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Cover design: Loewy Design

On the Cover

Nectar Callan, 2016
Blown Glass
12 × 9 × 5.5 inches
Photo credit: Russell Johnson

***Nancy Callan** (American, born 1964) is a contributor to the well-known art-glass scene in Seattle, WA. This "Droplet" form is part of a new series in which the artist is heavily inspired by nature, while experimenting with flowing and layered abstract lines in a wide range of colors. Callan's artwork channels the technique and style of master Venetian glassblowers, while centering her work around the new guard of studio artists who have embraced the Northwest since the late 20th century. Her works are permanently present in museums, galleries, and in prominent private collections throughout the world. This piece and others by this artist are available through Schantz Galleries in Stockbridge, Massachusetts.*
Visit www.schantzgalleries.com to view more works by this artist.

Although we have covered this topic a few times in the past, it is important to revisit it even as we speak. Behavioral biases are a part of our intellectual and emotional make-up, and they do play an important role in the way individuals—however smart, gifted, or even professionally educated—manage their assets. They affect both strategic—or policy—and tactical decisions. We will not revisit the issue of policy allocation, convinced as we are that the concept of goals-based wealth management, which alleviates a few of the issues, is increasingly accepted, although with various degrees of depth or faithfulness to the fundamental tenets that underpin it. Instead, our focus here will be on the extent to which behavioral biases—often reinforced by external stimuli—impact the way investors interact with markets.

Once upon a time, there was a definite difference between reporting and commenting on events or data. Unfortunately, nowadays, the difference between opinion and fact has become blurred to the point where it is increasingly difficult for individuals to ascertain what is truly happening from external sources. Whether this is an inevitable evolutionary trend or a reflection of some cyclical force, which may one day reverse, is an interesting question, but also one that we are not qualified to answer. The point, however, is simple: how can individuals make sense of what is happening in markets if they do not know the facts about either actual market developments or fundamental news? Equally important, even if they could know about actual facts, how would they be able to deal with such mirages as "availability bias" or the limitations of any form of statistical analysis when it involves too few data points? Finally, although most likely well-intentioned, regulatory authorities have tended to hinder a reasonable discovery process by defining "inside information" in arguably so narrow a manner as to risk entrapping serious analysts, while the legal establishment has imposed potentially massive penalties on anyone who falls short of these standards.

Yet, investors need two generic forms of education to find their way around the many snares that they face:

1. ***They need to learn the limits of any form of advice that they get*.** Although it may not be the most pleasant thing for advisors to admit, the fact remains that portfolio managers are wrong a meaningful proportion of the time. Many times, I have quoted Sir John Templeton, who said that he had never seen a portfolio manager who was right more often than 65% of the time. This leaves plenty of room for error and leads to the need for at least three important insights:

a. It may take quite a bit of time to distinguish between luck and skill. Whether this applies to a commentator or to a day trader, one can be right a number of times in a row without really having any skill.
b. One is better off making multiple small bets rather than a few large ones. Multiple small bets increase the chances that one will "capture" the real potential value added of the decision maker or influencer, according to the law of large numbers.
c. One should be aware of the availability bias, which makes us notice things that are "available" or "immediately recalled" more than those that are not. Thus, one tends to draw implications from only some fraction of the relevant examples and thus could be materially misled.

2. ***They need to question analyses that are presented to them***. In these times when quite a large body of our everyday life has been somehow politicized, it is important to look for forms of bias in the way data or information is conveyed to us. This has three important elements:

a. Does this or that piece of information lead to a positive or negative light being directed on a political entity, figure, or ideological viewpoint? Lower-frequency data indeed often seem at variance with higher-frequency data covering the same macroeconomic aggregate. Does this reflect a simple measurement error or a desire for some entity, figure, or ideological point of view to benefit from some "announcement value" for a lower-frequency aggregate that is watched particularly closely?
b. Does the focus on this or that piece of information or insight benefit a category of investors? In a trading environment, it is not unusual for prices to remain within some broader or narrower trading range. Traders typically ride the short-term trend, and when prices reach one or the other end of the range, they tend to reverse direction. Does the focus on some part of the data that are available seem reasonable, or does it appear to be primarily intended to trigger some price reversal?
c. Remember the difference between correlation and causality. Although it so happens that the sun almost always rises when I get up, I cannot reasonably assert that the sun rises because I get up.… Note, however, that the reverse might be true in an evolutionary sense. Thus, one needs to be careful that the rationale underpinning a recommendation is robust and not just based on some partial reading of the available information.

In short, in an environment where the playing field has been so leveled that one cannot count on expertise, and where the focus on short-term profits at times overwhelms the requirement to have the client's interest at heart, *caveat emptor* must prevail. Individuals must constantly check themselves—as a well-trained professional should—to question their impulses, to verify their sources of information, to be aware of the "naïve probability" of any outcome occurring, and to use highly disciplined investment processes. While it is true that the complexity of today's world does not make it easy, this is the only way an individual has a reasonable chance to be successful in the management of his or her assets.

