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SAFT ON WEALTH-Wherever you go, there you are

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(James Saft is a Reuters columnist. The opinions expressed are his own)

By James Saft

Dec 18 (Reuters) - Here is the thing about investing: wherever you go, there you are.

Which is another way of saying that we carry our problems, weaknesses and foibles as investors around with us, no matter how we approach the discipline or what tools we use.

While the investment world is constantly creating new, opaque and high-cost ways of separating investors from a portion of their capital, avoiding the obvious land mines is far from a guarantee of success.

Because we are human, and as such unique mixtures of such winning attributes as overconfidence, risk-blindness and hyperactivity, we have the capacity to take even great investing ideas and turn them into losers.

Take exchange-traded funds, which surely must be one of the most investor-friendly innovations of the past 20 years. ETFs, and here I am talking about those which passively track an index, are just brilliant: they facilitate diversification while providing liquidity and all at a low cost. In theory ETFs are a tool which allow investors to overcome many of their most common errors, and as an investment vehicle they have surely contributed greatly to the fall in average fees.

Like a sharp knife in the hands of a careless child, however, index ETFs as used by most investors are powerful tools which do more harm than good.

That, at least, is the conclusion of one new study, which found that not only did ETFs, as used by actual investors, not improve performance but dragged returns lower by an economically significant amount.

The paper, by Utpal Bhattacharya of Hong Kong University of Science & Technology, Benjamin Loos and Andreas Hackethal of Goethe University and Steffen Meyer of Leibniz Universität, looked at outcomes for nearly 7,000 German investors between 2005 and 2010 who used index ETFs. The upshot: the average ETF investor sees his net raw return lowered by 2.1 percentage points annually, and with a lower risk-adjusted return as well. (here)

Not only that, but the ETF users managed to use ETFs in such a way as to make their portfolios less efficient, implying that they are not getting the diversification benefit that is one of the main points of index ETF investing.

So how did these investors take a good tool and use it to nail their own feet to the floor?

It wasn't even so much that the investors used the wrong ETFs, picking the wrong asset class or over-paying in fees. Instead these investors lost more by playing, badly, at being market-timers.

Their fault was that they bought and sold at the wrong time, just like the human beings they are.

BEHAVIOR TRUMPS

"The wonderful innovation of passive ETFs, with its enormous potential to act as a low-cost and liquid vehicle for diversification, may not help individual investors to enhance their portfolio performance, even before transactions costs, if they actively abuse passive ETFs by trading them at wrong times," the authors write.

"Ironically, the low cost and high liquidity of these ETFs seem to encourage trading and aggravate the individual temptation to engage in this behavior."

This is all a bit like motorists deciding to react to a reduction in speed limits by choosing to text more while driving because it is 'easier' and 'safer' at low speeds.

And while the drags the ETFs caused were not statistically significant, they were economically important.

The study also ran a counterfactual analysis that showed that if investors had used ETFs as intended, to track the broad market using a buy-and-hold strategy, they would have made on average 2 percentage points more per year.

So why did these investors make bad decisions about when to buy and sell? The study doesn't answer that, but people do tend to allow their emotions to drive their trading decisions, getting in as momentum investors when markets are getting more expensive and bailing out during downdrafts.

Buy and hold isn't a good strategy, therefore, because it performs well in relation to changes in the world. Obviously, it doesn't.

Buy and hold can be a better (than otherwise) strategy because it takes the investor out of the equation.

That, admittedly, is an extreme solution, but it is an extreme solution to a pervasive problem.

Advice and counseling can also help, typically by stopping investors from making rash decisions and encouraging them to diversify, but as we know, financial advice is far from uniformly good.

Wherever we go, there we find ourselves. (At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund. You can email him at jamessaft@jamessaft.com and find more columns at blogs.reuters.com/james-saft) (Editing by James Dalgleish)

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