3byTwo FINANCIAL PLANNING

August 2018

Five principles to find the right investment manager

Principle 1: Think like a Black Friday Investor

The first principle is to think like a Black Friday Investor. Black Friday, of course, is the day when Amazon discounts their prices, becoming the biggest retail shopping day of the year. This is rational: as prices come down, we buy more. Yet, when it comes to investing, the average client seems to do the opposite. Investing after a period of strong market or fund manager performance and disinvesting after a period of underperformance. Essentially buying high and selling low.

These Black Friday moments in markets, when prices are so low, somehow turn us into sellers, not buyers. Why does this happen? It seems rooted in our mental software, which predisposes us to value losses disproportionately more than gains. Behavioural Psychologists, like Daniel Khaneman, have estimated that the emotional pain we suffer from experiencing a loss is approximately twice as powerful as the pleasure we feel from an equal, but opposite gain. This seems be why we panic when fund managers or markets perform poorly, and we end up selling.

To compound this issue, not only do we appear to "sell low" through the anxiety of loss, but we "buy high" too. In some ways, this is down to the fund managers marketing their performance to us – via awards and short-term rankings, making us see their fund as highly desirable. But, neither awards, nor short term rankings are useful indicators of the future and you should avoid being drawn in by them.

This effect of buying high and selling low creates a really poor outcome for us, over time. Data shows that we end up underperforming the fund we invest in: if we had simply invested in the fund and then done nothing other than stayed invested, rather than trying to time the market, we would have doubled our return over the long term. Studies by firms such as Dalbar Inc. show that we lose as much as 4% a year from this sort of behaviour. Dalbar refer to this as the 'Behaviour penalty'.

Principle 2: Think long term

The second principle is to remember to think long term, as we are regularly tempted by our emotions and advertising to be act in the shorter term. Through fund / manager ranking tables, awards and adverts, we are so distracted by what appear to be better alternative fund choices for us. And it is unsurprising that the average holding period of a fund is around 3 years, rather than the more reliable and more rewarding 5 or 10-year number. One-year returns are practically worthless when trying to assess an investment manager and have absolutely no predictive quality over the long term (five years or more).

The next three principles are more about finding good funds, rather than our own behavioural challenges when investing.

Principle 3: Do you trust them?

The third principle is finding a fund manager that you trust. Trust is so important. Fund management, as we see it is right up there with professions like teaching or medicine. Although their assets walk out the door at 5pm, the money they manage belongs to you and other investors, requiring a mindset of a steward or custodian.

So, how do you find a manager you can trust? The first stumbling block is the moral hazard created by their fee structures. Fund managers are almost always paid based on the value/size of the fund they manage, rather than the value they add. This encourages them to increase their size (of investments/assets) and to launch as many funds as possible. Both of these work against their clients, because clients would prefer fund managers had more focus, rather than dividing their day into running many different funds. Clients would also hope that fund managers were not managing substantial pots of money, making them cumbersome and unable to buy smaller companies. Therefore, fund managers need to consciously turn down short term profits, by containing their size and limiting the funds they manage, when their fee structures encourage them to do the opposite. Being turned away by a fund manager that is at capacity, is often a good sign. Fund managers who limit the number of funds they run are also likely managing their client's investment risk, rather than trying to manage their business risk.

How fund managers communicate with you is also important in building trust. Fund managers who promote anything misleading and obviously biased should concern you. They usually know, for example, that one-year fund performance has no relevance to the way they manage funds, but it does help them sell the fund. In their reports, they may also gloss over their mistakes and overstate their hits. They may also use language filled with jargon, rather than plain English, simple explanations. As the saying goes: "where there is mystery there is margin" and your fund manager should not be mysterious. We find that those fund managers who don't play hide the ball with their client communications are often trusted more. They tend to communicate openly, honestly, transparently and quickly and in a language that suggests that they are also co-investors in the fund. They tell you about their issues and challenges in a straight forward way so that you get the full picture and there are no big surprises after the fact.

Finally, find out if your fund manager has their own money invested alongside yours. We would urge you to ask them about this and be quite specific about how material the investment is to them and in which fund (if they manage a few). You should aim to find a fund manager that is, like you, a client inside the fund they manage.

Principle 4: Temperament

Principle number 4 is all about the team. The investment teams need to be stable over long periods and the strength of the bench is very important. Fund management is a human capital endeavour and is too complex for one person to do and so fund managers need to be good at building teams and working with others.

In terms of personal traits, we look for people that are experienced, passionate, competitive and who seek to promote a difference of opinion. If your fund manager is saying what others say, it is likely he or she is managing their business or career risk, rather than your investment risk. The team needs to be diverse and have a culture that encourages the best evidence to win an argument rather than the loudest voice. A team that is an echo chamber cannot grow their ideas through disagreement and debate. And this is why temperament is so important – disagreement with the consensus requires the fund manager to be decisive, have emotional stability, can recover quickly from negative emotions, has an open mind to criticism and feedback to enhance their views. This all requires them to have a thick skin, which is why we emphasize temperament as they key trait.

Principle 5: A simple, not easy, process

The fifth principle is finding a fund manager with a simple, but not easy investment process. Clients may find it surprising that great fund managers have hit rates in the low 50 percent's. Put another way, for every 100 stocks/companies they invest their client's savings in, only around 53 will do well (outperform the market) and 47 will do poorly (underperform the market). Therefore, the margin between success and failure is fractional. But, this is precisely what we would expect in zero sum game and we can use tennis to explain this, better. Roger Federer, arguably the best tennis player of our generation, only wins 54% of his points. This is because competition is strong, and every point has a binary win/loss outcome, making it a zero-sum game. In fund management, it is quite similar: when Coronation sell a company to Allan Gray, they can't both be right. They are both strong fund managers and yet often have opposing views. The key for the fund manager is to acknowledge that they need to get it more right than wrong, rather than expecting to be right all the time. And, crucially important, is that they understand that there is a paper-thin margin between being success and failure.

This is why the investment process needs to be watertight, simple and unemotional. When a fund manager is experiencing poor performance and they are therefore at their most vulnerable (emotionally), it is the repetitive, simple and unemotional nature of their process that keeps them on track. If they start to deviate, even slightly, the very small margin between success and failure can be gone in an instant.

Fundhouse, July 2018