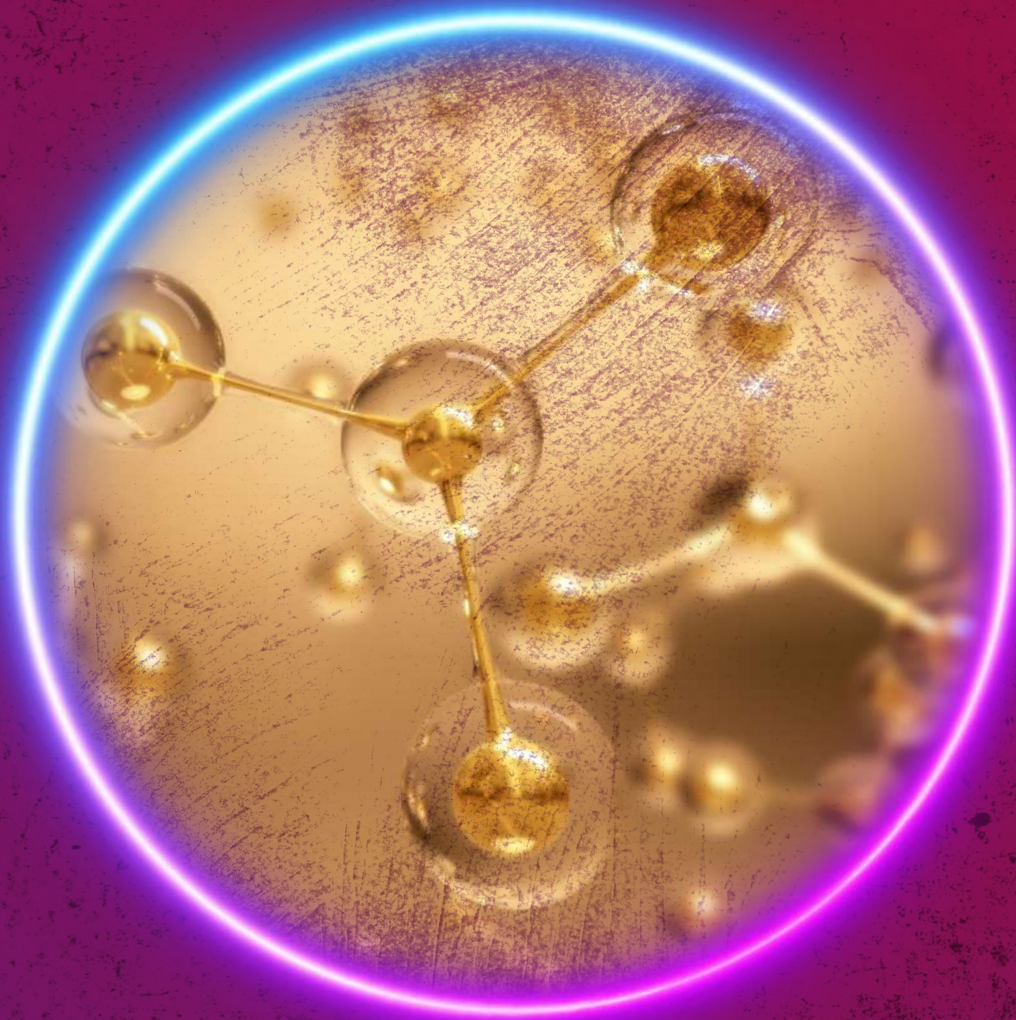
PORTFOLIOSCIENCE

A TRULY DIFFERENT APPROACH



COOPER PARRY
WEALTH

ABOUT COOPER PARRY WEALTH

Every business will tell you they're different. The private banks talk about their heritage and their global resources. Traditional stockbrokers will tell you how they can find you the best investments. And financial advisers shout about how they have more technical qualifications than everyone else. But there's one thing they don't like talking about...YOU!

We believe the traditional wealth management model is broken. It's focussed on products, not what they can help you achieve. And it's serving the needs of those selling these products, rather than those investing in them. Sure, you'll want to know what to invest in. But will that mean you can spend more time with your family? Will it stop you worrying and make it easier to sleep at night? Will it help you enjoy your retirement? At Cooper Parry Wealth we focus on the relationship with you, not your money.

NUMBER ONE

In 2010, we made the decision to do things differently. To break the mould. To be the best at what we do. We scrapped the traditional model and created a new proposition. One that helps our clients achieve the things that matter most to them. What we've created is simple but it works. We want our clients to make life count.

OUR INVESTMENT APPROACH

Unsurprisingly we don't follow the status quo when it comes to investing. We have built an investment model based on academic evidence, Nobel prize-winning research and, most importantly, common sense. It's about doing a few things exceptionally well and is based around six principles. Let's explore them…

EWAN ROSIE
CIO

CHAPTERS

INTRODUCTION

PART 1: PRINCIPLES 01
1.1 Accept the stock market is hard to beat 02
1.2 Understand risk and return are related 04
1.3 Don't put all your eggs in one basket 05
1.4 Focus on the investment mix 07
1.5 Keep your costs low 09
1.6 Control your emotions and think long-term 11

PART 2: PRACTICE 15
2.1 Decide what's on the investment menu 16
2.2 Apply some Nobel prize-winning theory 17
2.3 Build the growth engine and defensive mix 19
2.4 Establish the right mix for you 21
2.5 Use evidence-based funds 23
2.6 Review, rebalance and relax 25

INTRODUCTION

Investing is something we all need to do. It's also hugely important to get it right. If we do, it can help us realise our dreams and ambitions and enjoy life to the fullest. Get it wrong, and we risk being unable to afford to lead the life we desire.

You'd expect with so much resting on doing it well, investing would have been exposed to thorough empirical research. You'd expect there to be a broad academic consensus on the best way to invest, firmly based on what has been proven to work in the past. You'd also think that all financial professionals would have studied this evidence in detail and would be applying it to their daily work.

Well, there's good and bad news. The good news is that, yes, investing has been thoroughly researched by the academic community. There's plenty of independent, peer-reviewed and time-tested evidence, dating back to the 1950s. Several of the academics responsible for it have won a Nobel Prize in the process. The bad news is, extraordinary as it may seem, most financial professionals continue to recommend strategies that ignore the evidence altogether.

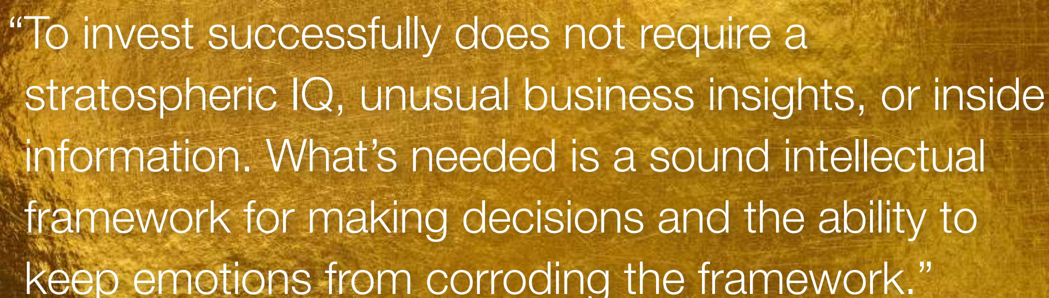
We're about to explain PortfolioScience. That's what we call our evidence-based investment philosophy. Part 1 sets out six key principles underpinning our approach. Part 2 explains how to put those principles into practice.

We've deliberately kept it short. Yet it contains more or less everything you need to know to achieve your investment goals. Successful investing is about doing a few simple things exceptionally well. In fact, the simpler you keep it, the more successful you're likely to be.

But the fact that it's simple doesn't mean it's always easy, and that's why we recommend that all investors use a professional adviser — not just to get them started, but also to accompany them along the journey.

One more thing. We say you should use an adviser. To be more specific, what you really need is a Financial Planner — someone to help you see the bigger picture. Because when you set out on any kind of journey, you have to know where you're going. You need to know why you're investing. What do you want to achieve? What's important to you? And what do you really want from life?

Right, let's get started.



PART 1: PRINCIPLES

Every day the prices of hundreds of shares are listed in the press. There are daily, if not hourly, updates on radio stations, and entire TV channels dedicated to bringing us the latest news from the trading floor. You get the impression that to be a good investor, you need to keep abreast of the markets, and what the experts are saying about them, all of the time.

The truth is very different. From an investor's point of view, the markets are really quite irrelevant. John Bogle, a US businessman and author who has helped to revolutionise the investment industry, refers to the markets as "a giant distraction from the business of investing"[1].

Essentially, investing on the stock market is about sharing in the profits of capitalism. Companies distribute those profits in the form of dividends. They generally pay higher dividends when they're doing well, and lower dividends when they're not. When the market expects future profits for a company to rise, the price of its shares tends to rise as well, and when profits are expected to fall, so does the price.

As a result, the value of our investments in shares, or equities as they're also known, constantly rises and falls. In the short-term it can fluctuate wildly.

But evidence shows that capitalism works and in the long-term there'll continue to be a demand for goods and services. Companies will carry on making profits and it makes sense to benefit from capitalism yourself.

Of course, the world faces big risks, such as terrorism, climate change and further pandemics. We can't rule out the possibility of a cataclysmic event such as a nuclear war or an asteroid strike. But, throughout history, the spirit of human enterprise has proven to be remarkably resilient.

