Absolute Return Partners

The Absolute Return Letter

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Investor Attention Deficit Disorder - aka the Goldfish Syndrome

"A few years ago, the city council of Monza, Italy, barred pet owners from keeping goldfish in curved bowls, saying that it is cruel to keep a fish in a bowl with curved sides because, gazing out, the fish would have a distorted view of reality. But how do we know we have the true, undistorted picture of reality?"
Stephen Hawking

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We are worse than goldfish

The attention span of human beings is getting shorter and shorter. A while ago, researchers did a study and found that it is now shorter than that of goldfish. 2,000 Canadians were surveyed, and the researchers studied the brain activity using electroencephalograms. The results showed the average human attention span has fallen to eight seconds. Meanwhile, they found the attention span of goldfish to be about nine seconds[1].

Although not everybody agrees that attention spans are getting shorter and shorter[2], at least in the world of investments, my 34 years of experience does indeed confirm that to be the case. I clearly remember the heyday of the mid-1980s, when I first started out in the industry. Our boss would regularly ask us youngsters to think about the long-term implications of what we intended to do and, by "long-term", it quickly became obvious to me that he meant next year, the year after that or sometimes even further out in the future.

Most people do not look that far into the future anymore. When I speak to investors today, and particularly to young investors, I sometimes get the impression that by "long-term", they mean next Monday morning - so dramatically have attention spans compressed in my lifetime.

1 Source: https://neurotracker.net/2017/05/24/humans-attention-span-shorter-than-goldfish/
2 See for example http://www.bbc.co.uk/news/health-38896790.

I could spend the rest of this month's letter speculating on why that is, but that is somewhat irrelevant – at least as far as a financial newsletter is concerned, although I am sure psychologists have an opinion. It will take me two seconds to prove, though. One of the best measures of attention spans is the willingness – and the ability – to read lengthy texts, and fewer people than ever read anything of any length anymore (Exhibit 1).

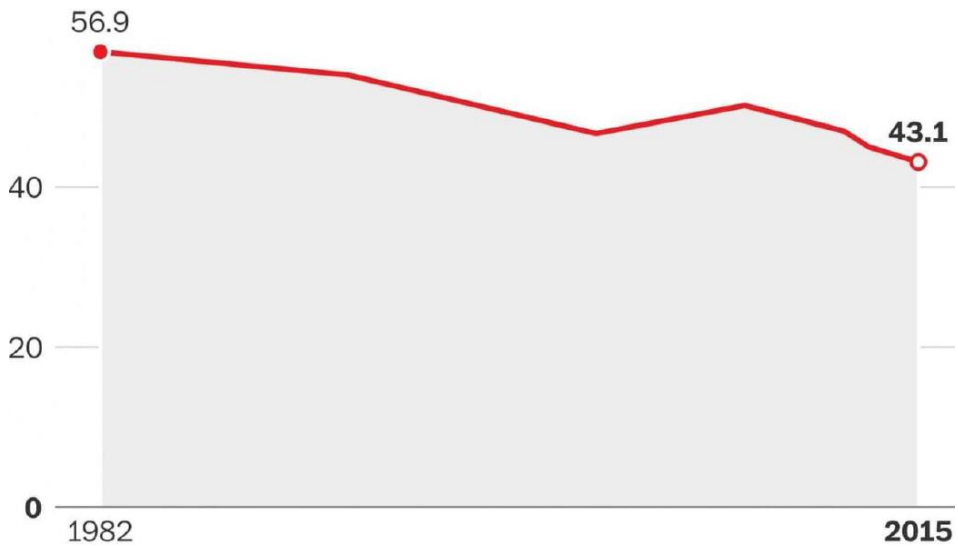

Exhibit 1: Percentage of American adults who read any work of literature in the past year

Source: National Endowment for the Arts, The Washington Post, September 2016

What is IADD?

The problem in a nutshell is what I call Investor Attention Deficit Disorder or IADD[3]. If you know somebody who suffers from IADD, you will know that they struggle to establish a coherent and robust investment strategy, and that they do highly irrational things such as buying shares in Alibaba just because they attended a dinner party last night where the host toasted to Alibaba, saying it is the next Amazon.

Sufferers from IADD do other strange things too. For example, afraid of upsetting anyone, they rarely make otherwise reasonable demands such as asking their investment manager to charge reasonable fees, which aligns the interest of the investor and the investment manager. They just go with the flow – probably because they are too busy monitoring the latest news on their smartphone.

