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Center for Applied Research

Executive Summary

THE FOLKLORE OF FINANCE:

How Beliefs and Behaviors Sabotage Success in the Investment Management Industry

The models for success in the investment management industry are broken. That may seem surprising given that global assets under management, net revenues and profit margins have all risen as the global economy has rebounded in the wake of the recent financial crisis. Indeed, the industry continues to be ranked among the most profitable.

BUT JUST BECAUSE THE INDUSTRY IS PROFITABLE, DOESN'T MEAN IT'S SUCCESSFUL.

Alpha production has long been considered the standard measure of success for investment professionals.

Due to its zero-sum nature, it is of course unrealistic to expect alpha to be produced by the industry as a whole. But as information efficiency and competition have increased, even skilled professionals are finding alpha more difficult to obtain.

Even if alpha were easy for skilled investment professionals to produce, it still wouldn't be sufficient.

True success includes not only producing alpha — perhaps more importantly, it also requires helping investors achieve their long-term goals, sustainably, over time. Unfortunately, *investors are not achieving their long-term goals,* and investment professionals are failing on *both* of these dimensions.

The industry faces a new crisis; but rather than being *financial*, this is a crisis of *faith*, driven by "the 3 Ds." Investors share a deep **distrust** of the industry that leads to their **dissatisfaction**, which drives increasing **disintermediation**, where a growing number of investors believe they can do the job of investment professionals themselves — better and for less money. Unfortunately, this disintermediation can be counter to investors' long-term best interests.

What is behind the industry's failure? Ironically, **the pursuit of investment success has given rise to its biggest impediment: the "Folklore of Finance."** This folklore reflects the shared beliefs, rooted in human bias, that govern both investment professionals' and investors' behaviors. Despite what are often positive motivations behind these behaviors, their effects often impede healthy decision-making.

The beliefs that constitute the **Folklore of Finance** fall into three categories. The first two — the **Folklore of Time** and the **Folklore of False Comfort** — exist as a result of conscious decisions. Investment professionals know, for example, that investing based on past performance or imitating their peers does not contribute to achieving success … and yet both of these practices persist. Likewise, investors know that the reason they invest is to reach long-term goals, yet they often fail to define success with these goals in mind. The **Folklore of Knowledge**, meanwhile, is rooted in unconscious thought. For example, without realizing it, investment professionals take credit for success while assigning blame to external factors. Equally unaware, investors demonstrate significant overconfidence in their own abilities. Clearly, all three folklores are detrimental to success.

The effects of folklore are most evident in the industry's day-to-day activities. Even though there are two dimensions that constitute true success for the industry — alpha and investors' long-term goals — **we need only look at the amount of time, money and energy the industry accords to each of these areas to see a significant misallocation in play**. Investment professionals pay significantly more attention to activities that they believe will contribute value to alpha; some of these are helpful, but many are of limited value. Meanwhile, they often underappreciate activities that have high potential to help investors reach their goals, even though many of these can also aid in alpha production.

While the Folklore of Finance is the reason many investment professionals and investors are failing to achieve true success, it is also the solution. **The industry needs to generate a new Folklore of Finance that reinforces the values necessary to achieve true success**. Folklore is difficult to influence directly. The industry's focus on activities, on the other hand, can be shifted. By fostering the right ones, industry participants will soon bring about positive changes. These changes will cause a reconsideration of beliefs, and a new folklore will begin to take shape.

New behaviors lead to new beliefs and, over time, a *new* Folklore of Finance will and must arise. True success depends upon it.