Author and financial adviser Mark Hebner sums it up: "With a total market capitalisation of over 51 trillion dollars, annual profits of over two trillion dollars, more than 13 thousand CEOs worldwide, and more than 82 million employees selling products in 195 countries, it simply isn't reasonable to believe that Capitalism Inc. will go out of business."[2]

The question then is how to maximise the returns you receive from participating in global capitalism. There's certainly no shortage of people giving you their opinion.

But what does the academic evidence tell us? Essentially, it all comes down to six important principles, which we're going to look at one by one.

[1] Bogle, J. (2007): The Little Book of Common Sense Investing
[2] Hebner, M. Index Funds: The 12-Step Recovery Program for Active Investors

1.1 ACCEPT THE STOCK MARKET IS HARD TO BEAT

One of the biggest misconceptions that people have about investing is that it's all about beating the stock market. The media certainly like to give that impression. In truth, however, consistently beating the market over the long-term is extremely hard, and only a tiny proportion of investors, including the professionals, manage to do it. This approach is called active investing.

Active investors pay fund managers to try to beat the market on their behalf — either through picking stocks or trying to get in and out of the market at the right time. Passive investors, on the other hand, use index funds which give exposure to all the stocks in a particular market and simply aim to capture the market return.

You as the investor, face a basic choice: do you invest actively or passively?

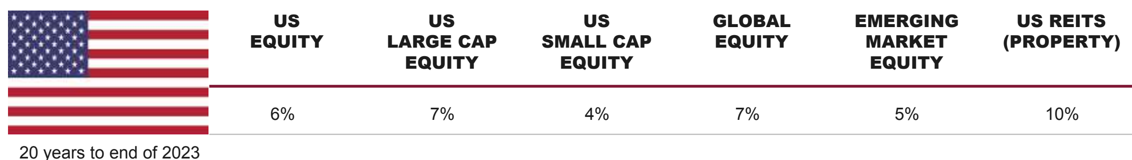
There have been numerous studies illustrating the difficulty that active managers have in outperforming the market. For example, Professor David Blake at Cass Business School in London has led an ongoing study into the performance of equity funds in Britain and the US[3]. It found that very few funds beat the market over the long-term and those that do, effectively recover any additional returns they generate from investors by charging higher fees.

That conclusion is consistent with data regularly produced by Standard & Poors (S&P) which keeps an on-going scorecard to show how active managers have performed. It's called SPIVA, which stands for S&P Index Versus Active. In other words, it shows how many active funds have beaten their respective benchmarks over different periods of time.

As you can see from the tables below, the SPIVA analysis shows that, in the ten years to the end of 2023, the vast majority of UK fund managers failed to beat their benchmarks, with the Global Equity sector being the worst performing as only 4% of the funds beat their benchmark[4].

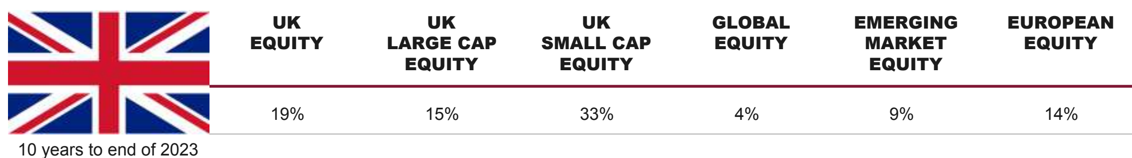
It's the same story in the US over 20 years, with most fund managers failing to beat their benchmarks and this has been a consistent message since the SPIVA research began.

Percentage of fund managers beating their benchmark



US EQUITY	US LARGE CAP EQUITY	US SMALL CAP EQUITY	GLOBAL EQUITY	EMERGING MARKET EQUITY	US REITS (PROPERTY)
6%	7%	4%	7%	5%	10%

20 years to end of 2023



UK EQUITY	UK LARGE CAP EQUITY	UK SMALL CAP EQUITY	GLOBAL EQUITY	EMERGING MARKET EQUITY	EUROPEAN EQUITY
19%	15%	33%	4%	9%	14%

10 years to end of 2023

Whilst we review it every year, the message doesn't change!

But it's not just in Britain and America that funds struggle to produce market-beating returns. There's now SPIVA data available on fund performance all around the world, and the figures are more or less consistent across different countries and asset classes.

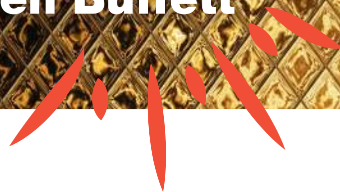
[3] New Evidence on Mutual Fund Performance: as Comparison of Alternative Bootstrap Methods, by Blake, Caulfield, Ioannidis & Tonks, June 2014

[4] S&P Indices vs Active Managers, April 2024

To understand why the market is so hard to beat, you need to visualise it as a giant super-computer, aggregating the opinions of millions of traders around the globe. All that information is already reflected in current prices. It's only new (and by its nature unknowable) information that causes prices to change, and the market responds within seconds. Every time they buy or sell, traders effectively express an opinion as to the value of a particular share and thousands of such trades are made every second.

To say that a share is either underpriced or overpriced is an extremely bold statement; effectively you're saying that you know better than the collective wisdom of the entire market. Of course, you may be right, but you're just as likely to be wrong. Plus, to beat the market consistently you need to keep on making correct calls time and again, and hope that any gains you make at least offset the costs involved in active trading.

> "We don't have to be smarter than the rest, we have to be more disciplined than the rest."
>
> **Warren Buffett**



1.2 UNDERSTAND RISK AND RETURN ARE RELATED

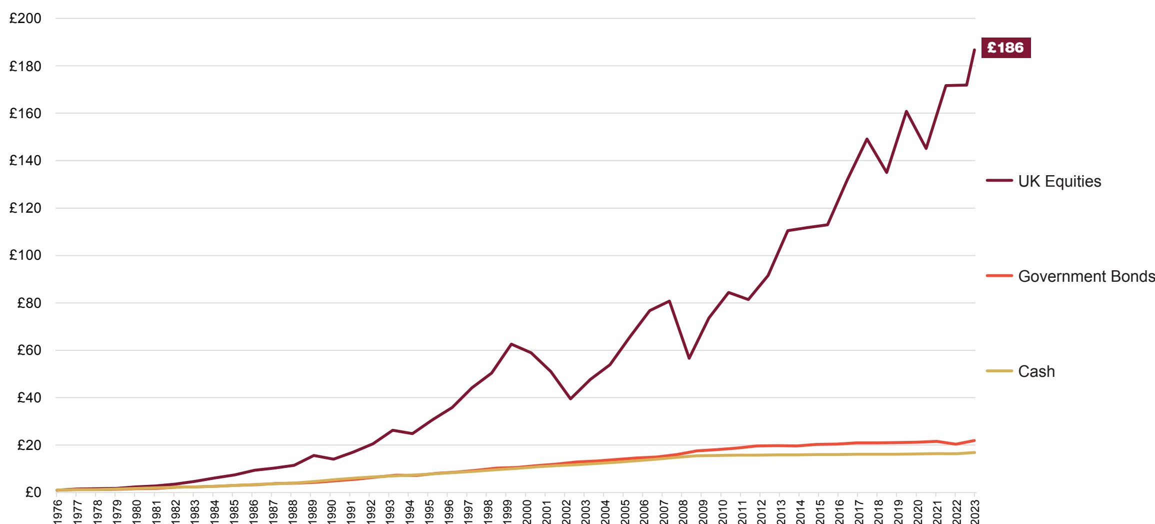
The second principle that you need to understand is that risk and return go hand in hand. There is no type of investment, not even cash or government bonds, that is entirely risk-free. Each of us only has the capacity to take a certain amount of risk, as we'll show you later, and any we do take needs to be carefully managed.

That said, you shouldn't be unduly frightened; it's risk that drives returns. The market rewards us for the risk we take. Risk doesn't guarantee a return; but, generally speaking, the more risk you're prepared to take, the higher the returns you can expect to receive.

Imagine you're playing a game of roulette, and you choose to place all your money on black. You'd have almost a 50/50 chance (because of the '0') of losing your money, and the same probability of doubling it. But perhaps it's not enough to double your money, and you need to take more risk, so you put your money on number 12. Now you could win 35 times your initial investment, but you'll also have a 35 in 36 chance of losing. You certainly don't want to rely on getting lucky, to provide you with the income you're going to need.

Thankfully, it's a rare occurrence to lose your entire stake when it comes to investing, stock markets can be very volatile in the short-term, but if you keep a long-term perspective and are able to ride it out, the risk of permanent, substantial loss of capital is relatively small.

Of the major asset classes, cash is the safest, but it also delivers the lowest returns, as you'll see from the chart below from Dimensional Fund Advisors. £1 in 1976, held safely in cash, would have turned into £17 by the end of 2023. If you'd have taken slightly more risk and invested in government bonds, it would have grown to £21. But if you'd invested in UK equities, you would have had £186 to show for it 46 years later. You would, however, have had to endure a much bumpier ride to get there.



So, remember the connection between risk and return. Don't fool yourself into thinking you can have low risk and high return. And if anyone offers you an investment opportunity with guaranteed returns of, say, 10% a year, you should run a mile.

