MULTI-ACT

11th November 2011

At Multi-Act we have often had to evaluate various financial instruments on offer and have observed that more often than not, the race to be “innovative” on the part of the “manufacturers” of these creative products actually works contrary to the financial goals of Families.

The task of making choices between financial products which are sometimes purely flavours of the season is one more “Challenge that Families face in Managing Wealth”.

Let a Thousand Balloons Float (upwards?)!

“The complexity and proliferation of investment strategies, instruments, manager styles & intermediary functions can make it seem all too daunting for Families. There is a great danger of “mis-buying” (entering into instruments, approaches and contracts) that is inconsistent with the goal of preserving family wealth and ensuring a reasonable risk-adjusted / inflation-adjusted return which should be the primary goal for a Family’s core investment program.”

In the first article we highlighted the macro challenges of the Global economy and its impact on India.

The second of our articles highlighted the inherent conflict of interest between the purveyors of financial services and the buyers of financial services that makes it important for a Family to understand the conflicts of interest and the incentives in a transaction and manage those conflicts and incentives as best as possible.

The above two factors make the inherently low return environment that families are enduring, an even worse one to accomplish their investment goals.

Purveyors of financial services have sought to meet an urgent need by investors for investment returns with safety of capital by proliferating their “wares”. It is doubtful, in our opinion, that they have been able to accomplish what investor families really want or need.

Let us recount the broad equity oriented strategies, their major pitfalls and why the majority of them fail to meet the Goals of Investors:

1. **Active Fundamental Investing:** This is the original “plain vanilla” strategy of investment management. We estimate that probably 70% plus of dedicated funds in equity investing are invested in this manner. There are many sub-approaches followed including: Value, Growth, Growth at a Reasonable Price, etc. But at all times managers who practice this approach believe; the client has done his asset allocation exercise; that he really wants to invest in equities at that particular time; and is not investing in response to either price momentum or as we like to put it: the “cocktail party chatter”.

   For example, Dalbar has done a long running study in the US where they compare the return of the S&P 500 and the return actually enjoyed by investors on a weighted average basis in the funds. The results of the twenty years ending 31/12/2010 are as follows: S&P 500 9.14%, Average Equity Mutual Fund Investor: 3.27%. This gap is known as the behavioral gap: investors chasing past returns. While we do not have any numbers for India, we are pretty sure that the behavioral gap in India would be worse.

So the fund manager by assuming that he has no particular skill in being able to determine whether the equity market is fairly priced or not; or more correctly, the assumption that the equity market is always “fairly” priced ends up doing a dis-service to the average mutual fund investor.

While “active” fundamental investing is beloved by most fund managers, we think as it is currently practiced, “active” investing, bereft of the use of any asset allocation framework, has outlived its usefulness. Why?

Firstly, there are too many managers that practice this approach. The stock market is a pari-mutuel system; it’s not what you know that is important, but what you know that others don’t! In a world of 90,000 CFA charter holders, more than 40 to 50 “sell side” analysts covering a single large capitalization stock, its unlikely many managers have any sort of “informational” edge left.

That leaves only two edges that we can identify: a “processing edge” and a “behavioral edge”. But active managers instead of trying to develop genuinely different insights all do practically the same thing: they read “sell side” research reports that pretty much use the same macro and micro analytical models, they build earnings models that focus on near term earnings momentum and try and outguess all the other forecasters as to which company is going to “beat” the earnings, they assiduously meet company managements, attend the same conferences, all in the hope that they will learn some “nugget” of information that has somehow been missed by the others!

This misplaced focus on an informational edge is reflected in the performance of active managers relative to their benchmarks. **Figure 1** below shows the percentage of US equity fund managers outperformed by their respective benchmarks over the past one, three, and five years. As is seen below, except large cap value fund managers, a vast majority of the fund managers (nearly two thirds) across investment categories underperformed their benchmarks. Interestingly, this is before the fees charged by fund management companies.

