Lifting the Veil of Ignorance

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Born a slave in 1856, 160 years ago, Booker T Washington was freed as a child and grew up to become an American educator, author, orator and presidential adviser. At the end of the 2008 presidential election, the defeated Republican candidate, Senator John McCain, referred to Booker T Washington's visit to Theodore Roosevelt's White House a century earlier as the seed that had blossomed into Barack Obama becoming the first black African American to be elected President of the United States. A monument was erected in 1922 on the campus at Tuskegee University, where he had been principal, called Lifting the Veil. The inscription at the base reads "He lifted the veil of ignorance from his people and pointed the way to progress through education and industry".

"He lifted the veil of ignorance from his people"; a wonderful epitaph that is remembered in the US by the numerous schools named after him.

Daniel Kahnman, one of the founding fathers of behavioural finance alongside Amos Tversky, published a book in 2011 called "Thinking, Fast and Slow" which summarises research he conducted over several decades. The central thesis is that humans have two modes of thought.

- Type 1 thinking is fast, instinctive, subconscious and stereotypical. 7x8=56. Stop at a red traffic light. Spiders are horrible.

- Type 2 thinking is slower, requires effort, is deliberate and logical. 17x24=? You know it is a multiplication problem. You know that answers such as 12,609 and 123 are improbable answers. But is 568 the correct answer? Once a precise answer did not present itself immediately, you had a choice: engage type 2 thinking or dismiss the question. For those of you who care, the answer to 17 x 24 = 408. But I suspect very few of you bothered to employ the mental effort required.

With pension freedoms now firmly in place, according to research by Money Management, more than 1 million people in the UK have a SIPP with an average SIPP value of £225,000. That might sound impressive but if you are looking for an income of around £27,500 per annum in retirement, roughly the current average salary for UK workers, you would need a pension pot roughly double the size of the average SIPP. There are two ways to end up with more money in your pension pot: pay more in and make bigger returns.

Let me illustrate by taking someone who wants to achieve a pension of £27,500 in today's money after 35 years of paying into a scheme. With a target of inflation plus 4%, someone would need to save around £500 per month, index-linked. Only achieve inflation plus 3% and the amount of savings required increases by 20% to £600 per month.

Of course we all understand that the more we save and the higher the investment return we achieve, the larger our pension pot will be. These are decisions that will have a material impact on our future lives. But for most of us the story is we do too little; too late. Why?

People do not realise the power of compounding until it is too late. As fans of the Hitchhikers Guide to the Galaxy will know if you want to visit Milliways, the restaurant at the end of the universe, "All you have to do is deposit one penny in a savings account in your own era, and when you arrive at the End of Time the operation of compound interest means that the fabulous cost of your meal has been paid for." But, for people in the 20's and 30's the urgent demands for everyday living expenditure (housing; family; fun) tend to displace the importance of planning for the future. With auto-enrolment it can be argued that the government is addressing a structural inefficiency and market failure but it is clear that more people need to save more if they are to avoid old age poverty.

The other moving part of the pension equation is the investment return. If a higher return can be achieved then surely investors should make the necessary adjustments? But how many of us already have an investment portfolio, be it in a pension wrapper or otherwise? And do we know the performance of their investment portfolio, say, in 2015? And have we taken the trouble to place that performance into context through some form of analysis?

I would contend that there is a "veil of ignorance" surrounding most investors when it comes to monitoring and understanding how their portfolio is doing. This is partly the fault of the industry: written and verbal communications from investment managers to their clients are often hard to decipher and too many investment managers do not provide performance data in a format that can be easily understood by a non-professional investor.

But it is not just a problem of data. It is a problem of complexity. Analysing investment performance is rarely possible using what Daniel Kahnman called Type 1 thinking. It requires time and effort, Type 2 thinking; and investors would rather "guess" the answer or ignore the question.

Asset Risk Consultants (ARC) has been seeking to address the problem of how the average investor can monitor investment performance for a considerable time. For those of you who follow us on Twitter or subscribe to our web research portal www.suggestus.com, you will have seen that we often employ the hashtag #investmenttransparency. More recently we have also employed the hashtag #democratisingperformance. This is because one of our aims is to allow any investor to place the performance of their portfolio into context against a sensible set of financial markets and against a suitable peer group.

Our goal is not just to lift the veil of ignorance through education but to allow investors to analyse performance using Type 1 thinking rather than guessing or giving up. To that end, users of Suggestus can create a simple factsheet for their portfolio which allows them to see at a glance whether their portfolio is performing well or not.

Over the last ten years, taking a typical steady growth portfolio with perhaps two-thirds of the portfolio invested in equities and the remaining third in bonds, cash, property and alternative investments, the performance differential between a first quartile private client discretionary manager and a fourth quartile manager has been at least 1 percentage point per annum. As we saw earlier, for someone targeting a pension of £27,500 per annum over 35 years a performance differential of 1 percentage point per annum equates to needing to save an additional 20% each month.

Investment performance and regular review matter. Let's help our clients understand the performance of their portfolios #investmenttransparency and let's help our clients interpret the performance of their portfolios #democratisingperformance. Visit www.suggestus .com for the tools to understand portfolio performance and to undertake very cost effective portfolio reviews.

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