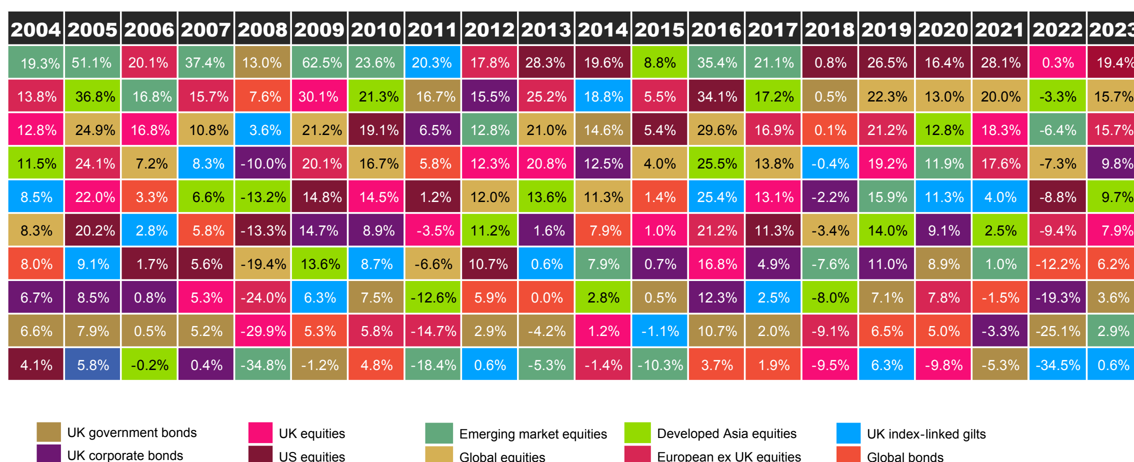
1.3 DON'T PUT ALL YOUR EGGS IN ONE BASKET

Let's go back to that roulette analogy for a moment. It's one thing to bet a pound on the ball landing on 12 for a bit of fun. But most of us wouldn't dream of investing our entire life savings in, say, the shares of a single company. Intuitively, you probably know that you shouldn't put all your eggs in one basket, but you'd be amazed at how many fail to diversify properly.

There is a broad academic consensus that investors should have a diversified portfolio that includes both higher-risk assets, such as equities, and lower-risk assets, such as bonds.

In short, diversification is about avoiding nasty surprises. It's not exactly rocket science, but there's more to it than you might think. It was Professor Harry Markowitz, whose work on portfolio construction earned him the Nobel prize, and who shaped our understanding of it.

We call the different types of asset — shares, bonds, property and cash, for example — asset classes. Markowitz found that, when combined together, asset classes where the returns don't exhibit identical patterns (or, in industry jargon, are "imperfectly correlated") can help to make the investment journey smoother without giving up return[5]. Combining two imperfectly correlated asset classes together can reduce the risk of a portfolio by a quarter. If you combine four, the risk can be halved, again without having a negative impact on your returns.



2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
19.3%	51.1%	20.1%	37.4%	13.0%	62.5%	23.6%	20.3%	17.8%	28.3%	19.6%	8.8%	35.4%	21.1%	0.8%	26.5%	16.4%	28.1%	0.3%	19.4%
13.8%	36.8%	16.8%	15.7%	7.6%	30.1%	21.3%	16.7%	15.5%	25.2%	18.8%	5.5%	34.1%	17.2%	0.5%	22.3%	13.0%	20.0%	-3.3%	15.7%
12.8%	24.9%	16.8%	10.8%	3.6%	21.2%	19.1%	6.5%	12.8%	21.0%	14.6%	5.4%	29.6%	16.9%	0.1%	21.2%	12.8%	18.3%	-6.4%	15.7%
11.5%	24.1%	7.2%	8.3%	-10.0%	20.1%	16.7%	5.8%	12.3%	20.8%	12.5%	4.0%	25.5%	13.8%	-0.4%	19.2%	11.9%	17.6%	-7.3%	9.8%
8.5%	22.0%	3.3%	6.6%	-13.2%	14.8%	14.5%	1.2%	12.0%	13.6%	11.3%	1.4%	25.4%	13.1%	-2.2%	15.9%	11.3%	4.0%	-8.8%	9.7%
8.3%	20.2%	2.8%	5.8%	-13.3%	14.7%	8.9%	-3.5%	11.2%	1.6%	7.9%	1.0%	21.2%	11.3%	-3.4%	14.0%	9.1%	2.5%	-9.4%	7.9%
8.0%	9.1%	1.7%	5.6%	-19.4%	13.6%	8.7%	-6.6%	10.7%	0.6%	7.9%	0.7%	16.8%	4.9%	-7.6%	11.0%	8.9%	1.0%	-12.2%	6.2%
6.7%	8.5%	0.8%	5.3%	-24.0%	6.3%	7.5%	-12.6%	5.9%	0.0%	2.8%	0.5%	12.3%	2.5%	-8.0%	7.1%	7.8%	-1.5%	-19.3%	3.6%
6.6%	7.9%	0.5%	5.2%	-29.9%	5.3%	5.8%	-14.7%	2.9%	-4.2%	1.2%	-1.1%	10.7%	2.0%	-9.1%	6.5%	5.0%	-3.3%	-25.1%	2.9%
4.1%	5.8%	-0.2%	0.4%	-34.8%	-1.2%	4.8%	-18.4%	0.6%	-5.3%	-1.4%	-10.3%	3.7%	1.9%	-9.5%	6.3%	-9.8%	-5.3%	-34.5%	0.6%

Each column in the chart above, from Vanguard, illustrates the returns for a particular year, and each asset class is colour-coded then ranked according to the size of those returns.

As you can see, it looks rather like a patchwork quilt. There are no reliable patterns, asset classes fall out of favour very suddenly, and in any one year the difference in returns can be huge. It's very hard, if not impossible, to predict which type of investment is going to perform best from one year to the next.

What the chart teaches us, more than anything, is the importance of diversification. Equities, the asset class that's produced the highest returns historically, is also the most volatile. By combining your holding in equities with holdings in, say, property or bonds, you can reduce the effect of that volatility.

It also makes sense to diversify geographically. You might instinctively prefer to invest in shares of companies of your own country; it's what's known in the industry as "home bias".

[5] Markowitz, H. M. (1991) Portfolio Selection: Efficient Diversification of Investments 2nd Edition, Cambridge, Massachusetts: Basil Blackwell

Investing too heavily in countries that happen to be in vogue is also a bad idea. In the 1980s, for example, Japan was seen as the country to invest in, but the Japanese stock market subsequently spent more than 20 years in negative territory. The logical thing to do is to invest in the shares of companies all over the world.

Finally, you should also diversify across the asset classes. Even the most successful companies occasionally come unstuck — Lehman Brothers in the US, for example, or Woolworths, Carillion or Monarch Airlines in the UK. So, instead of buying individual stocks, you should stick to funds, and specifically index funds, which allow you to access a much larger amount of companies and bonds, without having to purchase them all individually.

1.4 FOCUS ON THE INVESTMENT MIX

Simply put, there are two things you can do with your money to make it grow: you can either lend it to someone or become an owner in a company.

When you buy a bond, you're lending money, either to a business or a government. The returns you receive come in the form of interest paid on your loan. If the borrower defaults on its bond, you're nearer to the front of the queue of creditors to be repaid with any remaining capital.

When you buy a share, you're taking an equity stake in a business; effectively you become a co-owner in that business. Your returns come from a combination of dividends and any increase in the share price. If the firm goes bankrupt, you're nearer to the back of the queue of creditors.

Being an owner delivers far less certain rewards than those of being a lender. However, you should be rewarded for this additional risk over the longer term with higher returns. This is what's known as the equity premium.

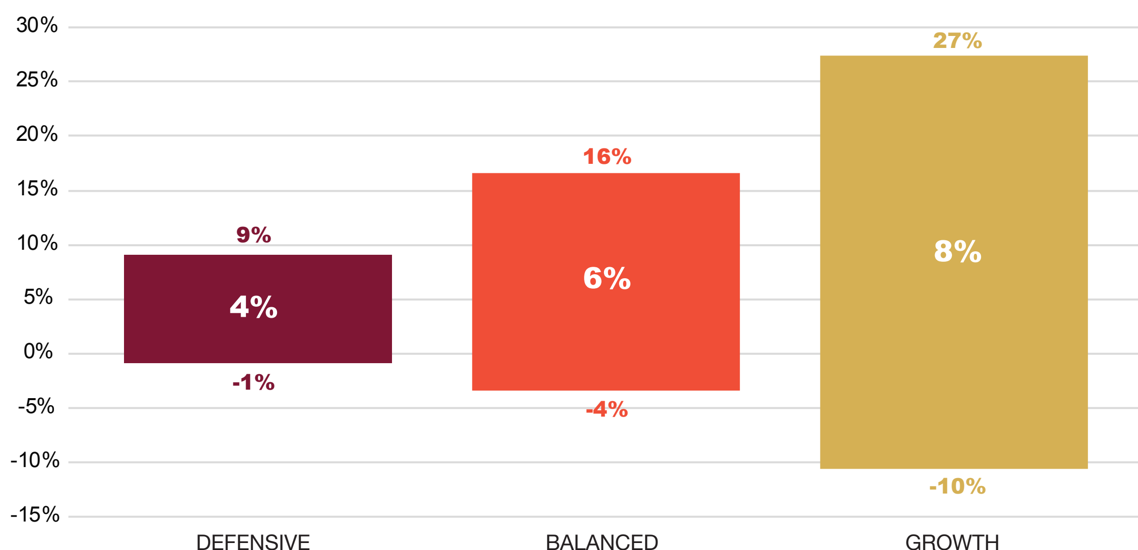
Ultimately, it's your investment mix (i.e. how much you own and how much you lend), or what financial professionals refer to as your asset allocation, which is the crucial factor.

The Sandler Report on the financial services industry, published in 2002 and commissioned by the UK Government, said this: "For the individual investor, the asset allocation decision is by far the most important factor in determining returns."

One academic study found that asset allocation accounts for as much as 93% of returns, compared with 3% for security selection and just 2% for market timing[6].