Report 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks

Fund Category	Comparison Index	One Year	Three Years	Five Years
All Domestic Equity Funds	S&P Composite 1500	48.99	55.16	58.27
All Large Cap Funds	S&P 500	60.47	63.96	61.28
All Mid Cap Funds	S&P MidCap 400	66.67	75.07	78.81
All Small Cap Funds	S&P SmallCap 600	47.48	63.08	60.69
All Multi Cap Funds	S&P Composite 1500	59.73	67.34	67.26
Large Cap Growth Funds	S&P 500 Growth	58.36	75.00	80.40
Large Cap Core Funds	S&P 500	70.96	68.20	62.50
Large Cap Value Funds	S&P 500 Value	45.40	44.13	35.32
Mid Cap Growth Funds	S&P MidCap 400 Growth	82.14	84.12	88.02
Mid Cap Core Funds	S&P MidCap 400	78.16	74.34	84.00
Mid Cap Value Funds	S&P MidCap 400 Value	56.63	63.27	66.67
Small Cap Growth Funds	S&P SmallCap 600 Growth	50.00	69.59	74.59
Small Cap Core Funds	S&P SmallCap 600	60.50	64.98	59.38
Small Cap Value Funds	S&PSmallCap 600 Value	39.64	52.29	47.67
MultiCap Growth Funds	S&P Composite 1500 Growth	46.05	77.71	82.71
MultiCap Core Funds	S&P Composite 1500	67.72	67.28	64.38
MultiCap Value Funds	S&P Composite 1500 Value	50.65	54.90	54.04
Real Estate Funds	S&P BMI United States REIT	65.25	66.04	70.00

Source: Standard & Poor's, CRSP. For periods ending June 30, 2011. Outperformance is based upon equal weighted fund counts. All index returns used are total returns. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Figure 1: Percentage of US Equity Funds Outperformed by Benchmarks, Source: SPIVA, Mid-Year 2011

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The same is also true of the international as well as emerging market funds. **Figure 2** below shows the percentage of International equity fund managers outperformed by their respective benchmarks over the past one, three, and five years. As is seen below, except small cap funds, a vast majority of the international fund managers (nearly two thirds) across investment categories underperformed their benchmarks. Interestingly, performances of emerging market funds were only worse.

Report 6: Percentage of International Equity Funds Outperformed by Benchmarks

Fund Category	Comparison Index	One Year	Three Years	Five Years
Global Funds	S&P Global 1200	66.48	57.04	61.22
International Funds	S&P 700	55.30	64.62	80.23
International Small Cap Funds	S&P World Ex-U.S. SmallCap	32.08	30.51	23.91
Emerging Markets Funds	S&P/IFCI Composite	63.23	80.77	86.96

Source: Standard & Poor's, CRSP. For periods ending June 30, 2011. Outperformance is based upon equal weighted fund counts. All index returns used are total returns. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

Figure 2: Percentage of International Equity Funds Outperformed by Benchmarks, Source: SPIVA, Mid-Year 2011

To us therefore it is imperative that genuine fundamental "active" investors, if they have a hope at all of "beating" the market develop some different analytical models. In other words bring some sort of "processing" edge.

Alternatively, they could bring a "behavioral" edge, in other words make a conscious decision NOT to "herd" with the crowd. Of course, the market as whole cannot do that, but Families that have large corpuses, long horizons and no need to mark themselves to market over artificial time-frames like a quarter or a calendar year, can make a conscious and successful decision to stay away from the "crowd".

2. **<u>"Passive" Indexing:</u>** As the shortcomings of the active approach became widely understood, "passive" indexing approach came into prominence. The idea here was that since 90% of the managers did not "beat" the index; why not just invest in the index? Such an approach led first to the indexing industry and then the ETF industry. The problem with indexing is that temporary investing fads can cause havoc to your actual returns. For example capitalization weighted indices will have the maximum exposure to individual constituents just when a particular investing fad is at the inflection point. For example at the peak of the IT mania in 2000, the technology stocks accounted for nearly 30% of the BSE Sensex.

   In 2007, 6 stocks accounted for a disproportionate weight in the Sensex. So an investor that hews to a "passive" strategy, unless he re-balances the asset class vigorously, is going to have the largest exposure to the most overvalued constituents of an Index at the inflection point. He will have done well in a series of short term performance comparisons by his relative outperformance only to have found himself literally "running off the cliff" at an inflection point. For a Family there would be numerous inflection points.

   In addition, the problems related to assumption of a client having performed his/her asset allocation exercise are further amplified with indexing or ETF investing. This is because to keep the tracking error minimal, the fund manager will have to keep the cash levels at minimal levels too. **Figure 3** below shows the total returns from investing in the SPX basket for rolling 10-year periods. As is seen, there have been several periods of sub-par investment returns over 10-year investment horizons with two of them yielding negative total returns! This can only happen when the index as a whole is severely overvalued.

