Charlie Munger: Overconfidence is Everywhere

While 98% of Active Managers Cannot Add Value, 100% Believe They Can

Pete Chiappinelli, CFA, CAIA, Chief Investment Officer

For those that follow the financial news, you no doubt heard about last week's passing of Charlie Munger, Warren Buffett's friend and investment partner at Berkshire Hathaway for almost sixty years. Financial websites, blogs, podcasts, LinkedIn, and other social media are jam-packed with remembrances, all sharing quotes and anecdotes from Charlie's life, and all are full of witty, pithy, and biting commentary.

There's no need to reprint any of those gems here, but I do feel compelled to share that three weeks before he died, Charlie sat down with a reporter from *The Wall Street Journal*.
After many hours, the reporter had one last burning question that went basically like this: "Charlie, you've spoken about the importance of psychology in investing and the role of biases. Is there a cognitive bias that you think is particularly significant in the markets today?"

Charlie paused. And then responded. He explained that there are all sorts of cognitive biases and bad behaviors that significantly impair our investment abilities - recency bias, confirmation bias, and many others. But the most pervasive and pernicious was "overconfidence, *the tendency to overrate one's own intelligence and skill."* Fascinating.

I mention this story because that very week, Standard & Poor's released a unique and sobering study on active management. It was the first time ever that the firm looked at the past track records of active managers vs. passive indices on *an after-tax basis.* For twenty years, the research firm has been publishing reports on the performance of active managers across the world on a *pre-tax* basis. The report that came out in November was their first on *after-tax* performance.

Taxes matter. First, most of the investable assets - we estimate 90% to 95% - for our Family Office clients are taxable. Further, these families are taxed at the highest Federal marginal tax rate. Furthermore, many of our clients live in high-tax states such as New York, New Jersey, Massachusetts, California, and others. Below is a small diagram that we share with our clients in Massachusetts, for example, to highlight the magnitude of what they're paying when they receive dividends, income, or when they realize short and long-term gains. These tax rates, as high as they are – over 53% for short-term capital gains - could actually move higher when the tax cuts of 2017 eventually sunset.

Tax bites out of your returns

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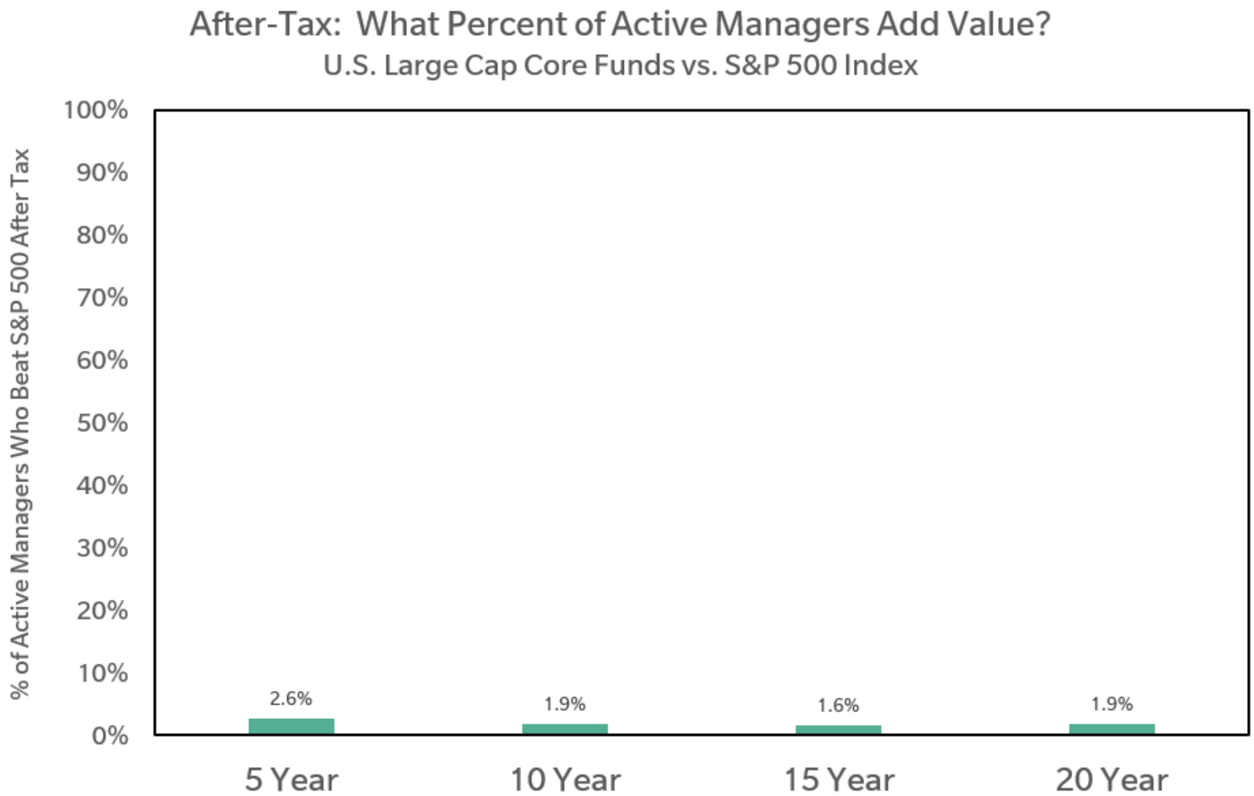
	Short-Term Capital Gains	Taxable Interest Income	Long-Term Capital Gains	Qualified Dividends
Federal	40.8%	40.8%	23.8%	23.8%
	+	+	+	+
Mass.	12.5%	9.0%	9.0%	9.0%
Total	53.3%	49.8%	32.8%	32.8%

