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Your Portfolio Is Broken: Who's to Blame and How to Fix It (a review)

Your Portfolio Is Broken: Who's to Blame and How to Fix It (2013). By Chris Turnbull, CFA
The Index House, www.theindexhouse.com. 90 pages, C$15.00.

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Abstract

In this guide to index investing, the author counsels investors with "broken portfolios"—characterized by high fees, high taxes, and high turnover—to consider such passive investment strategies as indexing and to seek professional investment advisers who will realign their portfolios pursuant to a disciplined investment process with achievable objectives and a firm eye on downside risk.

Albert Einstein defined insanity as repeatedly doing the same thing and expecting different results. Over the last two decades, global equity markets have undergone two 50% drops. Investors who have repeatedly followed a prediction-based approach have experienced frustration as a result of unpredictable investment markets and poor portfolio practices.

The problem, argues Chris Turnbull, author of *Your Portfolio Is Broken: Who's to Blame and How to Fix It*, lies partly in the conflict of interest inherent in stockbrokers' business model, which leads them to recommend what investors should buy rather than what their portfolios need. Following stockbrokers' soundbite recommendations, which may in fact represent the best ideas at the time, leads to what Turnbull calls a broken portfolio—a ragtag collection of investments rather than a carefully thought-out, well-diversified portfolio. Broken portfolios are characterized by high fees, high taxes, and high turnover that can be greatly reduced by adopting such passive investment strategies as indexing.

Turnbull observes that although it might appear from financial media accounts that many professionals deliver superior risk-adjusted returns, in reality few managers accomplish this feat consistently over a long period. Attempts to beat the market incur higher fees and expenses, which are primary causes of underperformance. For one thing, an intensely competitive industry leads to a high level of market efficiency, making active portfolio management difficult. By way of corroboration, research studies on developed markets have shown that new information is priced in within a few trades of the information becoming public, suggesting that returns to active investments have a very narrow window of opportunity. Furthermore, active prediction-based management strategies result in higher turnover, higher fees, higher taxes, and thus lower returns. Buy-and-hold strategies, says Turnbull, have the advantage of lower fees, lower turnover, and fewer of the realized gains that generate taxes. Moreover, index funds and exchange-traded funds—the instruments of passive investing—avoid unsystematic, uncompensated risks.

Accordingly, Turnbull favors a passive approach for most investors. He concedes, however, that anyone who can predict favorable investment outcomes consistently on a risk-adjusted basis should adopt active investment techniques to maximize portfolio performance. But to underscore how difficult active portfolio management is, he provides viewpoints from three financial luminaries. Benjamin Graham, who famously sought value through active investment management by using rigorous and disciplined analytical techniques, lent support to this view. In a

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1976 interview in the *FAJ*,[1] he commented that although elaborate security analysis had been a rewarding activity about 40 years earlier—when his seminal book *Security Analysis* (co-authored with David Dodd) was published—he was no longer an advocate of it because the market and industry dynamics had changed. In light of the enormous amount of research activity that was by then being pursued, Graham further expressed doubt whether, in most cases, extensive efforts would generate sufficiently superior selections to justify their cost. According to another luminary, Charles D. Ellis, "The investment management business is built upon a simple and basic belief: Professional managers can beat the market. That premise appears to be false."[2] Finally, Peter Lynch expressed the view that "all the time and effort people devote to picking the right fund, the hot hand, the great manager, have in most cases led to no advantage."[3]

Thus, Turnbull contends, investors would do better to focus on low costs than on trying to identify star fund managers. Good investment results, he says, start with an achievable objective. Investors should be more concerned about the risk of underperforming than about the possibility of achieving outperformance.

Those who will fare best, in Turnbull's view, are investors with experience and sophisticated knowledge of the workings of the markets. Most people are poor consumers of investment products and services. They commonly overlook the fact that brokers are compensated for transactions and thus manage client portfolios to match their own revenue targets, resulting in conflicts of interest. Enlightened investors, he says, are now asking, "How do we benefit from an industry of products and predictions?" He reasons that conflicts of interest can be overcome by engaging an investment counselor who charges a disclosed fee for financial advice, portfolio management, and proper performance reporting.

Turnbull cites emotion-driven investing as another cause of broken portfolios. Emotion-driven investing leads to overconfidence, hindsight bias, familiarity bias, and extrapolation, among other behavioral biases that disqualify an individual from being a rational investor. The investor's goal, Turnbull emphasizes, should be to combine asset classes and reduce portfolio risk in order to bring actual returns closer to expected returns *consistently*. Empirical studies have demonstrated that allocations to various asset classes are far more important determinants of returns than the selection of particular securities or the timing of investments. Turnbull contends that indexing empowers investors to focus on things that they can control, such as structuring portfolios to capture market returns, reducing risk, and minimizing tax leakage and other unnecessary costs.

Turnbull has included three case studies in the book to highlight broken portfolios of individual investors and how, as a portfolio manager, he remedied them. He identifies the steps to successful portfolio remediation as investor discovery, the asset mix decision, writing an investment policy statement, implementing the asset mix, rebalancing, and reporting. Turnbull's recommendations to every investor are to know your fees, know your returns, and know your benchmarks. This reviewer would add that providing every investor with a copy of the Statement of Investor Rights that CFA Institute has developed could constructively contribute to this process.

In *Your Portfolio Is Broken*, Turnbull has identified an example of cognitive dissonance. Investors believe that professionals who can consistently predict winning investments exist, and an extremely profitable industry of experts willingly caters to this illusion. Turnbull counsels investors to seek professional investment advisers who will realign their portfolios pursuant to a disciplined investment process with achievable objectives and a firm eye on downside risk. As an author, Turnbull faces an implicit conflict of interest of his own, being the founder of the Index House, a private wealth management company. Turnbull does mitigate the conflict, however, by offering the Index House philosophy: "If you know which are the best securities—if you can beat the market return—great! Do that. If not, then index!" In the end, Turnbull observes, achieving superior investment results is and should be a boring, predictable process.

—B.D.

[1] "A Conversation with Benjamin Graham," *Financial Analysts Journal*, vol. 32, no. 5 (September/October 1976): 20–23.

[2] Charles D. Ellis, *Winning the Loser's Game* (New York: McGraw-Hill, 2002): 3.

[3] Peter Lynch, *Beating the Street* (New York: Simon and Schuster, 1993): 60.

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Reviewer Information

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Book Review Editor Information