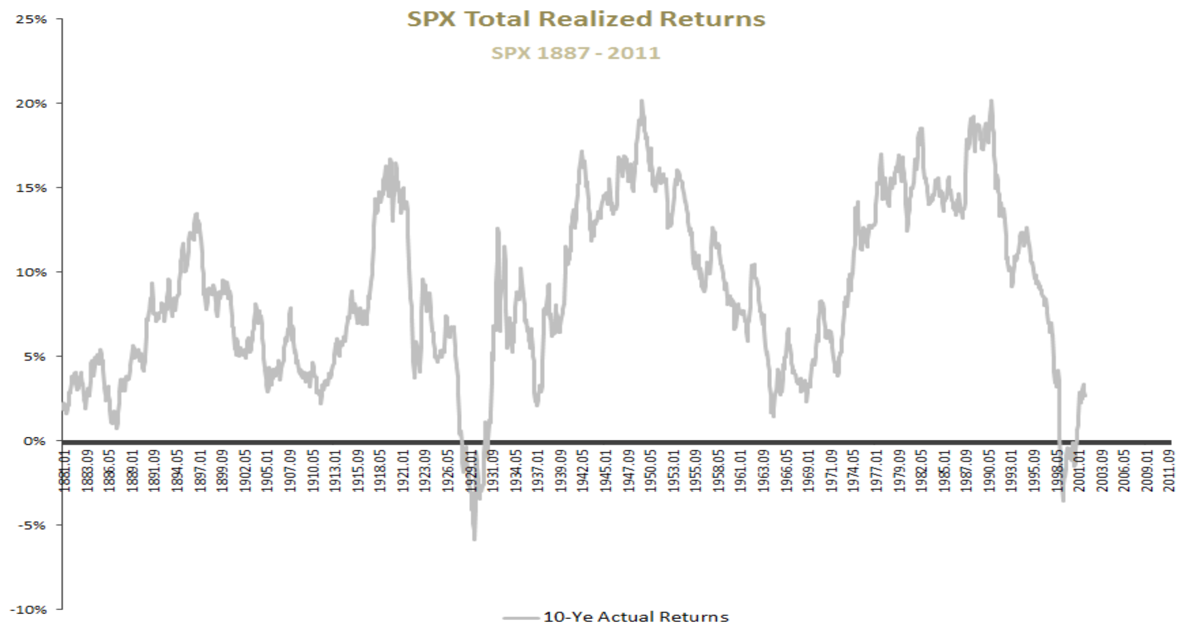

Figure 3: 10-Year Total Realized Returns, Source: Shiller and MAEG

3. **Quantitative Strategies:** One way of circumventing the behavioral problems that "active" managers display and the "inflection" problem was the growth of quantitative managers (or "Quants" as they are called). The idea here is that "Quants" would dispassionately parse the data and pick "market neutral" long/short portfolios that would deliver a steady if unspectacular return. The pure "alpha". No market risk is assumed and yet you are still in the market!

   For a while it worked well, until of course, in August 2007 when the immense popularity of the quant approach on "Wall Street" and on the prop desks caused a spectacular bust in many quant firms when they all found that they were using the same if not similar models and they all needed to sell the same stocks that they were long and buy-back the same stocks that they were all short. Recently many quants have gravitated to what is known is "High Frequency Trading" (HFT), where the positions are literally held for seconds before they are sold. How this has anything to do with investing is anyone's guess!

   In addition, the problems of quantitative strategies as practiced by many quants include a definition of risk in terms of standard deviation. With that definition of risk, many of them go about employing high leverage on strategies that yielded low standard deviations over the past few months or years of back testing. However, in a world where investment returns are not normally distributed and sport significantly fatter tail risk, standard deviation is inadequate at defining risk. **Figure 4** below shows the standard deviation of twelve months of trailing SPX returns. As is seen, periods of low volatility are followed by periods of high volatility.

