

Contents lists available at [ScienceDirect](#)

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length article

Do academic investment insights benefit society?



Wan-Ni Lai

KEDGE Business School, Domaine de Luminy, BP 921–13288 Marseille Cedex 09, France

ARTICLE INFO

Article history:

Received 21 February 2016
 Received in revised form 15 April 2016
 Accepted 18 April 2016
 Available online 21 April 2016

Keywords:

Investment
 Retirement
 Savings
 Industry practice

ABSTRACT

Sound investment decisions are crucial for retirement savings and the financing of education. The impact of investment mistakes on the general welfare in society can be tremendous. This paper reviews the implications of finance research for sound investment decision making and contrasts these with the evidence on actual investment practice which is infused with conflicts of interest and may damage investor welfare by promoting returns chasing, hiding bad performance and overcharging for services. The objective of this paper is to assess the current impact that academic research findings have on investment practice and social welfare, and discuss how researchers can contribute to improve the situation.

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1. Introduction

Investment blunders can be made when ignoring academic insights on topics such as risk and return, diversification and hedging. The impact of such mistakes on the general welfare in society can be tremendous. Retirees around the world rely on choices made by agents managing collective pension schemes, and children's higher education options often depend on their parents' investment decisions. With the shift from defined benefit to defined contribution pensions, beneficiaries increasingly make investment decisions directly (Poterba et al., 2007). Bad investment decisions will lead to bad retirement outcomes and compromise education opportunities. Like with many illness, the damage caused will be highest to the old, the young and the vulnerable.

Individuals rely upon the service of the investment industry. Unfortunately, investment product design rarely follows the implications of academic research findings. Instead, financial advice may be driven more by the interest of providers than by what is helpful to investors. Academic research in finance should play a key role in improving matters for society, just like medical research and epidemiology aim to improve public health. Zingales and Luigi (2015) forcefully argued that academics in the area of finance should recognize both the good and bad aspects of finance and help to promote the good aspects that benefit society. This paper addresses similar questions in the subfield of investments. This paper discusses what the current state of knowledge transfer from finance research to investment practice is and how researchers can contribute to improve the impact that academic research findings have on investment practice and social welfare.

2. Investment insights from finance research

2.1. Active management

There is a consensus that, after costs, investors on average do not benefit from using active management. Both empirical evidence (Fama and French, 2010; Busse et al., 2010) and simple arithmetic (Sharpe, 1991) show that the weighted average

E-mail address: wanni.lai@kedgebs.com

<http://dx.doi.org/10.1016/j.ribaf.2016.04.002>

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return of all active managers must be the market return less cost. Thus if active funds charge higher fees than passive funds, in aggregate they must have lower returns after cost.

Investors may think that they can invest in the winning active managers rather than the average active manager. However, benefiting from active management assumes that investors know how to pick the winners. [Barras et al. \(2010\)](#) emphasize the risk of “false discoveries” when trying to identify winners. Interestingly, even if a fund manager had skill, theory suggests that the decreasing returns to scale of active management would destroy any value to investors. [Berk and Green \(2004\)](#) Berk and Green’s (2004) model shows that winning managers will attract large inflows and charge high fees with no benefit left for investors. Empirically, research has found that some managers “add considerable value but capture this themselves in the fees they charge” ([Berk, 2005](#); [Fung et al., 2008](#)). [Jenkinson et al. \(2014\)](#) find that manager selection recommendations issued over the past decade by investment consulting firms do not add value. Overall, there is thus little reason to believe that investors would be able to benefit in practice from selecting the winning managers.

2.2. Diversification

Finance theory has given a formal grounding to the old adage “Don’t put all your eggs in one basket” ([Markowitz, 1952](#); [Samuelson, 1967](#)). Empirically, the benefits of diversification have been well documented. There is evidence that it pays to diversify portfolios across individual stocks ([Statman, 1987](#)), across countries ([Christoffersen et al., 2012](#); [Bergera et al., 2011](#)), across factors (see [Asness et al., 2013](#)), and across asset classes ([Campbell et al., 2003](#); [Kemper et al., 2012](#)). Diversification benefits may vary over time and be weaker in market downturns ([Longin and Solnik, 2001](#)), but the insight that diversification pays remains a fundamental principle of finance.

Diversification offers strong advantages. The benefits of diversification are known as a “free lunch”. Efficiently diversified portfolios deliver the same return at less risk compared to under-diversified portfolios. More importantly, diversification makes everyone better off. If an investor had an ability to select a superior active manager, any benefits would have to be offset by losses to other investors who are choosing poor managers. However, if two investors hold under-diversified but different portfolios, they would be *both* better off by pooling the assets they are holding into a more diversified portfolio. Thus diversification offers an improvement in the aggregate outcomes of investors, as opposed to an improvement for a subset of investors at the expense of others.

2.3. Factors

In addition to the “free lunch” of diversification, there is a “costly lunch”. Investors may increase returns by taking on additional types of risk. There is empirical and theoretical support for the existence of risk premia which cannot be captured by passive investments into broad market indices, such as momentum, value, and other factors ([Asness et al., 2013](#); [Hou et al., 2015](#); [Fama and French, 2016](#)).

There is an ongoing debate whether these premia will persist ([Harvey et al., 2016](#); [McLean and Pontiff, 2015](#)). If they do, some investors may want to tilt portfolios to such additional factors to increase expected returns. But contrary to diversification, such tilts cannot make the average investor better off. For each investor who tilts towards a factor, there must be another investor tilting way from it ([Cochrane, 1999](#)). A key difference with selecting a superior active manager is that such factor tilts can be implemented systematically and at low cost.

2.4. Hedging

Diversification and possibly factor tilts lead to a generic portfolio that targets at efficient risk adjusted returns (“speculative demand”). In addition, there may be investor specific “hedging demands” ([Samuelson, 1969](#); [Merton, 1971](#)).

For example, different investors may have different sources of income outside their financial portfolio, most notably labour income. Labour income may differ in terms of its level of risk and its relation with asset returns. Due to such hedging demands, two investors with the same risk aversion and similar objectives may have different optimal portfolios if their income sources are different ([Viceira, 2001](#); [Cocco et al., 2005](#)).

How risky assets are to an individual investor also depends on the expenditure objective. One may think of general inflation-protected assets as riskless for ensuring future consumption. But the relevant inflation measure is not the same for an investor looking to retire and another investor looking to pay a student’s living expenses and tuition for example. [Merton \(1992\)](#) emphasizes that investors should hedge against unanticipated changes in costs associated with their specific consumption objectives. A common example is to hedge one’s specific housing consumption cost (see [Cocco, 2005](#)).

3. Investment practice today: a dismal picture

3.1. Product offerings

Given the academic evidence, one should expect that investment products focus on providing well diversified portfolios, which avoid the perils of active manager selection and deliver low cost exposure to the broad market and possibly additional

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