In January 2017, Vanguard Asset Management released the findings of its own research on this subject[7]. It measured the performance of 743 balanced funds – in other words, funds investing in a mixture of different asset classes – in the UK over the period from 1990 to 2015. It found that asset allocation accounted for 80.5% of the variability of returns among the funds it looked at. Vanguard conducted similar analysis of US, Australian, Japanese and Canadian funds and found similar results. In the US, asset allocation accounted for as much as 90.1% of the variability of returns.

Practically, what does this mean for the construction of an investment portfolio? The following chart* provides some context:



From left to right, we have an example 'defensive portfolio', 'balanced' portfolio, and 'growth' portfolio. The middle point of each bar is a typical long-term expected average return. The defensive strategy is a 'lending' portfolio, i.e. bonds and the growth strategy is an 'owning' portfolio, i.e. companies and property. The balanced strategy is a mix between lending and owning.

* Source: CPW market assumptions

As expected, the defensive portfolio has the lowest middle point at 4% and the growth portfolio has the highest expected long-term average return at 8%.

The numbers above and below the different investment strategies highlight the possible range of returns of each investment strategy, i.e. the volatility. As you can see, the riskier the investment, the larger spread of investment return, both in terms of the potential upside and the potential downside.

To achieve the higher returns, an investor needs to be comfortable with this wider spread of investment returns and the volatility that comes with it. This is why the investment mix is such an important decision. If you get this mix wrong and receive a loss you simply aren't comfortable with, this usually leads to selling out of the investment and losing a lot of money, instead of waiting for the inevitable recovery of the value!

An investment portfolio needs to be structured in a way that achieves the returns an investor requires, without taking them to a place that would cause panic. This can only be determined by a thorough financial planning process, assessing an investor's comfort, need and affordability to take risk, and then looking at how likely a successful outcome will be achieved based on differing investment conditions and risk profiles.

[6] Brinson, G. P., Hood, L., Randolph and Beebower, G. L. (1986) Determinants of portfolio performance, Financial Analysts Journal

[7] Vanguard calculations, using data from Morningstar, Inc.

1.5 KEEP YOUR COSTS LOW

There are very few things about investing that you have control over, but how much you pay to invest is one of them.

To quote Warren Buffett in his 2018 letter to Berkshire Hathaway shareholders, "performance comes, performance goes, but fees never falter." Keep fees low, and you will almost certainly end up with higher returns.

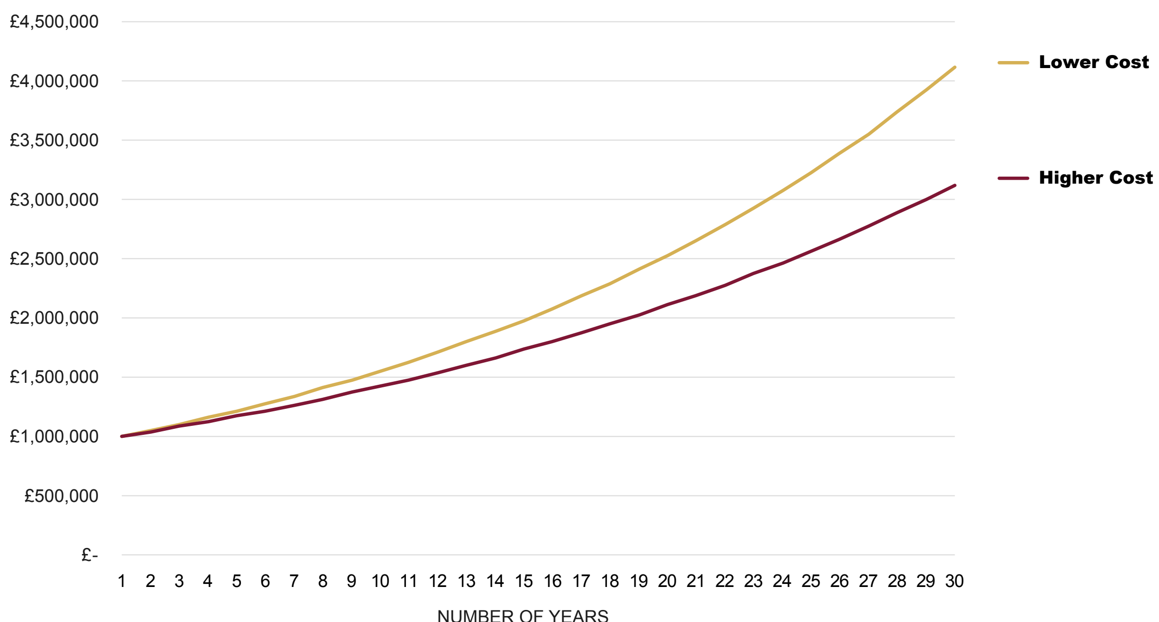
As consumers, we're conditioned to think that the more we pay for a product or service, the better it generally is. But, confusingly, it works the other way around with investing. To put it another way, in most cases, the less you pay to invest the higher your net returns will be.

To add to the confusion, the investing industry can make it very difficult to calculate what their different fees and charges add up to. The annual management charge, or AMC, for instance, is just part of the cost of investing in a particular fund. On top of that there's a range of other costs associated with transactions, such as dealing costs, dilution levies and stamp duty, etc. So the more your fund manager trades — and they tend to trade far more often than they should — the more you end up paying. We try to measure this by looking at 'portfolio turnover costs'.

Thankfully, product providers are now required by law to be more transparent. However, many of them continue to hide from consumers the full cost of using their products and how their funds perform compared to their benchmark index, once that cost is factored in. Research in June 2018 by the consumer pressure group Better Finance showed that 43% of funds based in the UK failed to provide the information required of them under European Union legislation[8].

Another reason why investors pay insufficient attention to costs is that, in percentage terms, they seem relatively modest. When you add together the various fees and charges, investors typically pay at least 1% more for high-cost funds and this is without advice costs.

That difference may seem trivial, but remember, you pay those costs each and every year. With the effects of compounding a high-cost fund can have a hugely detrimental impact on your long-term net returns.



[8] Better Finance (2018): Benchmark Disclosure Compliance Research

The chart on the previous page shows the difference 1% in charges can make over the longer term, using a 4% and 5% growth rate on an initial investment of £1 million.

Over 30 years, the difference is appropriately £1 million, which would have been paid to the fund manager instead of compounding in an investors investment portfolio.

Many in the industry, and even some financial advisers, will try to argue that the importance of fees and charges has been exaggerated. It's not about cost, they argue, but the value that a product provides. The evidence shows, however, that many financial products are effectively priced to fail. In other words, any market outperformance they provide is outweighed by the cost of using them.

Of course, it's possible to pick a fund that will outperform the market so substantially in the future that it will provide genuine value over and above any costs you incur. But again, the data shows that the odds of doing so are heavily stacked against you.

You might be wondering at this point about the cost and benefits of using a financial planner. Research by Vanguard highlighted five key ways financial planners help investors[9]. These were:

1. Selecting a suitable investment portfolio – well diversified, sensible risk profile and rebalanced regularly

2. Having appropriate investment costs – ensuring investors receive more of the returns

3. Tax efficiency – ensuring tax allowances are used and that drawdown decisions don't prove costly with regards to income tax, capital gains tax and inheritance tax

4. Spending strategy and withdrawal order – understanding how best to deliver the income and capital investors need to live life

5. Behavioural coaching – keeping an investor on track and coaching them not to react emotionally.

The last of the five was highlighted as the most valuable. Why? Because it is extremely important to remain disciplined over the long-term, particularly during times of uncertainty. That's when many people take the wrong course of action. Behavioural pitfalls such as trying to time the markets or chasing performance are among the biggest mistakes. But without a financial planner, how would you know this and how would you know when to remain disciplined and when to make a change?

The research showed that this well-rounded advice can add around 3% in net returns per year to your portfolio. Compounded over time, that will make a huge difference, quite apart from the peace of mind that having a trusted planner provides.

> "Beware of little expenses. A small leak will sink a great ship."
>
> **Benjamin Franklin**

[9] Vanguard (2016): Quantifying Vanguard Advisor's Alpha

1.6 CONTROL YOUR EMOTIONS AND THINK LONG-TERM

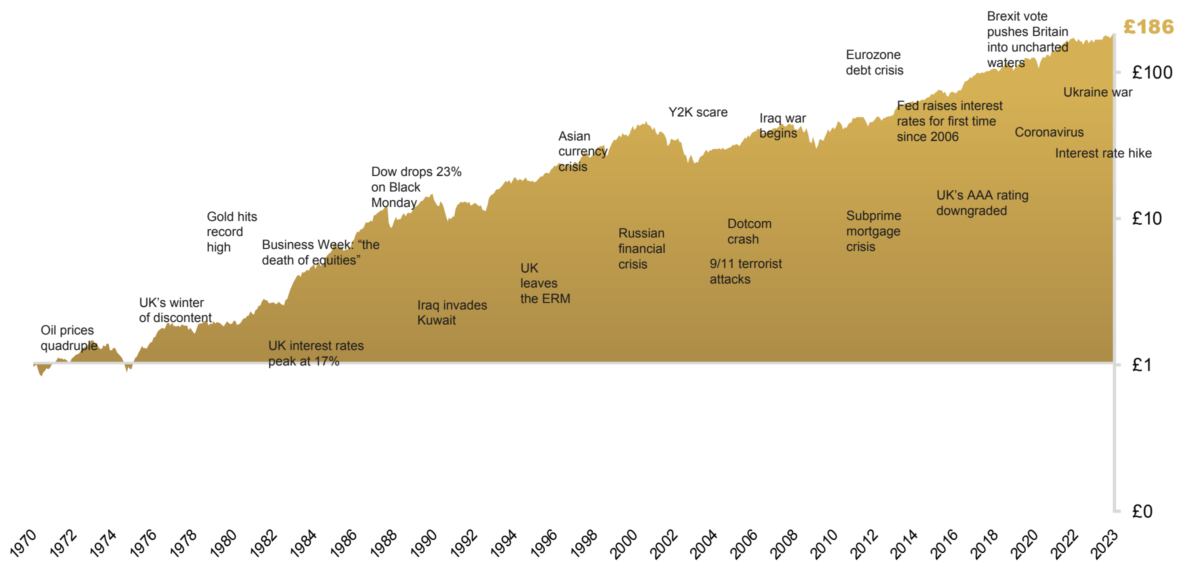
So, we've come to the sixth and final principle underpinning evidence-based investing, and it's arguably the most important of all. You could abide by all of the first five principles, but if you don't control your emotions and keep a long-term focus, you risk coming badly unstuck.

