Bad Advice Can Be Expensive

The S&P 500 hasn't had a negative return for nine years now. There's been some volatility in 2018 but overall things have been going pretty well for a while now.

When things are going well in the markets it can become easier for investors to focus on the minutiae.

Instead of focusing on the big picture -- documenting your investment plan, asset allocation, diversification, financial planning, etc. -- we start arguing about a few basis points in fees, the best formula for factor investment strategies, active vs. passive debates, and the like.

And don't get me wrong -- combining a handful of small edges in your portfolio can really add value when done in a thoughtful way.

But at a certain point, the law of diminishing returns kicks in and trying to optimize every minor detail can shift the focus from the things that truly matter in portfolio management.

Perfect is often the enemy of good when managing money.

The search for perfect investment advice can often lead to the wrong type of advice. And bad advice can be very expensive. Larry Swedroe tells a useful story on this in his latest book, *Reducing the Risk of Black Swans*:

In early 2003, Larry met with a 71-year-old couple with financial assets of $3 million. Three years earlier, their portfolio had been worth $13 million. The only way they could have experienced that kind of loss was if they had held a portfolio almost all in equities and heavily concentrated in U.S. large-cap growth stocks, especially technology stocks. They confirmed this. They then told him they had been working with a financial advisor during this period—demonstrating that while good advice does not have to be expensive, bad advice almost always costs you dearly.

Larry asked the couple whether any meaningful change in the quality of their lives would have occurred if, instead of their portfolio having fallen almost 80 percent, it had doubled to $26 million. The response was a definitive no. Larry then noted the experience watching $13 million shrink to $3 million must have been very painful, and that they probably had spent many sleepless nights. They agreed.

This is the old adage that concentrating your assets can make you rich but diversifying your assets keeps you rich. And I like that Swedroe walked them through the regret minimization exercise (it's just too bad it took place after the huge mistake occurred).

Swedroe also makes a seemingly obvious point about how bad advice is expensive, but I think many investors underestimate just how expensive it can be.

Quantifying good advice can be difficult because there are no counterfactuals. It's nearly impossible to add up the performance numbers or market value saved by avoiding mistakes or bad investment advice. But just because you can't specifically quantify the absence of good investing advice, doesn't mean it's not extremely valuable.

For example, you could have been invested in a portfolio of subpar actively managed mutual funds over the past decade and underperformed simple index funds (in fact, the odds are very high that anyone with a portfolio of actively managed mutual funds did just that over the past 10 years).

But let's assume that you were able to stay invested in these below-average performers throughout this time frame without jumping in and out of the markets or sitting in cash throughout the market gains. In this example, even though you would have underperformed the benchmarks, you still would have done far better than investors who were sitting in cash the entire time because they were worried about losing money.

A portfolio of underperforming funds is suboptimal but even a suboptimal strategy is far better than one that relies on advice that's constantly trying to outsmart the markets.

The financial services business can be a cutthroat place. Clients and prospects alike are constantly challenging their advisors and wealth managers with the question like:

"What's your value-add?"

"What differentiates you from the competition?"

Obviously, when making the decision about who to trust with your hard-earned money it makes sense to do your homework. It would also be nice to find someone who sticks out from the crowd.

But the big secret most people who work in this profession will fail to tell you is that there typically isn't a huge difference in the technical expertise or skillset of the majority of firms or advisors out there. There are exceptions of course but the ones who attract the most client money are usually better at building trust or telling their story than the competition.

One of the things that truly can set you apart in this space is the ability to avoid mistakes and help your clients avoid bad advice. Because there will always be a market for bad advice when money is involved. The temptation to chase fads, new investment products, and too-good-to-be-true promises can be relentless.

Wealthy people will always be targeted by charlatans, hucksters, and people who are better at selling than managing money.

Those advisors who have a system in place that allows them to filter out the noise and distinguish between what matters and what doesn't are the ones who can add value to their clients.

Unfortunately, these advisors will have a hard time quantifying the avoidance of bad advice. But just because you can't quantify something doesn't mean it's not valuable.

Bad advice is expensive so the simple avoidance of it can be a huge value-add.

Source:
Reducing the Risk of Black Swans

Further Reading:
Some Perspective on Investing Advice