RICHARDSON Wealth

TOUCHSTONE Newsletter

Richmond | Goodman Wealth Management

Simple > Complex

Simplicity is a great virtue, but it requires hard work to achieve it and education to appreciate it. And to make matters worse: complexity sells better.

–Edsger W. Dijkstra

Our tenure in the investment business has made us keenly aware of a profound investor bias toward complexity. This is not a constructive habit. We believe it to be mostly behavioral in nature, and can be partially explained by the following:

- the assumption by many investors that a complicated strategy is necessary to beat the market.
- the marketing machine behind some fund managers, designed to convince investors that complexity justifies their high cost.

Each explanation has implications—biased toward the negative—for an investor's long-term performance. Yet a preference for complexity is almost hardwired into investors, their agents, and asset managers because the intuition is that a complicated investment landscape requires a complex solution; and by extension that a complex strategy also supports a higher fee.

We would argue that simplicity leads to better investor outcomes. This is not because simplicity in and of itself produces better investment returns, but because a simple strategy encourages investors to own their decisions. In other words, it allows them to "know" what they own. Too often these days, investors do *not* know what they own.

There are many telltale signs of complexity within the investment landscape that investors and their advisors should be on the lookout for…and run in the other direction. These become especially prevalent toward the end of a bull market when investment "architects" design new products that seem simple but under the surface are convoluted and expensive. The result: layers of fees to enrich the managers, and legal loopholes that shield, least of all, the investor. As an example, we cringe whenever we see the term "a fund of funds".

So, if complexity doesn't naturally lead to outperformance, why do asset managers persist in offering increasingly complicated strategies to investors, and why do investors continue investing in them? Allow us to share an illustrative parable.

Doug & Phil's (*borrowed*) Fish Tale

The oceans in which fish hide are amazingly complex ecosystems. The circumstances leading to a successful day (or not) on the water are almost innumerable. The fish obviously have to be at the fishing spot. But that's probably less than half the battle. A veritable mosaic of tides, currents, sunlight, moonlight the night before, available prey, time of day, and so on, influence the catch. With such a myriad of factors, it's no small wonder that tens of thousands of fishing products jam their way into even the smallest of tackle shops.

But, as an avid deep-sea angler will attest to, they catch just as many tuna with the simplest of lures than the fancy, sparkling variety. The simple lure? The innocuous-looking cedar plug pictured in **Exhibit A**. Simple? Yes! It looks like an industrial part. Sexy and complex? Most certainly not.

Exhibit A. The Remarkably Simple Cedar Plug Lure

Imagine you get the itch to catch some tuna. Perhaps it's your first foray into tuna fishing so you decide to delegate the task to an expert charter boat captain. But which one? You stroll along the dock and ask each captain how they catch tuna. The first presents a cedar plug, just like the one in Exhibit A, and tells you, "I go out to where I see signs of fish and then I drag four of these lures behind the boat at a steady speed until I catch some. Then I keep doing it until it's time to head in."

The second captain displays a dozen tackle drawers filled with lures resembling those shown in **Exhibit B** and proclaims, "Tuna are very elusive. I have perfected a system over many years that optimizes my lure selection among 60 lures, five sunlight conditions, seven moon phases, and six different tidal stages. I then troll, adjusting my speed in five-minute intervals until I catch something. You hate long boat rides but are starving for fresh sashimi. Which captain would you choose?

Exhibit B. The Psychedelically Hued Synthetic Lure

Most sashimi lovers would pick the second captain. The ocean is big, and multiple factors influence the tuna catch. It seems like the higher-calibrated approach would be the way to go.

But we can tell you that it would probably yield a lower catch.

Even if we assume that it brings in the same haul, the second captain is going to charge significantly more. He/She must – their costs are structurally much higher. The innumerable combinations that need to exist for the second captain's matrix of moon and sunlight conditions to perfectly align are unlikely to say the least. Not to mention the increased risk of dozens of lures lying around to jab in your foot.

Investors' Preference for Complexity

Complexity appeals to investors because the markets that drive securities prices, like the teeming and mysterious ocean, are deep and complex. It only stands to reason (right?) that a sophisticated strategy is a requirement for mastering and benefiting from the intricate web of financial markets and asset classes. The globally integrated investment markets and economies are anything but simple, so it would not at first appear that a simple strategy could carry the day. The belief that simple relationships (basic supply and demand) exist is counterintuitive to most casual—and sometimes not so casual—market observers.

Persuading an investor that a complicated strategy—often derived through "*selective*" data mining (i.e. back testing historical data until it produces what can be viewed as a signal)—is much easier. The air of scientific authority exuded by PhDs who scribble differential calculus equations as fast as Charles Schultz drew *Peanuts* comic strips gives just that much more "credibility" to black box approaches.

The net result: asset managers find it easier to charge a higher fee for a complex strategy (i.e. flashier lures with molded plastic and psychedelic paints) than for a simple strategy (i.e. unpainted cedar plugs).

Simplicity vs. Complexity: Why Does It Matter?

The point we wish to make is not that simple strategies ***always*** perform on par or better than the complex ones. Our point is that complexity creates a problem for investors, which is unfortunately largely self-induced: complexity encourages performance chasing and high fees.

When presented with a complicated investment strategy, an investor's immediate response may be "I don't understand the strategy. Clearly I'm not as smart as this asset manager." The next thought is: "because this asset manager is so smart, their strategy must outperform. I think I'd like to invest with this asset manager." The investor then feels safe and comfortable in making a rational delegation decision. At the end of the day, the acceptance of complexity is related to calming the investor's ego—at least temporarily.

Choose Simple.

We believe that making investors aware of the benefits of selecting a simple approach, strategy, or model is crucial. Unnecessary complexity is costly, not only directly (i.e. fees), but indirectly. Complexity can dampen investor understanding, which can lead to poor investment decisions. This may lead to a shortfall on the realization of their long-term financial goals.

We apologize for the longer than usual newsletter. However, we think it is a timely message at this stage of the investment cycle. Too often we are seeing the offering documents for investments that contain phrases such as the following:

- Value-at-risk, Delta Hedge, Smart Beta, Hurdle rate, Transportable Alpha, R-squared, etc.

The list of terms is endless and designed to convince investors that the managers are the smartest "captains in the marina" and the only ones able to catch the big tuna. And who wouldn't be willing to pay the highest cost for the "*chance*" to catch the big one, even if in trying it increases the risk of severe cuts.

Doug & Phil