To quote John Bogle, "the historical data supports one conclusion with unusual force: to invest with success, you must be a long-term investor"[10]. We don't know how the markets will perform in the short-term, nobody does. But we do know that in the long run, they've almost always rewarded investors with globally diversified portfolios.

The entire twentieth century, in fact, illustrates the resilience of equity markets. Despite two world wars, the spread of Communism and the nuclear arms race, a single dollar invested in global equities in 1900 would have grown to $295, around £225, by the year 2000[11].

It's because disciplined investing has proven to be the best strategy, that controlling your emotions is so important. But again, that doesn't mean it's an easy thing to do. One of the problems is that human beings aren't cut out to be good investors because of the way we've evolved. We're tuned to respond to immediate threats. When markets fall sharply, for example, we find it hard to ride it out.

The fact is that periods of market volatility are really very common, as you can see from the chart below. On several occasions over the last half a century, there were times when things looked extremely bleak for equity investors. But each time markets recovered and ended up reaching new heights.



MARKET VOLATILITY OVER THE YEARS*

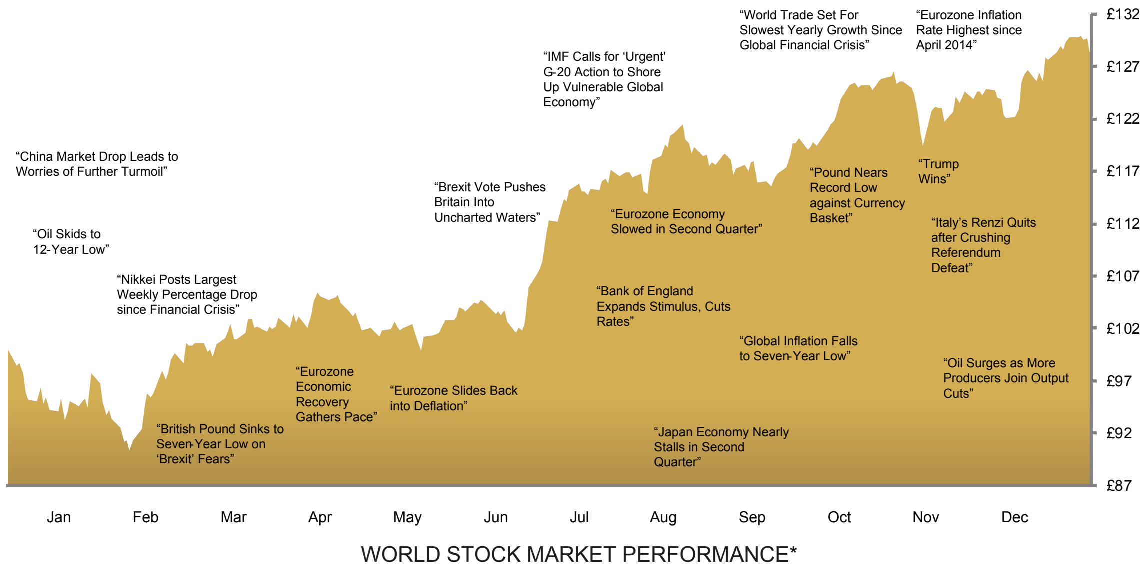
[10] John C. Bogle (2010) Common Sense on Mutual Funds: John Wiley & Sons

[11] Elroy Dimson, Paul Marsh, Mike Staunton (2002) The Triumph of the Optimists (Princeton University Press)

* Source: MSCI data © MSCI 2024

2016 is a good example of why market timing is best avoided, see chart below. That year there were two major events which the experts predicted would have a negative impact on stock prices; first, Britain voted to leave the European Union, and then, five months later, Donald Trump was elected President of the United States.

But, as it happened, markets rose sharply in the months that followed, and investors who heeded the warning to get out of the market totally missed the substantial gains.



WORLD STOCK MARKET PERFORMANCE*

So, how much better can we expect our investment returns to be if we manage to control our emotions? An annual study produced in the US by the consultancy firm Dalbar shows it can make a huge difference[12].

Between 1998 and 2017, Dalbar calculates, the average equity fund investor who periodically bought and sold earned returns of 5.29%, while an index tracking fund invested in the S&P 500 returned 7.2%. An investor who owned a globally diversified index portfolio would have seen returns of 9.04%.

[12] Dalbar's Quantitative Analysis of Investor Behaviour 2017

* Source: MSCI World Index

SUMMARY

We've reached the end of Part 1. We've explained, in a nutshell, how to be a successful investor. As we said at the beginning, it has nothing to do with speculating on the financial markets; it's simply about investing in global capitalism and enjoying a share of the profits that it generates.

Hold on to those six key principles:

- Understand how hard it is to beat the market
- Remember that risk and return are related
- Focus on your investment mix
- Diversify your assets
- Keep costs low
- And, crucially, control your self-destructive instincts, ignore the short-term noise and focus on your long-term goals

The problem is, though, that there's a world of difference between knowing the principles of successful, evidence-based investing and putting them into practice. That's what we're going to look at in Part 2.

Warren Buffett

PART 2: PRACTICE

In Part 1 we established six key principles you need to understand to be a successful investor. Now we're going to address the question of how to apply those principles when building and maintaining an investment portfolio.

There are some important points to note before we start. Firstly, everyone is different. We all have different goals, priorities, time horizons and attitudes to risk. The right portfolio for one person may be totally inappropriate for another. Secondly, use the academic evidence to put together a portfolio that is simple and easy to understand. Most important of all, make sure that it's one you can stick to.

Different financial planning firms have different ways of doing things. Even where firms share an evidence-based philosophy, there are different points of emphasis. The six-step process described here is the approach that we at Cooper Parry Wealth have developed over many years, and it's one which has consistently delivered excellent outcomes for our clients.

Will our process change? We will, of course, continue to monitor it closely, keeping tabs on the latest research. But we certainly won't change it for the sake of it, and nor will we act on ideas just because they happen to be flavour of the month. Nobel Prize-winning economist Professor Eugene Fama said "In academic finance, there are three to five ideas that survive every 20 years. In marketing and applied finance, there are ten new products a week."

Some investment advice firms change their philosophy, and the funds they recommend, on a regular basis. They claim to be doing the best for their clients, though often they're simply reflecting demand for the latest trendy products. Either way, all that chopping and changing produces worse results, not better.

What follows then, in short, is the academic consensus on the best way to construct and manage an investment portfolio, and we'd be surprised if the rules are very much different 20 or 30 years from now.

2.1 DECIDE WHAT'S ON THE INVESTMENT MENU

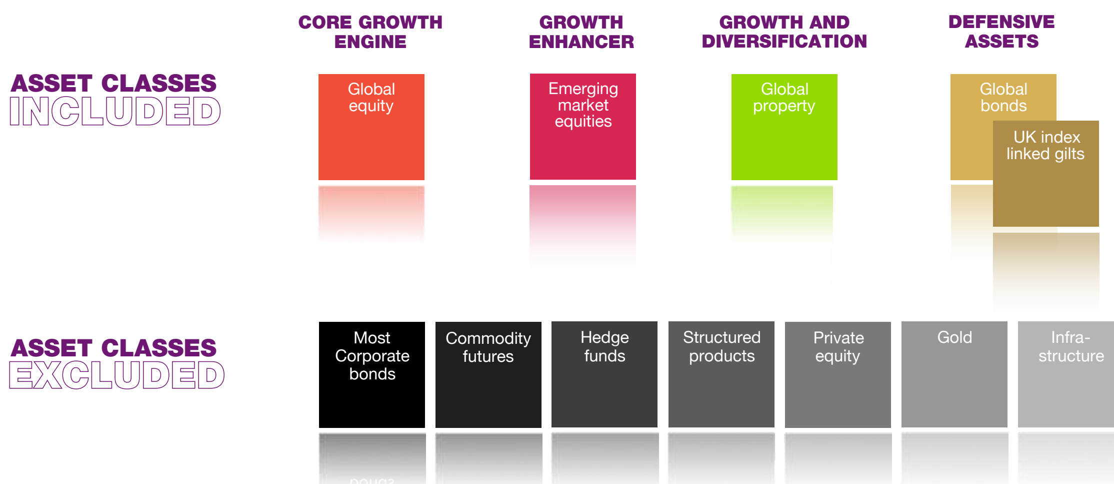
There are so many different options open to investors today that the choice can feel overwhelming. Open any investment magazine or one of those money sections in the weekend papers and you'll find pundits making what seems like a plausible case for investing in all sorts of things.