I happen to know one or two of them, and I can assure you their life is not easy. Allow me to introduce you to my long-standing friend Joe, who was diagnosed with IADD about 10 years ago. Joe would love for things to change, but he is so addicted to the smartphone lifestyle that he simply cannot deal with things the way you and I can.

The three key drivers of financial markets

Why do shortening attention spans affect investment returns? In order to understand that, let's take a closer look at the three key return drivers in financial markets:

1. Behavioural patterns

[3] *For the worried reader, I should point out that IADD is not a recognised medical condition.*

2. Cyclical trends
3. Structural trends

Behavioural patterns

Behavioural patterns have indeed changed with the arrival of the smartphone but, at the end of the day, basic human behaviour rarely changes. Let me explain what I mean by that.

Take a classic behavioural aspect such as *availability bias*. It refers to the human tendency to overestimate the likelihood of some event happening, either because something similar has happened recently, or because we feel very emotional about a previous event of a similar nature.

A classic example of availability bias is how the near-meltdown of financial markets in 2008 have impacted our perception of financial crises. Despite the fact that we have only experienced two events of that severity in the past century, you cannot open a newspaper these days without somebody telling you the next 2008 is around the corner.

Or take *herding*, which is one of the most powerful drivers of investment returns. Herding is the tendency to ignore your own work and conclusions, and instead go with the flow. Simply do what 'everybody' else does.

As attention spans have shortened, behavioural patterns have become more influential. I believe herding is a particularly powerful behavioural aspect (in terms of affecting financial markets), although I never call it herding. I look instead for *crowded trades*. If the sentiment surrounding a particular asset or asset class is very one-sided (whether positive or negative), I am reluctant to side with the consensus view. Why? Because it is already so crowded.

Example: If I get the sense that the vast majority of investors believe interest rates can only go up from here, one could argue – and I do - that most (rational) investors have already positioned themselves accordingly; hence there is not much point in also going short the bond market.

Having followed financial markets for decades, I firmly believe that behavioural aspects have a bigger say on financial markets today than they did years ago. The implication is that investors (like Joe), who allow themselves to fall into traps like herding or availability bias, are likely to suffer mediocre returns despite financial markets actually doing (more than) OK.

Cyclical trends

Cyclical trends are important. They affect financial markets a great deal and should not be ignored. Having said that, of the three key drivers of financial markets, I consider them the least important. Why is that? It is obviously not irrelevant whether the retail sales number to be published next Monday morning are good or bad, and it is not entirely meaningless whether next week's CPI numbers suggest consumer price inflation to be running at 2% or 3% at present.

Having said that, I have learned over the years that there is a lot of coin tossing involved in the art of predicting cyclical trends and, even more importantly, should your prediction actually be spot on, financial markets don't always react to that number as you would expect.

As far as Joe is concerned, speculating on next week's CPI report may be as far into the future as he is prepared to go, and that may be why markets sometimes behave quite irrationally to some of those economic reports, because he does indeed behave quite irrationally. I have also noted that, when we haven't had a recession for a very long time (like now), he behaves like it is *never* going to happen again.

Structural trends

The big opportunity set, I believe, is in the cluster of structural trends that will affect the world in the years to come. Even better, those structural trends are all virtually set in stone, i.e. no need to speculate whether they are going to happen or not, because they *will*. It is only a question of time. Anyway, here is the list:

1. **The end of the debt super-cycle**
2. **Retirement of the baby boomers**
3. **Declining spending power of the middle classes**
4. **Rise of the East**
5. **Mean reversion of wealth-to-GDP**
6. **Disruption**
7. **Running out of freshwater**
8. **Electrification of everything**

You can read more about each of the eight structural trends that we have identified at Absolute Return Partners here:

https://www.arpinvestments.com/investment-themes

Even better, why don't you read my recently released book? In *The End of Indexing*, I review many of those trends in great detail (Exhibit 2).

Exhibit 2: The front cover of *The End of Indexing*

Sources: Harriman House & True Design

If you haven't bought the book yet, but still want to have a go at it, you can find it here:

https://harriman-house.com/endofindexing

or here:

https://www.amazon.co.uk/End-Indexing-Structural-Mega-Trends-Investing/dp/0857195492/

The great beauty of the story is that most investors either don't care to think, or they are not capable of thinking, that far into the future. The opportunity set is therefore vast, *as long as* you structure your portfolio based on those

structural trends rather than trying to predict what is going to happen in the short term. Just don't shout at me if the investment strategy in question doesn't work between now and next Monday morning.

