Goodhart's Law, How It Affects Investing...and Cobras.

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Goodhart's Law is the idea that once a measure becomes a target, it is no longer a good measure. Goodhart was a British economist and was examining monetary policy when he suggested this and since then, the idea has been expanded into many other areas. An example is the government in India introduced a bounty on dead cobras in an attempt to reduce the number of venomous snakes in the country. Unfortunately, what happened was that locals began raising cobras to collect the bounty.

Another more tragic example is the Soviet whaling industry during the cold war that hunted many species of the ocean mammal to near extinction. This was done almost entirely to meet arbitrary five-year plan numbers that were set by bureaucrats in Moscow. There was very little demand for whale products in the Soviet Union.

In the investing world, we see Goodhart's Law in practice with an unhealthy focus on indexes. A portfolio over the long term has to have some sort of measure to ensure that it is doing what it should. Yet too short of a time frame when measuring one's returns against a stock index (such as the S&P/TSX 60 or S&P 500) or a set of benchmarks (such as conservative or growth index) can cause unintended consequences.

Closet indexing is one of these. Closet Indexing is when a money manager buys securities that mimic the index that their livelihood depends on. They know that if they are too far off this number on an annual basis their jobs are at jeopardy. This almost guarantees that after considering fees, clients will not outperform.

This fixation on indexes could be causing dislocation in markets themselves. Buying an index or index fund is called passive investing. This passive investing allows investors to buy diversified portfolio without having to do any analysis of stocks or scrutinizing a money manager. This type of investing has grown from less than 5% of equity investing in the 1990's to 48% percent today. This is worrisome, because some of the most outrageously priced stocks are becoming bigger and bigger components of ordinary people's retirement plans. By using the index as a target, we may be setting ourselves up for some very negative, unintended consequences.

In the last tech meltdown 20 years ago the Nasdaq index (which is and was primarily composed of technology stocks) fell 75% from its high in 2000 to 2003. Expensive tech stocks comprise a much higher percentage of more mainstream indexes today.

We need yardsticks to see and measure aspects of the world we live in. Though we need to be careful that the yardsticks don't encourage us to start raising cobras in our backyards.