Much Ado About Nothing | November 2017

"Doing nothing is very hard to do…you never know when you're finished."
Leslie Nielsen

In a world that values and incentivizes action, 'doing nothing' carries with it certain negative connotations. It conjures up images of laziness and complacency or succumbing to inertia and the status quo. But there are often times when doing nothing is our best option, and it's usually when it is the hardest thing to do (or not do).

A famous medical example is the insertion of stents, tiny wire cages, to open narrowed arteries in the heart. Studies have shown that for patients with stable chest pain this invasive procedure is no more effective than taking medications. Despite this evidence and the risks of the procedure, many cardiologists continue inserting stents, finding it hard to believe that nothing can be better than something.

Perhaps this is why in training army officers to make combat decisions, one of the most valuable pieces of advice is 'doing nothing is also a decision.' While inaction on the battlefield may not be a particularly wise choice, when investing money, sometimes doing less yields more desirable results. After all, most of us can think of a time when we would have been better off sitting on our hands.

In their paper, 'Trading Is Hazardous to Your Wealth,' Brad Barber and Terrance Odean concluded that the more retail investors traded, the further their performance lagged the market. While the commissions and costs of transacting contribute to this lag in returns, the underlying theme is that we are often our own worst enemies due to overconfidence and poor market timing.

This effect is also chronicled in Morningstar's annual 'Mind the Gap' report. These reports analyze the difference between a mutual fund's net return and that earned by the average investor in that fund. In the 2017 report, the gap for Canadians over the last five years was -1.09%. The obvious question is why are people underperforming to such a degree? The costly difference is mainly attributed to the timing and magnitude of the inflows and outflows into and out of the funds.

Put simply, this 'behavioral return gap' is caused by buying high and selling low, with people piling into investments during periods of strong returns and running for the exits when results are poor. The fear of missing out pushes us to chase good performers, and the bitter pain of loss leads us to sell at the troughs.

Naturally the definition of 'doing nothing,' is broad, and it needn't imply the sort of laziness or inertia that gyms rely on to have more members than they could fit through their doors. For some, it simply means following a passive investment strategy, while for active managers, it could mean patiently letting winners run or adopting a defensive posture in the late stages of a bull market.

No matter how one chooses to define it, following through can be very difficult. A runaway bear or bull market will test the resolve of a passive investor to stay the course, and an active manager always needs to resist the urge to tinker simply because they feel they ought to. In both cases, discipline is required and an understanding that doing nothing is something and sometimes it is the best option.

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