Remember that they often have a vested interest in promoting what they do. Fund providers and their marketing departments also want you to buy their latest products. Most new products are specifically launched to capitalise on the publicity surrounding an asset class that's been on a good recent run, which is probably the worst reason to invest in it.

The challenge in working out which types of asset to invest in, is to tune out the noise and narrow the options down to the asset classes that have been proven to deliver the best long-term results in the past.

At Cooper Parry Wealth we measure all potential investments against the following five-point checklist:

1. Do returns come from the market or from fund manager skill? – As we've seen, the skill of active fund managers adds very little value, so we'd expect returns to come from the market.
2. Does quality data exist? – We're only interested if we have at least ten years of performance data to base a decision on.
3. Do the rewards match the risk? – It's only worth taking the risk of investing in something if you can expect to be suitably rewarded for it.
4. Do they contribute to the portfolio? - What matters is the performance of the whole portfolio, and each part has to serve a function on a portfolio level.
5. Are they robust? – Anything we invest in needs to be low-cost, highly liquid and uncomplicated.



We've listed in this chart the asset classes which tick all of these five boxes, and those which don't. You'll see we've also labelled the purpose of the different asset classes.

Global equity is what we call our growth engine. Emerging market equities we term as a growth enhancer. Global property investment is included partly to provide growth but mainly diversification. Finally we have our defensive assets — high-quality, short-dated global bonds (in other words, bonds that are repaid in less than a year or two) and short dated UK index-linked gilts. The sole purpose of these defensive assets is to reduce the impact on the portfolio of stock market crashes and corrections.

As we mentioned earlier, our process is under constant review, and we won't rule out including one or two of the asset classes that are currently excluded in the future. But there simply isn't the evidence to warrant their inclusion as of now.

2.2 APPLY SOME NOBEL PRIZE-WINNING THEORY

So, we've established that the growth we need from our investment portfolio is principally going to come from equities. Because we don't want to be over-exposed to any one market, and we don't know which country's stocks will perform best from one year to the next, we're going to include equity from all around the world.

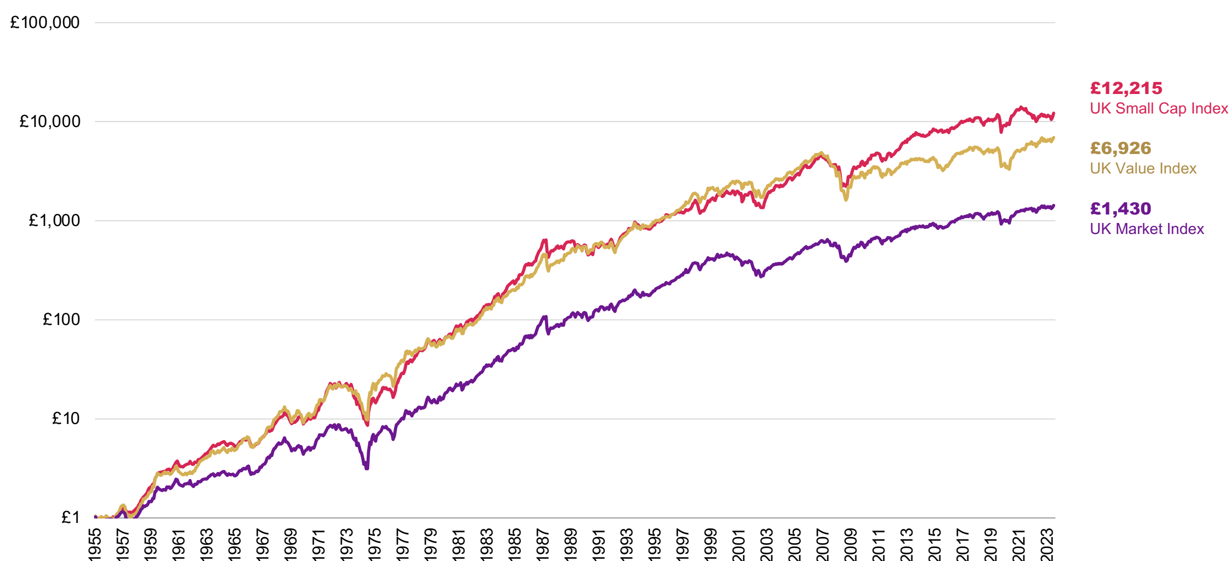
There's academic evidence that shows there is more we can do to maximise our equity returns too.

For many years, portfolio construction was based on what was known as the Capital Asset Pricing Model, or CAPM for short. The CAPM was developed in the early 1960s by, among others, William Sharpe, who later won the Nobel Prize in Economic Sciences.

Sharpe put forward the idea that investors are rewarded for "market risk" — in other words, the risk that remains after all company-specific risk is diversified away. The more market risk you take, Sharpe said, the higher you can expect your investment returns to be.

Building on his work, Eugene Fama set about investigating whether certain types of stock perform better than others over long periods of time. So he divided market risk into smaller segments. With the help of another academic, Kenneth French, Fama discovered that, over the long-term, stocks of smaller companies outperform those of larger companies, and stocks of undervalued companies (or value stocks) outperform growth stocks. The only downside with both smaller companies and value stocks is that they are more volatile than the market as a whole.

Although their primary focus was on US equities, Fama and French also observed the small-cap and value premium in stock markets around the world. This chart from Dimensional Fund Advisors supports their research, by showing how £1 invested in the UK Value Index and the UK Small Cap Index in the mid-1950s would have grown by the start of 2023, compared to £1 in the UK Market Index.



There is, of course, no guarantee that small-cap and value stocks will outperform in the future to the same extent that they have in the past. Indeed no one can be certain that they will outperform at all. But it does make sense, assuming you are willing and able to accept that extra volatility, and you have a long enough time horizon, to include modest elements of both small-company and value stocks in your portfolio. We call it tilting towards small-cap and value, and we do this at a global level across our equity allocation.

So, what will the returns of a portfolio that's tilted towards small-cap and value look like over time, compared to the returns of the broader market? Well, small-cap and value stocks are imperfectly correlated. In other words, they outperform and underperform the rest of the market at different times. So, the shorter the time horizon, the more unpredictable your returns will be. The longer you invest for, the easier it will be to harvest the returns of the different premiums.

Eugene Fama, incidentally, like Markowitz and Sharpe before him, also won the Nobel Prize and we've got even more evidence from more Nobel laureates to come. Some investors choose to ignore the findings of some of the brightest minds in academic finance at their expense.

Academics have also identified two main factors that should be considered when investing in bonds. They are:

TERM RISK – this is the length of time before the bond issuer must repay the bond capital (maturity), i.e. how long an investor lends out their money for. The longer a bond's maturity, the riskier it is, because if interest rates and/or inflation increase, an investor could be tied into a bond which pays a lower rate of interest. This would then lead to a fall in the bond's price as nobody would want to purchase the uncompetitive bond. We therefore focus on using short term bonds to reduce this sensitivity in our portfolios.

CREDIT RISK – this is the possibility that the provider of the bond is unable to repay an investor's capital. This could be because a company has gone bust or a government doesn't have the funds to make the repayment. We therefore mainly use high quality government bonds (such as those provided by the UK and US) and some high quality corporate bonds for diversification purposes, meaning this risk is minimised as far as reasonably possible.

We invest in global and UK, short dated bonds, and also short dated UK index linked government bonds, to provide an inflation hedged return.

2.3 BUILD THE GROWTH ENGINE & DEFENSIVE MIX

Let's recap. We've worked out which types of investment we're going to use, based on five key criteria. We've also applied some academic evidence to ascertain the types of equities that should give us better-than-market returns over the long-term, assuming we're patient enough and are willing to accept some additional volatility.

It's now time to use those building blocks to construct an investment portfolio. In fact we've already done the work for you. We've put together nine separate model portfolios. Although each has a different risk profile, they're all built in the same way.

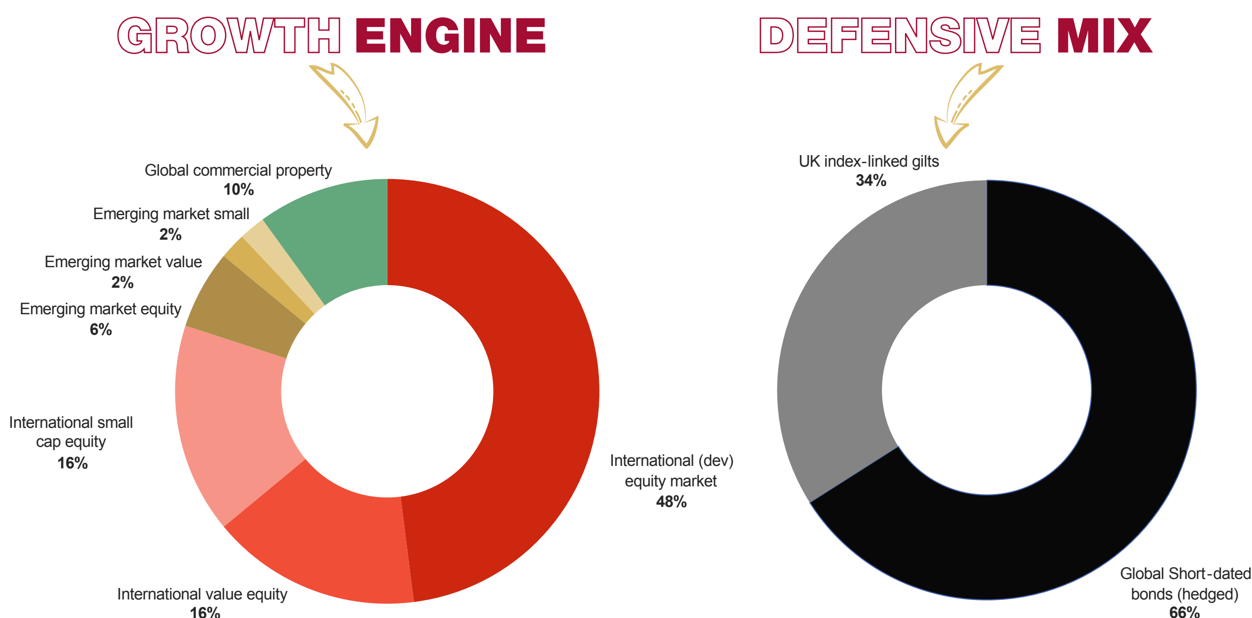
Our process is based on a theory developed by the Nobel Prize-winning economist James Tobin. In a paper written in 1958, he described a concept that became known as the Separation Theorem[14]. This suggested that the most efficient portfolio available is the "market portfolio" — containing, theoretically, all of the listed stocks available.