A letter from a client

I would like to share (most of) the content of a letter that I received the other day from a client of ours (he has granted me permission to do so). As I don't want to upset anybody, the email has been sanitised, though. He wrote:

"The real problem is the investor. He is the guilty [party] because he accepts to be lured into lousy investment managers [and lousy investment funds]. I do not [...] know why rich people, in some cases filthy rich people, act so stupidly, but they do. Go figure."

"Hedge funds should be happy charging 1+10 or, even better, 0.5+25. The reason they don´t do that is ourselves! We accept [their higher fees] because we eternally believe they will deliver. Well, guess what, most of them don´t."

"Investors are way too lenient. They are sheep instead of wolves. What we, investors, should be questioning is: why [...] 2+20 is so much the standard fee? WHY? Why don´t you see a much higher [range] within the fees charged? Why can a newcomer [hedge fund manager] start charging 2+20 without factual proof he can deliver what he states he WILL deliver? And why don't excellent hedge funds charge ZERO management fee and 50% performance? Why?"

"Maybe because it took forever for investors to start analysing and questioning those very high fees. Well, once again, shame on investors!"

If you think my client (who shall remain unnamed) suffers from IADD, you are wrong. I can categorically tell you that he doesn't. Having said that, it is probably fair to say that he thinks there are many more IADD sufferers out there than I do.

In preparation for this month's letter, I spent an evening or two googling various things, as I always do when preparing for the next Absolute Return Letter. During my research, I came across a deeply disturbing story, which only goes to show that IADD is probably more widespread than most of us realise:

https://ofdollarsanddata.com/how-hedge-funds-get-rich-hint-its-not-their-returns-4630db9a9f6e

Having read that story, it is hard not to agree with my client - he is probably spot on. 2+20 is (in many cases) daylight robbery, and it is a mystery why so many hedge fund investment managers keep getting away with it.

At Absolute Return Partners, the attitude towards fees is quite simple. At the end of the day, what really matters to us is the net return to our clients after all costs – fees, admin costs, etc. In that context, it is deeply disturbing that, in recent years, many hedge fund managers have earned more in fees than their investors have earned in returns.

The way forward

Going back to the point I made earlier - that (many) investors need to put more pressure on investment managers, especially hedge fund manager, to lower their fees - let me introduce what I think is a very fair model. Whether we'll ever get there depends on the medical profession's ability to deal effectively with IADD, though.

To begin with, if an investment manager wants to charge a performance fee (which is fine by me), the management fee should *only* cover admin and operational costs of running the investment management business, and that is *before* bonuses to traders and portfolio managers. To allow an investment manager to get fat on both management fees and performance fees is entirely unnecessary and grossly unfair to the investor.

For an equity fund with $1 billion of AuM, such costs typically amount to less than ½ % of AuM, but the number can vary a great deal from case to case. In practical terms, my proposed model implies that the management fee (in percentage terms) would be reduced as the fund grows in size.

Secondly, the performance fee should only be charged on the alpha (outperformance) component after all other costs have been deducted. Why would you pay a performance fee on beta (market) returns? An index fund charging a few basis points can do the job for you.

Let's take an equity long/short fund with $1 billion of AuM, and let's assume the investment manager does really well. In a year where the equity market is up 10%, he is up 15% before any fees are charged.

Under the prevailing 2+20 model, our investment manager will earn about $45 million in management and performance fees combined. In addition to those fees, investors will pay various other costs for a TER of about 5%. In other words, the 15% return has suddenly turned into 10% after all costs - no better than an index fund would have done, and no wonder many hedge fund managers fly around in private jets.

Now, let's play with those numbers. Let's assume our investment manager agrees to lower the management fee to only cover admin and operational costs, and let's assume that the 20% performance fee is now only charged on the alpha component. Under this model, total fees charged by our investment manager will drop from $45 million to $14 million (still enough to give the management team a more than decent lifestyle), and the TER drops from 5% to 1.9%.

From the investor's point of view, the difference is massive. The gross return of 15% no longer turns into a net return of 10%, but is now a tad above 13%. Maybe my friend Joe doesn't realise it, or maybe he doesn't have the willpower to speak up, but I can assure you that pension funds all over the world *do* care.

They are desperately trying to eliminate a funding deficit that has been growing for years, but they need *all* investors to 'gang up' against the most scrupulous hedge fund managers. Otherwise nothing will ever change.

Niels C. Jensen
4 June 2018

Important Notice

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

Visit www.arpinvestments.com to learn more about us.

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