Investing In Funds

My wife just showed me her mutual fund statements and reports which she received from the manager. After 15 years, this much vaunted fund manager had generated a nominal return of… zero.

After inflation, living in Singapore, her investment wouldn't be able to buy a bicycle let alone pay the downpayment on a retirement home in Southern Malaysia.

I also noticed that there had been a forced redemption. The manager had shut down one of their funds. Well, thanks. So after a decade of managing her money, the manager finally decided that they were not very good at it after all, and decided to hand the money back to her. "Here, you manage it," is not really acceptable after you've taken a decade of fees off the investor.

Why did my wife invest in the fund? Well, she didn't. In my earlier days, and in my folly, I decided to give her a birthday present which was not something she could carry, wear, eat or ride around in. So I bought her units in a mutual fund. Romantically, this is equivalent to shooting oneself in the temple. Twice.

I do invest in funds. I think its the smart thing to do, if you do it in a smart way. I don't just invest in brand names. When it comes to fund managers, brand names are often asset gatherers who are better at getting your money than they are at managing it. I avoid brand names unless I can meet and interview the specific managers managing the relevant funds. Meeting and interviewing the managers is a necessary condition for me to invest with any fund. I need to assess for myself if the track record they have achieved is the product of skill or luck. I will only pay management (and or performance fees) for skill.

I invest in funds for a number of reasons.

– I can't get the diversification I need for the amount I'd like to invest. Funds pool investors' money into a bigger pot which can be deployed in assets which the hapless retail investor may not have the scale to access.

– I don’t have the time to dedicate to a particular strategy. I only have 24 hrs a day. I cannot engage in arbing interest rates, hedging converts, investing in mergers, trading credit correlation and structuring reg cap relief solutions all by myself.

– I may not have sufficient skill. This will most often be the case. Understanding an investment strategy and being able to execute it with the requisite skill are two different matters. If one doesn’t understand a strategy, the best advice is to not invest. It is irrational to invest in any scheme or strategy that one doesn’t understand. On the other hand, just because you understand a strategy doesn’t mean you can do it. It just means you know how its done. That’s all.

– I don’t have the scale for certain strategies. Not every day trader in his basement can obtain the necessary terms to trade the instruments that a strategy may require.

What I never do is invest in funds for silly reasons such as:

– A good track record. A good track record is never enough. One needs to understand how the track record was achieved, and if it can be repeated. One also has to know if the track record is real. Bernie Madoff had an excellent but fake track record. Yet so many clever investors invested with him.

– A clever trade. A clever trade does not a fund make. There are specialized closed ended private equity funds that take advantage of very specific opportunities but open ended mutual funds need to be based on more than a single opportunity. And I’m fine with those, in fact I think they are very interesting vehicles that are often launched to capture phenomenal opportunities. It worries me when managers launch funds to take advantage of the recovery post 2008. What happens when the trade is done? The manager is typically unwilling to return capital and will likely try their luck in another trade, one that you didn’t sign up for, one that the manager may not be experienced at. I want strategies that can last at least 7-8 yrs, because that’s how long, at least, I expect to leave my money in their hands.

– The market is running and I want exposure. If you want market returns, use an ETF, or buy the underlying instruments yourself. Funds are not cheap. You shouldn't be using them as trading vehicles but as long term investments. If you want exposure to a particular segment of the market and no ETFs are available, using funds is a legitimate way of buying exposure. Luxury goods companies for example are not represented by an ETF and can be accessed through a fund.

– A brand name. A brand name is not a bad thing but it shouldn't be the only thing, and the brand should add no additional comfort. Each fund must be assessed on its merits and this means due diligence. I have never given my trust freely, and I certainly don't give it to brand names per se. Trust has to be earned, and it takes time. Brands are often good from a due diligence perspective, however, since they provide the basis for the question: how did they build a successful brand? Usually, a high quality product or service is the answer. Due diligence seeks to confirm and verify the answer. There are no assumptions in due diligence, or at least there are very few. I have very strong views about due diligence and how it is to be conducted. You have to identify the manager, meet the manager, his team, his ops, his service providers, speak to them about what they do. Cutting and pasting an AIMA DDQ into the file is a gross dereliction of duty, and something I've seen done even by institutional investors. It is for these types of investors that funds like Madoff were designed.

– I don't know the strategy well and I want to outsource it to a professional. This is an excellent way to lose money. If you don't know the strategy well, how do you know whom to outsource it to? If one doesn't know a strategy well, the first and best course of action is to learn all about it. The second best and quite frankly lazy course of inaction is to stay away.

Investing is not easy. Whether one invests in funds or directly in securities, one is responsible for one's own decisions. Using consultants is one way of delegating the research and due diligence but it means one has to research and perform due diligence on the consultant or intermediary.