Briefly Noted

You Can Judge a Fund by Its Volatility

Unlike returns, fund volatility can be persistent, according to an S&P Dow Jones Indices study. Actively managed funds with high levels of volatility (as measured by the variance in returns) are likely to stay highly volatile. Actively managed funds with low volatility are likely to continue to experience low volatility.

S&P Dow Jones Indices split actively managed U.S. funds into five quintiles. Excluded from the analysis were index (passive) and leveraged funds. Monthly return data from June 2007 through June 2015 was used. During this period, an average of 80% of U.S. funds were more volatile than their category benchmarks.

Nearly half (47%) of the least-volatile U.S. funds in a 24-month period remained in the least-volatile quintile over the subsequent 24-month period. An additional 23% ranked in the second-least-volatile quintile. At the other end of the spectrum, almost two-thirds of the most-volatile funds remained in the two most-volatile quintiles (43% and 23%, respectively) over the subsequent 24-month period.

Higher-volatility funds allocate more to higher-beta stocks, as would be expected. Investors are not being adequately compensated for the larger variance in fund returns, however. A hypothetical portfolio made of funds whose full-period (June 2007 through June 2015) volatility ranked in the top 20% of all U.S all-cap broad and U.S. large-cap broad funds underperformed the S&P 500. The annualized return for the higher-volatility fund portfolio (HVFP) was 7.8%, versus 7.9% for the S&P 500. This underperformance occurred even though annualized volatility was nearly three percentage points higher for the HFVP portfolio: 17.2% versus 14.7%.

The lower-volatility fund portfolio (LVFP) underperformed with an annualized return of 7.2%. (The LVFP also underperformed the S&P Low Beta United States Index.) This portfolio was less volatile than the S&P 500 index, however, with annualized volatility of 13.2%. The study's authors attribute the return characteristics of low-volatility funds to a "significant cash allocation." To prove their point, they constructed a hypothetical fund portfolio with an 89% allocation to the S&P 500 and an 11% allocation to cash. The performance of the LVFP was almost indistinguishable from this S&P 500/cash mix.

Source: "The Volatility of Active Management," Tim Edwards, Craig Lazzara and Luca Ramotti, S&P Dow Jones Indices.

Tax Uncertainty and Traditional Versus Roth IRAs

The decision to allocate between a pretax retirement savings vehicle (e.g., a traditional IRA) and an aftertax retirement savings vehicle (e.g., Roth IRA) depends on both current and expected future wealth. Aftertax retirement savings accounts are preferable for workers with both low and high current incomes. Those with intermediate incomes should opt to use both so as to avoid being pushed into a higher marginal tax bracket.

This was a conclusion of an analysis of retirement accounts and historical changes to the tax code. The study's authors considered both the progressive nature of the U.S. tax code and how income tax rates have changed over time. Time periods of 10 and 30 years before retirement were used.

Those with low levels of current income benefit from the low tax rate on contributions. By using Roth accounts, investors lock in low tax rates. Doing so hedges them against having higher income in the future and therefore being exposed to higher tax rates.

High income earners face a trade-off. If future tax rates are known, pretax retirement accounts are preferable to avoid paying the higher marginal income rates on aftertax contributions. When future tax rates are uncertain and guaranteed future income is high, paying the highest current tax on contributions offers certainty. The current tax rate is paid on the Roth IRA contributions and avoids potentially higher tax rates down the road. Should investment performance be worse than expected—bad enough to put the investor into a lower tax bracket—pretax accounts offer some advantages.

Those with intermediate incomes should consider how close they are to the lower and/or higher current tax brackets. Pretax contributions should be used to stay in the lower tax bracket or avoid being bumped into the higher tax bracket. Any marginal dollars beyond this amount should be placed in aftertax accounts.

Some assumptions were made to simplify the analysis. Only three tax brackets were used. The ability to convert pretax retirement savings into a Roth IRA was also not factored in. Randomized historical tax rates were used and the actual variance in future tax rates may differ.

Source: "Tax Uncertainty and Retirement Savings Diversification," David Brown, Scott Cederburg, and Michael O'Doherty, SSRN, July 25, 2016.

"Trusting Your Gut" Not Proven to Increase Returns

A study of traders suggests gut feelings "are more than the mythical entities of financial lore." Rather, they can provide valuable physiological signals. Before completely trusting your gut, however, be aware of the study's limitations. The authors conceded that their research "could not establish causation."

Researchers studied the trading results of 18 high-frequency futures traders. Each of the traders held positions often for a few seconds or a few minutes, and at most for a few hours. Access to information was determined to be equal. Compensation consisted entirely of a share of trading profits. Trading activity was tracked near the end of the European sovereign debt crisis.

Gut feelings were measured as the ability of a trader to generate and sense an interoceptive signal—an awareness of a stimuli originating within the body. Examples include breathlessness, a racing heart and increased body temperature. Previous research has shown that such signals can lead to improved decision-making in laboratory settings. Little research has been done so far in real-world settings.

To test how aware traders were of their body's physiological reactions, the researchers measured study participants' (both traders and a control group) awareness of their heart rate. Participants were asked to count their heartbeats over randomized time periods. Each person's count was then compared against the actual number of heartbeats.

The most successful traders were those who scored highest on the heartbeat detection. The more accurate a trader was at counting heartbeats, the more profitable the trader was. Furthermore, detection scores rose with experience. Beginning traders (those with one to four years of experience) had detection scores that were indistinguishable from the control group. Experienced traders (those with more than eight years of experience) had significantly higher heartbeat detection scores than the control group.

Despite the link between profitability, experience and the ability to accurately count one's heartbeats, the researchers downplayed a causation element. They did not give a clear reason as to why. Luck was briefly mentioned as a possible "unobserved variable."

Source: "Interoceptive Ability Predicts Survival on a London Trading Floor," Narayanan Kandasamy, Sarah Garfinkel, Lionel Page, Ben Hardy, Hugo Critchley, Mark Gurnell & John Coates, Scientific Reports, Nature.com, September 19, 2016.

IRS Allows Waivers on 60-Day Rollover Deadline

The Internal Revenue Service (IRS) requires rollovers of retirement accounts—including individual retirement accounts and qualified workplace plans—be completed within 60 days. Failure to meet this deadline can result in the assets being taxed at ordinary income rates and an additional 10% penalty being assessed. Certain exceptions exist, including the account owner having reached the age of 59½.

The tax code allows the 60-day rollover requirement to be waived when "the failure to waive such requirement would be against equity or good conscience." The IRS clarified the reasons it would consider a waiver claim acceptable:

- An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
- The distribution, having been made in the form of a check, was misplaced and never cashed;
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
- The taxpayer's principal residence was severely damaged;
- A member of the taxpayer's family died;
- The taxpayer or a member of the taxpayer's family was seriously ill;
- The taxpayer was incarcerated;
- Restrictions were imposed by a foreign country;
- A postal error occurred;
- The distribution was made on account of a levy under Section 6331 of the Internal Revenue Code and the proceeds of the levy have been returned to the taxpayer; or
- The party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Within 30 days after being able to make the contribution, taxpayers must submit written certification to a plan administrator or IRA trustee to take advantage of the waiver. The model letter included in IRS Rev. Proc. 2016-47 can be used on a word-for-word basis or "a letter that is substantially similar in all material respects" to the model letter. In doing so, the contribution can be reported as a valid rollover unless otherwise notified by the IRS. Those seeking to claim a waiver must not have been previously denied for waiver, however.

Source: "Waiver of 60-Day Rollover Requirement," Internal Revenue Service Rev. Proc. 2016-47.