Four inevitable changes in investing

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Stein's Law, a rule of thumb which applies to politics, economics and business, is that "If something can't continue, it will stop." If you step back and look at the status quo in the financial advisory business and ask yourself what things simply don't make sense and are unsustainable as a result, you will come up with a surprisingly long list. This article focuses on inevitable changes in the investing environment.

NOT IF BUT WHEN

Stein made a deceptively simple case! The moment that you identify the status quo as unsustainable – whether it is interest rates, house prices or deficit spending – you should assume that it will change. It's not a question of if, but when. History teaches us that it's impossible to predict the timing of that change, in large part because the status quo can persist for longer than the skeptics believe possible. Just remember how long tech stocks continued their rise in the late 1990s and the way that housing prices defied the skeptics in the mid 2000s. Once change starts to kick in, however, it can assume a life of its own and move much faster than so-called experts believe possible. In the words of a friend who left South Africa after power passed from the white minority to the black majority: "My friends and I always knew that apartheid couldn't continue forever, but we thought that change would happen in our grandchildren's lifetime or maybe even in our children's lifetime – never in ours."

STEIN'S LAW AT WORK IN INVESTING

Recognising that things are always clearer after the fact, it's easy to find recent examples of Stein's Law at work:

- Some Western observers argued that its inefficiency made the Iron Curtain status quo in the 1980s unsustainable. But, even for the doubters, no one foresaw the collapse of the entire European Eastern bloc over only two months in 1989.
- The Arab Spring revolts of 2011 saw power shift in Egypt and other Arab countries. These revolts arrived seemingly overnight with virtually no warning.
- There's a long list of once-dominant market leaders that fell on hard times. The Big Three auto companies and names like Kodak, Polaroid, and Xerox come to mind. In all of these cases, growing customer dissatisfaction, new competitors and a sclerotic resistance to change made those companies vulnerable and inertia and historical

dominance masked that vulnerability, until all of a sudden it didn't. And, once their market shares started to slide, the decline rapidly accelerated.

So the critical question becomes: What are the things today that are unsustainable and that have to change as a result? Just to be clear, we're not necessarily talking about change in the next year or two, but things that a rational observer would say make little sense and are unsustainable in the mid to long term as a result.

When I look at inevitable changes in the investing arena, I'm not referring to short-term bubbles in social media valuations or Bitcoin. Rather I'm talking about fundamental structural shifts in things that make little or no sense today.

Here are my nominations for four aspects of investment advice today that are unsustainable going forward and to which Stein's Law applies as a result.

Shift 1: Closing the gulf between smart money and dumb money

The portfolios of most sophisticated institutions and family offices bear little resemblance to how most retail investors operate, with many sophisticated investors referring to retail investors as dumb money. Recognising that there are big differences in liquidity considerations, timeframe and risk tolerance, a yawning gap between more informed and less informed buyers isn't sustainable in any business.

Some of the shifts that will inevitably make future retail portfolios look more like those of institutions:

- using a broader range of asset classes in diversified portfolios, with greater focus on alternative investments within long-term holdings.
- More use of low-cost indexing in efficient sectors, adopting the "core and explore" approach of many sophisticated investors.
- Using tools such as active share to ensure that investors get what they pay for with active managers and that they deliver true active management.

In the period ahead, these will increasingly enter the mainstream.

Shift 2: Greater use of annuities in retirement portfolios

Academics have written extensively about the annuity puzzle – why immediate annuities are so dramatically underrepresented in retirement portfolios, even in the face of clear-cut evidence of their ability to enhance risk-adjusted returns. This will change, in part because the financial media will respond to advice from respected voices. As a result, five to 10 years from now, we will almost certainly see a substantial increase in the awareness of annuities and their use by retail investors.

Shift 3: Reduction in home-market bias

Something else that makes academic researchers scratch their heads is the home-market bias that is common to investors around the world. One of the first research studies on this in 1991 indicated that Japanese investors had 98% of their equity portfolios invested domestically, while the number for US investors stood at 94%.

This is in the face of clear evidence on the positive impact of international diversification in increasing returns and reducing risk over time and a resulting shift by institutional investors overseas. In a 2000 article, Harvard’s Ken Rogoff and Berkeley;s Maurice Obsfeldt identified home-market bias as one of the six major puzzles in international macroeconomics.

It may take more effort to persuade reluctant clients to increase their allocation overseas. Despite that, a rational observer would have difficulty visualising home-market bias continuing five and 10 years from now at today's level – another example of Stein's Law at work.

Shift 4: Incorporating lessons from behavioral finance

A fourth inevitable shift will entail the broader use of lessons from behavioral finance to help investors make better decisions. Two Nobel prizes in economics have been awarded for work in this area (Princeton psychologist Daniel Kahneman in 2002 and last year, Yale economist Robert Shiller), with rising profile for other well-known names like Chicago's Richard Thaler and Duke's Dan Ariely.

Chicago's Cass Sunstein wrote a book on how "nudges" lead to better decisions. In particular, default options, in which the "right" decision is made automatically unless consumers choose to make a change, have been shown to have a dramatic increase in rational outcomes.

Today, it's the rare financial adviser who fully incorporates the principles of behavioral finance into his or her advice to clients – but in light of the growing body of research in this area, looking forward this will be common place.

So, those are my thoughts on four inevitable shifts in the investing landscape. You may agree with all, some or none of these and chances are you have others that aren't on this list. What's important is to step back and think hard about the things happening today that aren't sustainable – and then to incorporate the inevitable changes that will follow into your planning.

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