The Parable of the Divining Rod That Unearths Skillful Investment Managers

- Early consultants discovered a divining rod that identifies investment manager skill. It is still being used today.
- As long as everyone sticks to the old ways, only the clients lose, but they don't know it.
- Some consultants could break away from the pack and employ real science rather than divining rods.

Divining Rod. A forked rod believed to indicate the presence of water or minerals especially by dipping downward when held over a vein.

Parable

A long time ago in the ancient land of 1970s Pension Investing, a group of adventurers banded together and collected the investment performances of professional investment managers, who were mostly banks at that time. As early entrepreneurs, the adventurers organized their investment return numbers into "Becker Green Books" that sorted performance from high to low, and they sold these Books to pension plan trustees.

Before the Green Books, no one knew how their pension plan had performed, although they did care; plan fiduciaries trusted their investment managers, but had no way of verifying that the trust was justified.

Eventually, an amazing divining rod appeared that could find the best managers. The rod hovered over the Green Books and always pointed to the managers with the highest returns. "Skill" had been discovered for the first time, and it was easy to find – just look at the top of the list. No surprise, those managers at the top of the list became very rich. Over time, the amazing divining rod discovered different skillful managers. In fact,

each new Book contained a new list of skillful managers. Skill would pass from one manager to another with very little predictability. It was fleeting.

Many years later, a group of wise men calling themselves “The CFA Institute” wrote a “Benchmark Study” in which they recommended the abandonment of the old divining rods, replacing them with science, but no one listened.

The Lesson

The old ways of searching for investment manager skill have never worked, and never will. This failure is the reason that active investment managers fail. There are way too many incompetent investment managers with business because the consulting profession continues to use those old divining rods to identify skill.

Indexes and peer groups don’t work. Indexes only work for index huggers, but those folks can’t add much value by definition. The right benchmarks for evaluating active investment managers is a passive, low cost, portfolio that could be held instead of that manager – a custom benchmark.

Peer groups don’t work for a variety of reasons but the most obvious is “Loser Bias.” Researchers routinely report that 80% of active managers fail to outperform their benchmarks. Accordingly, 80% of peer group members are losers. Beating the losers is not a win. Peer groups are especially dumb for evaluating hedge fund managers, as explained in this fun video.

S&P, Morningstar, Vanguard, etc. say Active Managers Have Failed

Contents: 80% Losers, 20% Either Good or Lucky

So what?

Investment consulting is a credence good, similar to auto repair services. The buyer doesn’t know if the service is good or bad. But investors are catching on. Robo advisors are the beneficiaries because if you don’t know how good the advice might be, you shouldn’t pay much for it.

Some consultants will seize the opportunity to differentiate by throwing out their divining rods, replacing them with today’s evaluation science, and telling the world.