink significant amounts into securities they feel are better than the others. Each new transaction piles another security onto a supposedly diversified portfolio."

It's not always the broker who pushes the trades, either.

He recalls one client who called him after watching a segment on BNN, eager to place an order for the stock she had just seen touted on TV. Never mind that she didn't even remember the name of the company; she gave Mr. Turnbull a brief description and asked him to identify the stock and place an order.

To be sure, the industry engages in a long list of self-serving practices. These include inappropriate security recommendations, flipping of risky new issues, excessive trading and a focus on high-fee products such as mutual funds with deferred sales charges, all of which hurt investor returns. In many cases, clients don't even know their returns or how much they are paying in fees, because the industry hasn't been required to provide this information (new rules are being phased in that mandate better disclosure of costs and performance).

But investor psychology also contributes to the problem of subpar returns. Many investors are obsessed with trying to beat the market, which leads them to take more risk than necessary and also makes them vulnerable to brokers with a seductive pitch – what Mr. Turnbull calls "sound-bite security selection." Investors also tend to base investment decisions largely on short-term predictions about where individual stocks or the market are heading next.

In reality, far from outperforming the market, most investors badly underperform it. Mr. Turnbull cites data from research firm Dalbar for the period from 1989 to 2008, in which the average U.S. equity mutual fund returned 5.5 per cent on an annualized basis. Over the same period, the average investor in those funds made just 1.87 per cent.

What accounts for such dramatic underperformance? Investors sabotaged themselves by buying at lofty prices when markets were euphoric, and selling at depressed prices when markets were overcome by gloom.

The 1.87-per-cent return looks even worse when measured against the S&P 500's 8.4-per-cent annualized gain over that period. An investor who simply bought and held a low-cost index exchange-traded fund would have come very close to matching the S&P 500's performance.

It was the realization that passive investing produces superior returns, without all the costs, risks and drama of an active stock-picking strategy, that led to Mr. Turnbull's conversion into an indexing evangelist.

"Investors following a non-predictive indexing portfolio strategy opt out of the illusions created by the investment industry and tune out the distractions of the media," he writes. "It's liberating!"

If done properly, it can also save investors from themselves.

References

1. tgam.ca/eci5