Investors should own this market portfolio, Tobin said, and add risk-free assets to reduce their overall exposure. In reality, no asset is entirely risk-free, although assets such as high-quality, short-dated bonds can be considered a reasonable substitute.

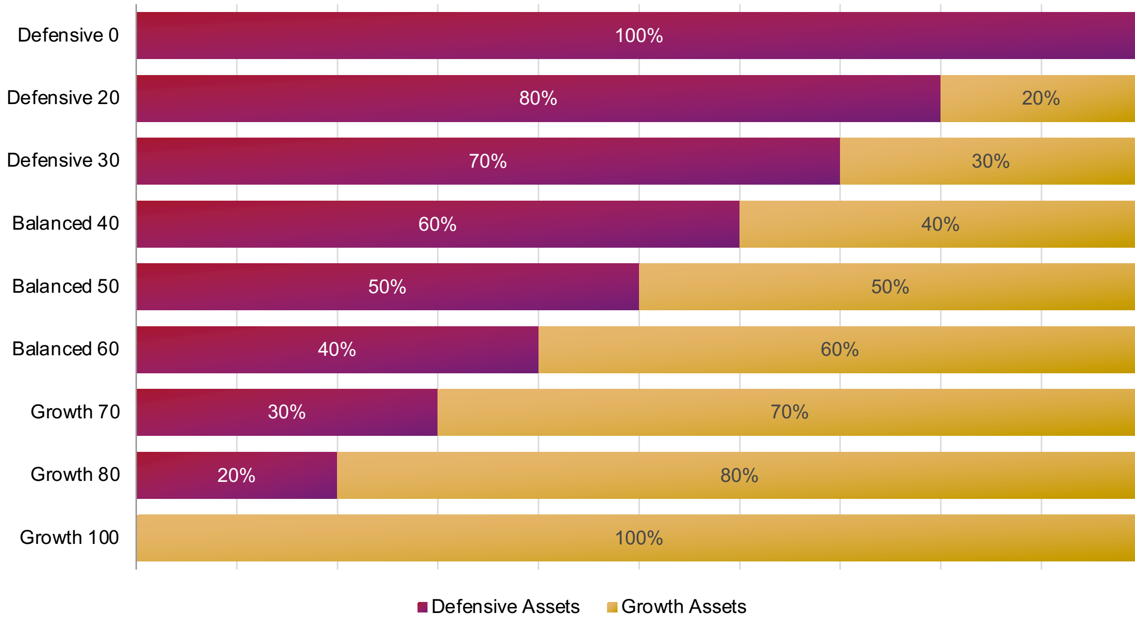
In his book, Smarter Investing, Tim Hale refers to this as the "whisky and water" approach, and it's a very useful analogy. "Considerable care is taken in the creation of a blended malt whisky," he writes, "to create a distinctive flavour from a number of single malts that is robust and will remain consistent over time… Whilst some will drink their Scotch neat, others will dilute it with water to a flavour and strength that is right for them."

The whisky element is what we call the growth engine. It mainly comprises of globally diversified equities, with a tilt towards small and value stocks; but, for added diversification, we allocate 10% of it to global commercial property. The water element we call the Defensive Mix. The majority is invested in global short dated bonds, and the balance is invested in UK short dated index linked gilts.

Our nine different portfolios simply contain different proportions of the Growth Engine and the Defensive Mix. Our most defensive portfolio contains nothing but the Defensive Mix, and our most adventurous portfolio — the neat whisky option, if you like — contains just the Growth Engine. In practice, the vast majority of clients will choose a portfolio that includes an element of both.



Here's our complete range of model portfolios:



2.4 ESTABLISH THE RIGHT MIX FOR YOU

The next step is to decide which of our nine model portfolios is the right one for you.

It's a crucial decision to make. If you're too cautious, you risk ending up with a portfolio that's too defensive and doesn't generate sufficient returns to give you the sort of lifestyle you want, now or in the future.

If, on the other hand, you opt for a portfolio that is too skewed towards growth, you'll be in danger of panicking in the event of a stock market crash or correction and bailing out at the wrong time. To quote the investment blogger Ben Carlson, "investing 100% of your retirement assets in stocks may seem like the right thing to do on paper, but very few investors have the intestinal fortitude to pull it off in the real world."

So, how do we work out which portfolio would best suit your needs? Well, we look at three things: comfort, affordability and need.

COMFORT

Few people feel entirely at ease investing solely in equities. Stock markets can fall a long way and very fast. Even the most cool-headed investors were unnerved by the global financial crisis of 2008-09, when markets around the world typically fell by about a half before starting a slow recovery.

It's really important to feel comfortable with your choice of portfolio. So, as part of the advisory process we ask clients to complete a risk profiling questionnaire that uses psychometrics to help gauge their emotional ability to tolerate risk.

This is a very personal issue. You might be surprised at the results the risk profiling produces. You may also find that you're either much less or much more able, emotionally, to tolerate risk than your spouse or partner. In any case, it's far better to find out what your risk tolerance is before you choose your portfolio than further down the line when it may be too late.

AFFORDABILITY

The second consideration is how much risk you can afford to take. If, for example, you're in your early 30s, you may be able to afford to take more risk than someone in their early 50s, because you still have a long way to go until retirement.

Say, for example, you need to generate an income of £100,000 a year in retirement, and you have a portfolio worth £1 million, you'd be less able to take risk, because a large fall in the markets could seriously reduce the amount of money you can take from your savings.

NEED

The final consideration is how much risk you actually need to take. Again, owning stocks is inherently risky, and there's no point in exposing your wealth to unnecessary risk. You may, for instance, have a portfolio worth £25 million but only need an income of £20,000. In this case there's clearly no need to invest solely in stocks and risk big short term losses.

At Cooper Parry Wealth we offer all of our clients cashflow modelling. This is a process which enables us to calculate your future income and expenditure, and crucially, the amount of money that you're going to need at different points in time. Armed with this information, we're much better placed to work out how much risk you should take.

The choice of portfolio is based on these three factors and balancing them against your needs and objectives. Many financial advisers focus only on the first factor, comfort, and even then, many of those have an unscientific approach to working out your risk tolerance.

But you need the full picture before you can make a decision with confidence, and you should walk away from an adviser who tries to cut corners.

2.5 USE EVIDENCE-BASED FUNDS

We've finally reached the implementation stage — choosing which funds to invest your money in — and here we face a crucial decision. Should we try to beat the market, or simply aim to capture the market return that's on offer?

The question revolves around whether to choose an "active" fund manager who tries to use their insight and resources to buy and sell the right stocks at the right time, or a "passive" fund manager who seeks to replicate the entire market.

There are all sorts of myths about passive funds, not least that they're run entirely by computer. In fact it requires considerable skill to manage a passive fund, to track a market as closely as possible and keep costs to a minimum.

We've already seen that, although there will always be some active funds that outperform the market, particularly over the short-term, the probability is that an investor will enjoy higher returns in the long-term if they invest in passive funds instead.

It was in 1974 that Paul Samuelson, yet another Nobel laureate, wrote a paper in which he pointed out the absence of "brute evidence" in favour of using actively managed funds[13]. The following year, investment author and consultant Charles Ellis wrote another famous paper in which he described active management as a "loser's game"[14].

Since the 1970s, the number of funds that beat the market over the long-term on a risk and cost-adjusted basis has continued to fall. Professor David Blake, who led a comprehensive study in 2014 of fund performance in Britain and the US, puts the figure at around 1%[15].

We mentioned earlier that S&P publishes a regular scorecard, called SPIVA, showing how active funds perform compared to their respective benchmark indices. SPIVA shows, year after year, that only a very small number of funds outperform in the long run. The Active/ Passive Barometer published by Morningstar paints a very similar picture.

Even if the vast majority of funds underperform the market in the long run, isn't it possible to pick the funds that do outperform? Yes, it's possible, but your chances of picking a winner, in advance, in every major asset class are very, very small.

Can a financial adviser identify future "star" managers for you? Again, it's possible, but it's highly unlikely that they'll pick a whole portfolio of winners. Some advisers like to give the impression they can do it. In practice, they're far better at telling you which funds have outperformed in the past than those which will do so in future.

One of the problems you face when picking active funds is that past performance is no guide to future performance; indeed it's in the nature of active fund performance that a fund that's been on a good run then goes on to underperform.

