

ACADEMIC GENIUS LEADS TO SUCCESSFUL INVESTING

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Early promise

In the early days of his career, long before winning the Nobel Prize and having just graduated, Myron Scholes was asked to do a study of Wells Fargo's investment operations. His advice was that a passive investment strategy should be launched. His studies had convinced him it was difficult to beat efficient markets and Wells Fargo would save a lot of money by not having to hire analysts. Within a few years they launched the first index fund.

So, at this very early age he can be credited with the invention of passive investing strategies, which now have about forty years of evidence to prove their value.

Umbrellas and Deckchairs

Longstanding clients will be familiar with one of the stories I use to illustrate the benefits of a balanced investment strategy.

It starts with the idea of investing in umbrella, deckchair and ice cream businesses in Blackpool, and at this point please remember this is only a story!

In most years visitors experience both sunshine and rain and there will always be someone eating an ice cream. Due to this clever business plan the risk of investing has been reduced, as you own businesses for all weathers.

This Blackpool story is simply a metaphor for holding a truly diversified portfolio with growth investments and defensive investments.

Getting rid of the umbrella

Myron Scholes added another concept to the story, and one that has been very important recently. He said that when you buy an umbrella it uses up some of your resources and it feels like its slowing you down - its a bit of a burden when you have to keep carrying it around with you every day. For this reason, some people who believe they are good at forecasting the weather believe there is no need for an umbrella. But when they are eventually caught in a big storm they get a good soaking and when they are forced to buy an umbrella during the storm (from a street vendor) they have to pay an awful lot for it!

You can interpret this story a number of ways. To me the main thrust of it is that some people will speculate by turning their backs on portfolio diversity. They can make a lot more money if at the start the markets are good to them, and of course they



Photo: from the left: Michael Barr (chairman elect of the EBIS group), and Nobel Laureate Myron Scholes.

mistakenly think investing is easy. When markets change and the financial sun stops shining, they suffer big losses, and it costs them an awful lot to get out of the situation.

In recent times, banks and other institutions, and many of their clients, have exposed themselves to unprotected risks, which they didn't understand, and hence the credit crunch.

Putting all of your intellect together

Some critics say that our passive strategies look like a lazy way of investing; although it is more likely they have never studied the evidence or understood it.

You have to consider the millions and millions of pounds spent by institutions on market research. Thousands of experts are competing with each other and trying to gain some form of information advantage so they can beat each other.

However, when you think about it, it is all this research and activity that determines the share prices of companies and their market values. The FTSE100 Index for example, has not been put together randomly at all. It is actually the result of all that research and brain power which collectively has determined the values of the companies in the Index and which companies should rank from 1 to 100.

So when we invest in an Index fund, and follow a passive strategy with the objective of capturing a market's return, we are indirectly benefiting from all that research and brain power - but we are not paying anything for it!

This is surely a little bit of genius.