Also, and correspondingly, a significant dose of humility is required of every actor, individual investor included, to ensure that the risks that are taken are both analyzed well enough and comfortable enough that no single bet that goes wrong (which should be expected to happen roughly at least 40% of the time) can jeopardize the long-term viability of the portfolio, the ability of the investor to "stay the course" in the face of adversity, and the probability of achieving of one's goals. Although it is natural for certain people to "sell" themselves, the buyer must be careful to note whether that "seller" displays the required humility or simply makes unreasonable claims; in a parallel fashion, the "buyer" must keep the proper perspective as to the value and applicability of his or her own judgment.

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The Winter 2017 issue of *The Journal of Wealth Management* remains as diversified as usual. Hopefully, all readers, whatever their individual specialty, will find topics of significant interest.

The first article stands on its own. Manuel González-Igual, Teresa Corzo Santamaría, and Patricia Castán Agustín analyze the relevance of behavioral finance in the functioning of financial markets, studying the awareness and level of education in behavioral finance, determining a clear gap of learning experience for professional investors, classifying professional investors through their investment profile, identifying overconfidence as a predominant bias affecting investors, and finding a clear disconnect between investors and their clients.

The next four articles relate to a variety of investment issues. First, prior contributor Jarkko Peltomäki and Janne Äijö focus on the issue of smart beta—recalling in my mind the classical rhetorical question once reputedly asked by Kenneth French: "Is there such a thing as dumb beta?" They address the relevance and the style mix of four common smart beta strategy indexes: minimum volatility, momentum, fundamental value, and equal weight, discovering that the major proportion of equity smart beta beyond a market-cap-weighted index originates from the momentum smart beta strategy, while, for example, the value smart beta strategy has little relevance. Then, Daniel Ziggel, Christian Armbruester, Josua Gösmann, and Tom Tardif propose an alternative solution for generating consistent yields, exploring the different types of inherent private lending investment strategies and outlining a portfolio construction and optimization methodology whose results are presented. Third, Robert Dubil revisits his earlier [2016] study of corporate bond bargains with new data and a new methodology. Following bonds of the same issuer over time in 2016–2017, he finds that prices on nearly identical bonds move in opposite directions or move by vastly different amounts, concluding that one might suggest that investors' fixed-income allocations may be cost- and duration-optimized through buying individual bonds rather than through investing in active bond funds or index ETFs. Finally, Kristine L. Beck, James Chong, and G. Michael Phillips examine the performance of the 10 largest active ETFs and conclude that active ETFs are not appropriate as stand-alone investments, while, on the other hand, as part of a portfolio consisting of an active ETF, a benchmark index, and a risk-free asset, active ETFs play an integral role in the outperformance of the portfolio over the benchmark.

Our next article also stands on its own. Frequent contributor John A. Haslem delves into the issues of mutual fund revenue sharing and presents nuanced literature treatments and interpretations of the issues, noting that the world of fund distribution to intermediaries for sales of fund shares is not quantum physics, but it is much more hidden and convoluted than logic and law require.

The next four articles, still somewhat heterogeneous, cover various aspects of the asset management scene or financial markets. First, Salma Ben Amor and Maher Kooli investigate the determinants of a firm experiencing a merger or acquisition in the five years following its IPO, focusing on the role of the venture capitalist and the effect of asymmetric information on the probability of post-IPO M&A and finding that the reputation of the venture capitalist positively influences the likelihood of an IPO firm to engage in acquisition, confirming that an IPO represents an opportunity for new issuers to become single and even frequent acquirers. The next piece, by C. Michael Smith, focuses on an approach to systematic trading for investors requiring equity-like returns but lacking the risk tolerance to endure extreme losses, presenting a strategy based on trading moving average crossovers and finding that it remained a simple and effective risk-reduction strategy over the last 20 years, even when results are analyzed on an after-tax basis. Our third piece is by frequent contributor and Advisory Board member Greg N. Gregoriou and Jason Moschella, who investigate the efficiency and productivity of 25 of the largest currently operating offshore and onshore hedge fund families, finding that on a relative basis, most of the hedge fund families in the sample did not gain or lose a competitive edge from 2012 to 2016 and that hedge funds have, for the most part, adapted their operations to reflect the challenging investment environment for active managers. Our last piece is this group is by Anwar Hasan Abdullah Othman, Hasanuddeen Abdul Aziz, and Salina Kassim, who look into the Malaysian unit trust funds (mutual funds), noting that most funds trail the market portfolio and risk-free returns, as fund managers in Malaysia show poor selectivity performance and lack of timing skills. They investigate the long- and short-run relationships among all net asset values (NAV) of Islamic unit trust funds in Malaysia over the period from April 2006 to December 2015, showing that the NAV of all Islamic funds share a long-run equilibrium relationship in Malaysia.

Our final piece is also the sole entry in its category as Kevin A. Diehl discusses the choice between donor-advised funds and family foundations, indicating which might work best in wealth management.

Jean L.P. Brunel
Editor