

## OUTSIDE THE FLAGS

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# The Art of Letting Go

In many areas of life, intense activity and constant monitoring of results represent the path to success. In investment, that approach gets turned on its head.

The Chinese philosophy of Taoism has a word for it: “wuwei.” It literally means “non-doing.” In other words, the busier we are with our long-term investments and the more we tinker, the less likely we are to get good results.

That doesn’t mean, by the way, that we should do nothing whatsoever. But it does mean that the culture of “busyness” and chasing returns promoted by much of the financial services industry and media can work against our interests.

Investment is one area where constant activity and a sense of control are not well correlated. Look at the person who is forever monitoring his portfolio, who fitfully watches business TV, or who sits up at night looking for stock tips on social media.

In Taoism, by contrast, the student is taught to let go of factors over which he has no control and instead go with the flow. When you plant a tree, you choose a sunny spot with good soil and water. Apart from regular pruning, you leave the tree to grow.

But it’s not just Chinese philosophy that cautions us against busyness. Financial science and experience show that our investment efforts are best directed toward areas where we can make a difference and away from things we can’t control.

So we can’t control movements in the market. We can’t control news. We have no say over the headlines that threaten to distract us.

But each of us can control how much risk we take. We can diversify those risks across different assets, companies, sectors, and countries. We do have a say in the fees we pay. We can influence transaction costs. And we can exercise discipline when our emotional impulses threaten to blow us off-course.

These principles are so hard for people to absorb because the perception of investment promoted through financial media is geared around the short-term, the recent past, the ephemeral, the narrowly focused and the quick fix.

We are told that if we put in more effort on the external factors, that if we pay closer attention to the day-to-day noise, we will get better results.

What's more, we are programmed to focus on idiosyncratic risks—like glamor stocks—instead of systematic risks, such as the degree to which our portfolios are tilted toward the broad dimensions of risk and return.

Ultimately, we are pushed toward fads that the financial marketing industry decides are sellable, which require us to constantly tinker with our portfolios.

You see, much of the media and financial services industry wants us to be busy about the wrong things. The emphasis is often on the excitement induced by constant activity and chasing past returns, rather than on the desired end result.

The consequence of all this busyness, lack of diversification, poor timing decisions, and narrow focus is that most individual investors earn poor long-term returns. In fact, they tend to not even earn the returns available to them from a simple index.

This is borne out each year in the analysis of investor behavior by research group Dalbar. In 20 years, up to 2012, for instance, Dalbar found the average US mutual fund investor underperformed the S&P 500 by nearly 4 percentage points a year.<sup>1</sup>

This documented difference between simple index returns and what investors receive is often due to individual behavior—in being insufficiently diversified, in chasing returns, in making bad timing decisions, and in trying to “beat” the market.

Recently, one of Australia's most frequently quoted brokers broke ranks from the industry and gave the game away on this “busy” investing. In his final note to clients before retiring to consultancy work, Morgan Stanley strategist Gerard Minack said he had found over the years that investors were often their worst enemies.<sup>2</sup>

“The biggest problem appears to be that—despite all the disclaimers—retail flows assume that past performance is a good guide to future outcomes,” Minack said.

“Consequently, money tends to flow to investments that have done well, rather than investments that will do well. The net result is that the actual returns to investors fall well short not just of benchmark returns, but the returns generated by professional investors. And that keeps people like me employed.”

It's a frank admission and one that reinforces the ancient Chinese wisdom: “By letting it go, it all gets done. The world is won by those who let it go. But when you try and try, the world is beyond the winning.”



*“Outside the Flags” began as a weekly web column on Dimensional Fund Advisors’ website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor’s control—including portfolio structure, fees, taxes, and discipline. Jim’s flags metaphor has been taken up and recognized by Australia’s corporate regulator in its own investor education program.*

1. “Quantitative Analysis of Investor Behavior,” Dalbar, 2013.

2. Gerard Minack, “Downunder Daily,” Morgan Stanley, May 16, 2013.

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