Source: Internal Revenue Service for Federal government and Commonwealth of Massachusetts These are the highest marginal tax rates.

This study on after-tax performance, then, has significant meaning for our clients. And to the point above, it also speaks to Charlie Munger's observation about overconfidence. See the chart below. It shows the success rate of active managers over various time horizons:
5, 10, 15, and 20 years. Basically, 98% of active managers fail to add any value once fees and taxes are taken into account. The final sentence of the report was stark in its conclusion: *The results of this scorecard highlight that, at least in broad U.S. equities, and at least over the last 20 years, taxes would have made a considerable impact on the average returns of actively managed funds, and that the task of selecting an active fund that outperformed after tax was almost (if not completely) impossible.*



Source: Standard & Poor's Index vs. Active (SPIVA) report, for periods ending December 31, 2022, and Ballentine Partners.

Now, given the dismal odds of success, does this inconvenient data stop active managers from showing up to work each day, thinking they've got a chance? No. Does this inconvenient data stop the active management industry from creating dozens of new products each year hoping to achieve the seemingly impossible? No. Is this a con job of epic proportions? Probably not. These active managers are genuinely confident they can add value despite overwhelming evidence to the contrary. But it is, in the words of the late Charlie Munger, further proof of the most pervasive and pernicious cognitive bias in the active management industry. Overconfidence.

About Pete Chiappinelli, CFA, CAIA, Chief Investment Officer

Pete is Chief Investment Officer at the firm. He is focused primarily on Asset Allocation in setting strategic direction for client portfolios. Pete has 30 years of experience in research, investment strategy, and thought leadership regarding the management of multi-asset class portfolios, inclusive of equities, fixed income, and alternatives. His work has been featured in leading financial publications such as *The Wall Street Journal*, *The New York Times*, *Barron's*, and others in Canada, Europe, and Asia. His market commentaries have been featured at major industry conferences, in TV documentaries on capital markets history, and on social media outlets. Prior to joining Ballentine Partners in 2022, he was a Senior Portfolio Strategist on GMO's Asset Allocation team. Prior to that, he was an Institutional Portfolio Manager at a specialized unit within Fidelity Investments and was the Managing Director of Institutional Investment Strategy & Research at Putnam Investments. He is a graduate of Carleton College and holds his MBA from The Wharton School at the University of Pennsylvania. Pete holds the Chartered Financial Analyst (CFA) designation, is a member of the CFA Institute and CFA Society Boston, and he holds the CFA Institute Certificate in ESG Investing. He also holds the Chartered Alternative Investment Analyst (CAIA) designation and was the founding President of CAIA Boston. Pete lives in Hingham, MA with his wife, Cheryl, and enjoys travel, cooking (definitely not a "foodie," but a "foodie wannabe"), sourdough breadmaking, and conjuring up ways to embarrass his three children.