Avoiding Filter Failure

Last week Morgan Stanley made some waves in the investment industry by announcing they would no longer carry Vanguard mutual funds. This may seem like a problem what with the growth in passive investing but I say it's not that big of a deal for the following reasons:

- No one goes to Morgan Stanley to invest in Vanguard funds
- They still allow the use of Vanguard ETFs
- Vanguard funds are a very small piece of the Morgan Stanley fund platform
- The pay-to-play business model where fund firms pay to get "shelf space" is something Vanguard doesn't do

Here are the details courtesy of Investment News:

Morgan Stanley has reduced the number of mutual funds on its platform by 25% and currently offers more than 2,300 funds, she said. The funds the firm is closing to new sales, including Vanguard, represent less than 5% of the total mutual fund assets clients own, she added.

Vanguard ETFs remain available to Morgan Stanley clients. The firm halted new sales of Vanguard funds as of Monday. Clients who own Vanguard funds can add to their positions through the first quarter of next year.

The thing that stood out to me from this story was not the fact that Morgan Stanley is dropping Vanguard mutual funds; it's that their fund platform currently offers 2,300 mutual funds and that's a reduction from previous numbers (the story also says that competitor Merrill Lynch recently dropped the number of funds on their platform from 3,500 to 2,000 and they cut off Vanguard as well).

In some ways these numbers make sense. Morgan Stanley's wealth management division runs over $2 trillion in assets. Merrill has a similar amount of assets.

Maybe financial firms with trillions of dollars under management are the problem here but it seems to me that the paradox of choice with that many mutual fund options (and I'm guessing this list doesn't include ETFs?) has to be paralyzing for many of their advisors and brokers.

Obviously, it's not just these huge wealth managers that have to deal with an enormous number of investment options. Here's a quick rundown of what you're up against:

- There are 33,000 or so individual public corporations trading on global stock exchanges.
- There are more than 9,500 mutual funds in the U.S. alone.
- There are around 4,700 ETFs worldwide (2,000 or so in the U.S.).
- There are around 10,000 hedge funds.

To put these numbers in perspective -- there are 3,000 Chipotles, 7, 000 Taco Bells, and 24,000 Starbucks locations worldwide (these stats don't really tell you anything but I was curious so decided to include them as my made-up benchmark).

The sheer number of choices we're faced with is both a blessing and a curse.

There was a well-known study a number of years ago performed at a grocery store where researchers gave out samples of different kinds of jam. Every few hours they would switch from 24 selections down to 6. The average number of jams sampled, regardless of the number of selections available, was around 2 per person. Each sampler was then given a coupon to save money on said jam.

The interesting thing is that more people were sucked in by the 24 count than the 6 count -- 60% of people passing by stopped at the table with 24 jams while just 40% of people stopped at the one with 6 jams. But those who only had 6 jams to choose from were far more likely to make a purchase. Just 3% of people decided to make a purchase when the table held 24 jams while 30% of people made a purchase when there were only 6 jams.

So a high number of choices sucks people in but once they see a large number of options in front of them it becomes paralysis by analysis.

People are dealing with this not just with investment products but with the firehose of news, data, pictures, social media networks, websites, and information available at our fingertips every day.

So how do you try to keep yourself from becoming debilitated in the face of the world awash in choice?

A few thoughts:

Having a good filter is more important than ever. Howard Lindzon at Stocktwits once said something along the lines of, "There is no such thing as information overload...only filter failure." If you don't have good filters in place up front to weed out the good from the bad in terms of investment options, pundits, sources of information, opinions, or analysis you have no shot at keeping up these days.

Be a bouncer or find yourself one. My colleague Josh Brown likes to say that a good investment advisor is like a bouncer at a club - they should be constantly turning away investment ideas and products. Something I was taught early in my career is that even great investment opportunities should be passed on when they don't fit within your philosophy, portfolio, or personality. Going outside of your circle of competence can lead to more problems than it's worth.

Understand opportunity cost. Opportunity cost is simply the alternatives you give up when making a decision or taking a course of action. This means that even doing nothing is a decision. I like to say that all investing is a form of regret minimization. Opportunity cost can help you understand how those regrets will manifest themselves as things play out. There will always be more investment opportunities that come along but huge mistakes at the wrong time can be killer.

The best investment decisions you make are often the things you don't invest in. Avoiding the wrong stuff is often more important than finding the right stuff.

Source:
Morgan Stanley's decision to cut Vanguard's funds likely due to DOL rule (Investment News)