To examine the consistency of active fund managers, Vanguard ranked all UK equity funds in terms of their excess returns for the five years ended 2017. They then divided the funds into quintiles, separating out the top 20%, the next performing 20% and so on. Vanguard then tracked the funds' excess performance over the next five years, through to December 2022, to see how consistently they performed. If the funds in the top quintile displayed consistent performance, we would expect them to remain in the top 20%.

To 12/2017		To 12/2022					
QUINTILE	Funds	Highest	2nd	3rd	4th	Lowest	MERGED/ LIQUIDATED
Highest	557	20.29%	17.59%	16.70%	17.06%	12.93%	15.44%
2nd	556	22.12%	17.63%	13.67%	12.05%	11.69%	22.84%
3rd	556	11.87%	18.53%	7.45%	14.93%	12.59%	24.64%
4th	556	10.79%	11.87%	14.93%	17.45%	16.55%	28.42%
Lowest	557	8.80%	8.26%	11.13%	12.39%	20.11%	39.32%

Source: Vanguard and Morningstar, Inc.

Interestingly, the results appeared relatively random. Whilst around 20% of the top quintile funds retained their position over the subsequent five year period, the same funds stood more of a chance of falling into the bottom quintile, or even closing. Similar research is regularly run by S&P on US investment funds and reaches a similar conclusion.

This again highlights that past performance is no guide to future performance and that successfully selecting the winning funds in advance is very difficult, if not impossible, particularly as you are selecting them in advance and not with the benefit of hindsight.

All this begs the question, why do so few active managers consistently beat the market? There are several reasons, but these three are the main ones.

MARKETS ARE PRETTY EFFICIENT

Prices reflect publicly available information quickly and accurately. At any point in time, they represent the fairest assessment of value. Trying to beat the market is like pitting your wits against millions of traders around the world. The chances that any one investor, professional or otherwise, will consistently have valuable insights that other market participants don't are very slim. Even in cases where managers do outperform consistently, it's almost impossible to tell whether their success is down to skill or just plain luck.

ACTIVE MANAGEMENT IS A ZERO-SUM GAME

There's a very simple truth to the active management game: an equity being sold by one investor, presumably because they think it is going to perform poorly relative to the market, is bought by another investor who presumably thinks it is going to perform well. They cannot both be right; one will win relative to the market and one will lose. One active investor can only win at the expense of another active investor.

COSTS ARE A VERY HIGH HURDLE

The final reason why active managers typically fail is that just beating the market isn't enough; they need to beat it by a big enough margin to justify the costs entailed in using them. On average, by definition, fund managers will produce average returns, but from those returns you have to subtract what John Bogle calls "the cost of playing the game". For the vast majority of managers, fees and charges are too high a hurdle to overcome, and for the end investor, using active funds is actually less than a zero-sum game.

Ultimately, our conviction that passive investing is the logical choice for every investor isn't based on opinion; but on simple arithmetic. In the words of William Sharpe, "properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs"[16]. By choosing the passive route, you are giving yourself the best possible chance of a successful outcome.

These, then, are the main reasons why we exclusively use low-cost, passively managed funds. Specifically we use products from Vanguard, Dimensional Fund Advisors and iShares. These are best-in-class funds, and many of them are only normally available to institutional investors and not to the general public.

[13] Samuelson, P. (1974): Challenge to judgement, The Journal of Portfolio Management

[14] Ellis, C. (1975): The loser's game, Financial Analysts' Journal, Vol. 31

[15] Blake, D., Caulfield T., Ioannidis C. & Tonks I. (2014): New Evidence on Mutual Fund Performance: A Comparison of Alternative Bootstrap Methods, Journal of Financial and Quantitative Analysis

[16] Sharpe, W. (1991): The arithmetic of active management, The Financial Analysts' Journal, Vol. 47

2.6 REVIEW, REBALANCE AND RELAX

It's tempting to say at this stage that we've almost finished, but the truth is that we've barely begun. Establishing a suitable and effective portfolio is just the start of the lifelong process of managing wealth.

It's unlikely that the academic consensus on how to build and maintain a portfolio will change significantly in the coming decades. But that's not to say that it won't change at all.

At Cooper Parry Wealth, we spend considerable time and effort monitoring the ongoing effectiveness of our approach. Circumstances change, and new research and products are emerging all the time.

We have an Investment Committee which meets regularly to assess the robustness of each fund used in our client portfolios. It includes Tim Hale from Albion Strategic Consulting, whose book Smarter Investing we referred to earlier. As and when we decide it is in our clients' best interests to change our portfolios, or our wider investment strategy, we will do so.

There are two other very important things we do for each of our clients on an ongoing basis — rebalancing and reviews.

REBALANCING

The asset allocation in your portfolio needs to reflect your personal capacity for risk. Over time, that asset allocation will naturally drift. Say, for instance, you're in our balanced 50; in other words, 50% is invested in the defensive mix and 50% in the growth engine. As stock markets rise, the Growth Engine will account for a larger proportion of your investments, making it necessary to restore your portfolio to the original allocation.

Rebalancing should be done in a passive, disciplined and unemotional way. It requires selling assets that have risen in value and buying those that have fallen in value, which can seem counter-intuitive. At times it can take a strong stomach to sell out of rising markets and to buy into falling markets.

We generally rebalance our clients' portfolios once a year, at the time of the annual review. We do however monitor our rebalancing strategy throughout the year. In the event that markets move significantly, we sometimes carry out an interim rebalance, looking closely at the trades required and the costs involved in making them.

REVIEWS

Finally, we're dedicated to providing you with regular, insightful and succinct reviews of your circumstances.

We assess how your investments are performing, to ensure that you're still on course to achieve the financial goals that you've set. We also consider any changes in your circumstances, and decide with you any changes your financial plan requires.

In our experience, though, by far the most valuable aspect of these meetings is the reassurance they provide you with. Investing can be a very emotional business, and there are bound to be issues of concern from time to time that clients want to discuss with us.

It's inevitable as well that during your investing lifetime you'll experience some severe market downturns. There will also be times when markets appear to be going up and up indefinitely. It's typically at times like these that investors who don't use a financial adviser are vulnerable. They tend to buy just before markets fall and they sell just as they're about to rise. It's our job to be your voice of reason, to keep you on an even keel and prevent your emotions getting the better of you.

WE WANT YOU TO RELAX!

To put it bluntly we want to stop you undermining your own success, allowing you to enjoy the best possible investment returns.

Research by Vanguard shows that a good financial planner can add, on average, 3% a year to the value of a client's portfolio, and about half of that value, Vanguard calculates, comes from on-going behavioural coaching[17]. Compounded over several decades, that can make a huge difference.

But, for us, the value we add is about far more than your returns, hugely important though they are. More than anything, we want you to feel relaxed about your investments and your financial life in general.

In 2019, Dimensional Fund Advisors (DFA) conducted a survey of investors on behalf of the advice firms, like ours, that they work with[18]. It polled nearly 23,000 people around the world. In answer to the question, How do you primarily measure the value received from your adviser?, by far the most popular response was "sense of security/peace of mind".

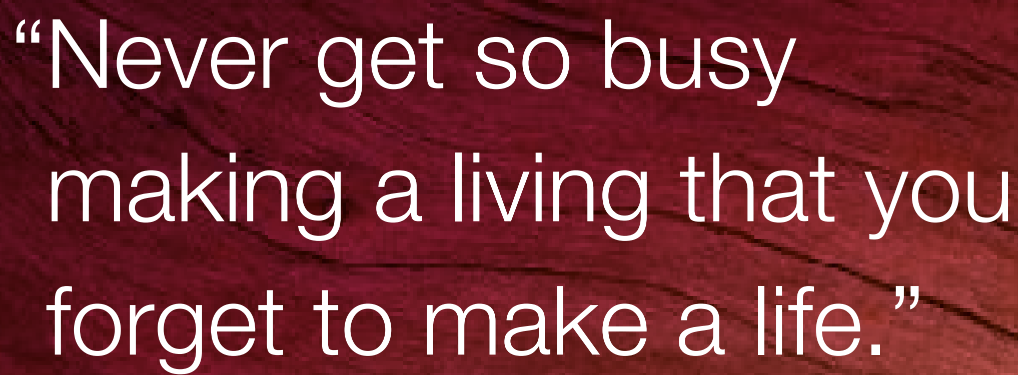
That research really struck a chord with us. It's our experience too that what clients value most are the more intangible aspects of the client relationship, not the returns they receive.

Many of our clients, in fact, aren't particularly interested in talking about the financial markets. What they want to know is that they're going to maintain their standard of living for the rest of their lives. They want the assurance that they're still on track to achieve their goals, whether it's retiring early, travelling the world, paying for their children's or grandchildren's education, or simply spending time with the people they love.

Knowing you can carry on leading the life you want to lead gives true peace of mind. How can you possibly put a price on that?

[17] Vanguard Asset management: Adviser's Alpha, March 2015

[18] Dimensional Fund Advisors: Global Investor Insights 2019


“Never get so busy
making a living that you
forget to make a life.”
Dolly Parton

GET IN TOUCH

If you have any questions, or would like to discuss anything in more detail, please get in touch.

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cooperparrywealth.com

Our teams of talent operate right across the UK – with hubs in London, the Midlands, the South East and Bedfordshire

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- Investment into any of our investment portfolios should be regarded as medium to long term i.e. for at least five years.
- The value of investments and the income from them can fall as well as rise. The value of your portfolio is not guaranteed and you may get back less than the amount invested, and you could lose part or all of your capital. Past performance is not a guide to future performance.
- Changes in exchange rates could affect the value of overseas investments.
- The effect of inflation could reduce the future purchasing power of your investments.

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