Why Invest In Funds? What Can They Do For Us?

In investing and trading, easy to identify strategies are rare. Asian convertible bonds in late 2008 are an example, the QE2 liquidity infused rally of 2010, the first LTRO rally, the rebound in RMBS in 2009, are others. The massive relief rally on early 2009 was harder to identify and caught most investors off guard. The rally in US treasuries in the last 3 years, the rally in gold, the implications of the second LTRO, all have been diabolically hard to call and trade.

Even worse, what is obvious to one investor is unclear to another. And of the events listed above as ‘obvious’, most were only obvious well after the fact.

In the best of times, markets are risky places for investors; in the worst of times they are treacherous waters, graveyards of fortunes lost.

1. Directional investing is vulnerable to market risk. Whether it is in equities, credit, commodities or FX, taking directional bets on asset prices exposes one to the general direction of markets. Even the multi-directional nature of global macro investing is not spared. Fund managers express directional views on asset prices based on their understanding and analysis of macroeconomics and policy. Most fail to deliver consistent returns, but some are uncannily consistent. These rise to become the premier global macro hedge funds we come to know. Soros, Brevan Howard, Caxton, Tudor, Moore, et al. Long only funds are examples of directional funds where one direction (short) has been denied them.

2. Relative value investing is less vulnerable to market risk but exposes one to idiosyncratic risk. In relative value, basis risk is actively sought. The manager seeks to express a view on one security doing better than another, one company, commodity or currency outperforming another. Market risk is reduced, not eliminated. It is also transformed into a more complex risk. The relative value manager seeks to assume a specific risk, while hedging out other risks. Buying GM and selling Daimler is a bet on the

quality of management, but it also includes bets on the relative fortunes of luxury versus regular automobiles, the relative strength in the economies of Europe, or Asia or North America depending on the relative exposures of each company to each area. Some risks can be hedged away, some cannot. Be that as it may, relative value represents a more targeted way of assuming risk, and seeking returns, than making open ended long only wagers on the fates and fortunes of companies, commodities, or countries.

3. Arbitrage is the Holy Grail of investing. Most of the time it does not exist. On those rare occasions when it does, it is hideously difficult to identify and capture. Most arbitrage trades are quasi arbitrage in that there are risks, but they are remote or have been missed by the arbitrageur. True arbitrage involves buying something, simultaneously selling it or its equivalent for less and picking up the difference without assuming any risk. Most of the time, risk in quasi-arbitrage leaks into the operational, settlement, delivery, legal and regulatory aspects of the trade.

The financial crisis of 2008 is now 4 years behind us. Yet its ripples haunt us over time. This period arguable represents one of the most important turning points in recent history. The main themes surrounding this turning points are:

A. Reversal of US current account and trade balance deficits.
B. Reversal of the falling savings rates in the West.
C. Reversal of weak USD.
D. Reversal of falling USD interest rates and bond yields.
E. Global wide debt reduction with implications for economic growth.
F. Regulatory and Policy responses to the past abuses of the Principal Agent relationship.

The short term perturbations around these reversals will confuse and confound investors. It is necessary to have a specialized skill set in asset market in order to navigate these difficult investment conditions. The logical implication is to outsource investment decisions to experts, to dedicated fund managers.

Even here there is a dilemma.

1. Private investors who are not full time dedicated investors often lack the

expertise to invest in certain markets, or indeed the expertise to asset allocate across a range of investment opportunities. Professional fund managers have the experience, expertise and resources to invest money in their areas of expertise. This is the strongest argument for investing in funds. And yet…

2. Professional fund managers are restricted in their function. There are certain norms and accepted practices in fund management which create certain biases in manager behavior even if they are sub-optimal. One example is that managers feel that they need to be fully invested even when conditions are unclear or they are unable to find sufficient compelling investment opportunities. The behavior of investors in the past (who believe that managers should earn their fees) have driven managers into this type of irrational behavior. A rational investor may decide to refrain from investing for not insubstantial periods of time if the outlook is unclear or there is a dearth of investment opportunities.

The choice of manager becomes extremely important.