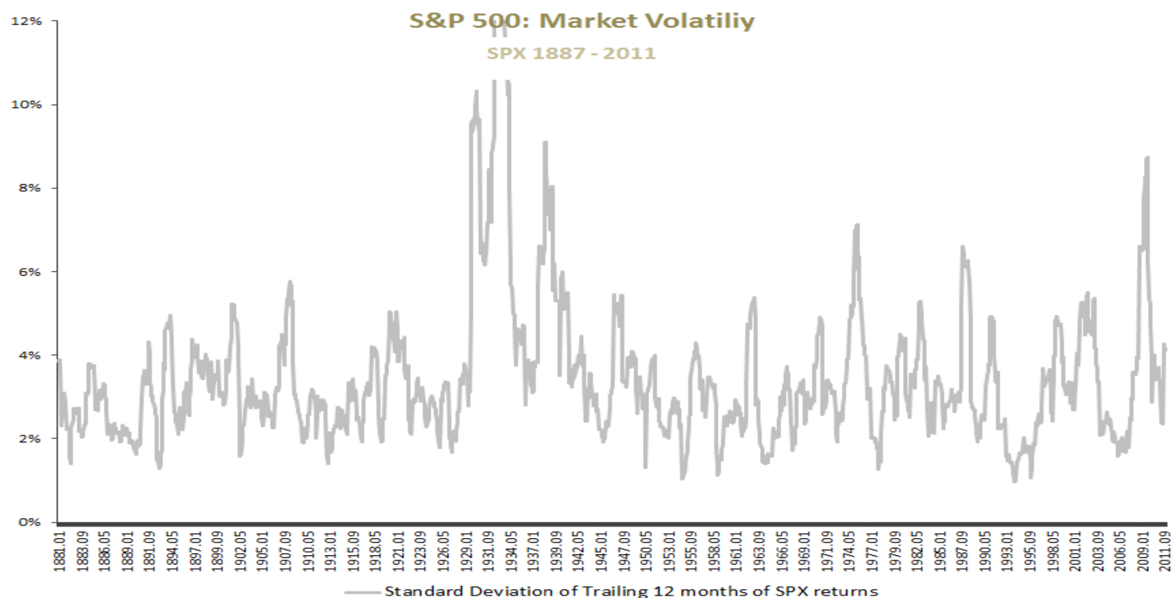

Figure 4: SPX Volatility of Monthly Returns, Source: Shiller and MAEG

4. **Long-Short Strategies, Hedge Funds and Fund of Funds:** Hedge Funds are supposed to be a peculiar nirvana that has been sold to investors –sometimes on the basis of returns but no risks. For a while this indeed seemed to be the case – until 2008-9 came along when many hedge funds went down 23%. Since then many of them have had a hard time coming back making one wonder if Hedge funds are all risk and no return! When hedge funds were doing well, many shops sprang up that promised that they would monitor these hedge funds and build a superior vehicle which only had the best hedge funds after doing all sorts of due diligence, etc. Jim Grant had a good phrase for it, he called it “fees upon fees upon fees”.

5. **Private Equity:** This one for a while was the new wheeze. On the back of the superior investment returns that the Yale and Harvard Endowments were able to show, many families were urged to adopt the “model”, many investors were sold on the concept of making PE commitments and assuming severe illiquidity on the basis that was a return that could be “picked” up. Again the fallacy was exposed in the time of the GFC when many investors found themselves in extremely illiquid and leveraged instruments without any adequate compensation and where they could not get out of except with massive discounts (90%) on appraised values.

   The ridiculousness of the current investment scene becomes apparent when one considers that while there maybe 9,000+ listed securities on the NYSE there are apparently 8,500 collective vehicles in the US to invest in this self- same listed securities in different permutations and combinations (refer **Figure 5** below). If you include the ETF’s, hedge funds, fund of funds etc., there are 15,681 collective investment vehicles as the figure below shows. Is there any real purpose being served by all this?

	Number of Funds
Total Number of US Mutual Funds	7,581
ETFs	923
Fund of Funds	964
Others	5,694
Total Number of Hedge Funds	8,100
US-based	2,500
Offshore	3,000
Fund of Hedge Funds	2,600
Total Number of Funds	**15,681**

Figure 5: Number of Funds, Source: Investment Company Institute, 2011 and Strategic Financial Solutions, 2005

In summary, I borrow a quote from Warren Buffet which aptly captures the thought behind all of what has been enumerated above, "Only when the tide goes out do you know who is swimming naked".

So what is our advice to families?

We would strongly suggest going back to the basics of investing. The basic reason for investment remains: to earn an inflation- adjusted return that compensates for the risk of the relevant asset class.

Refrain from getting involved in the rat race of a short term performance derby. It is actually detrimental to earning reasonable long term returns.

Where it comes to equities, we would say the answer is remarkably simple: try and buy "good" companies (by that we mean companies that have cash flows approximating their earnings; that earn at least the cost of equity –if not higher-over a full cycle), selling at "Fair prices" and hold them for long periods of time as long as they continue to remain good businesses.

I look forward to hearing from you if you should have any questions or would like to discuss or debate any of the discussions in the three articles that we have sent you so far.

With best regards,

Prashant Trivedi, CFA

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