

Some inconvenient truths

"We are born brave, trusting and greedy – and most of us remain greedy." – Muriel Strode.

Just *following* the investment markets this past year has been a largely thankless task. A Chinese water torture of ongoing black comedy from a now distinctly subprime banking sector has reduced formerly strong individuals – and hitherto credible financial institutions – to gibbering rubble. In the wake of Northern Rock, Bear Stearns and <insert the name of any random bank here>, the financial sector has largely taken its lumps and moved onward - if downward. Banks aren't necessarily fairly priced yet (water may be an increasingly scarce resource; bank shareholders, however, are still in for further dilution), but the bad news is well and truly in the market. Time for the rest of us to move on.

In search of new enthusiasms, one opens the second section of the Financial Times with an almost giddy sense of optimism, only for one's spirits to sag once again at around page 29 or so – the start of the London Marathon that is the Managed Funds section – lots of entrants, and plenty of them both amateurs and comedians. To view this jammed thoroughfare of third party managed funds in a vaguely positive light, it at least points to the vigour of competition in the asset management market – if not necessarily to the health of the underlying funds.

An anniversary that never fails to fire six bullets into one's *joie de vivre* as an asset manager is that point in the early 1990s when the number of mutual funds (roughly 4,300) on the New York Stock Exchange amounted to **double** the number of stocks listed on that same exchange. A particularly fat tail had started to wag a somewhat vulnerable dog. Now a new book by Louis Lowenstein (the title seems to give the game away: "The Investor's Dilemma: how mutual funds are betraying your trust and what to do about it" – John Wiley & Sons) serves to remind us of one of the financial services industry's dirtier not so little secrets:

"There is a profound conflict of interest built into the industry's structure, one that grows out of the fact that (mutual fund) management companies are independently owned, separate from the funds themselves, and managers profit by maximizing the funds under management because their fees are based on assets, not performance."

The figures are startling, and drive a peculiarly large nail into the coffin of efficient market theory, or for that matter plain economic sense. Between 1980 and 2004, the assets of stock funds in the US increased 90-fold, from \$45 billion to \$4 trillion. Fund managers harvested a lustrous crop of fees irrespective of whether their investments rose or fell in value. (Many of the same managers spend much of their time criticizing their hedge fund rivals for charging too much fee income from the surely more ethically defensible goal of making absolute, rather than relative, returns.) What is almost painful to relate is that while the industry now manages \$6 trillion in equity funds, it manages a further \$3 trillion in bonds and money market funds. Portfolio theory, and plain common sense, would suggest that while there are limited opportunities to generate value ("alpha") from inefficiencies in the equity market, there are virtually none in the bond market and certainly not overmany opportunities in the money market once fees are taken into account.

Mr. Lowenstein evidently marshals a number of damning arguments in his systematic dismantling of the mutual fund industry. One of the more compelling touches on the alignment of interests between manager and client. From 2003 to 2006, by way of example, the chief investment officer of T. Rowe Price (no relation) amassed ownership of equity in the management company worth over \$75 million. His total personal investment in T. Rowe Price's mutual funds amounted, apparently, to \$1 million. Whatever the quality of the cooking, there was precious little eating going on. The contrast between "traditional" funds and hedge funds, in this respect, is explicit. The role played by hedge fund management fees is worthy of a whole separate jeremiad, but the alignment of manager

and client interests in the form of equity participation in the underlying funds is worthy of note. Many hedge fund managers – as the failure of Peloton earlier this year revealed – have much of their personal net worth invested in their funds. That obviously betokens no guarantee of ultimate success, but if failure is the outcome, investor misery can at least enjoy some company.

As we have noted before, egregious fee extraction is not restricted to so-called hedge funds. Traditional fund groups are perfectly comfortable charging high fees for substandard performance. If future market returns are likely to disappoint by comparison with the now almost mythical 1980-2000 bull market, and they surely may, then the imposition of any fees whatsoever will hinder portfolio returns. As Alistair Blair, writing for Investors Chronicle, wrote last year:

“consumers simply cannot grasp the fact that the man sitting in front of them and the people behind him are being paid via a long-term and hugely expensive levy on the returns from their savings.. here’s a suggestion.. Investment products should be required to be sold with a warning comparing the total impact of fees over 20 years with the impact of fees on the least expensive indexed product on the market. I believe this slot is currently occupied by the Fidelity Moneybuilder UK Index Fund, which has an annual management charge of 0.1% and total expenses of 0.3%. The warning would run like this:

- 1) This product aims to deliver you a greater return than you would obtain by buying the Fidelity Moneybuilder Index Fund directly. It will need to do so because our costs are much higher. Very few people understand the effect of fees – even apparently small ones – on investment returns, SO PLEASE READ THE FOLLOWING CAREFULLY.
- 2) If you invest £5,000 in the Fidelity Moneybuilder Index and it achieves 7% growth a year for 20 years, your £5,000 will grow to £18,000. If you invest in our product and it achieves 7% growth for 20 years, the effect of our higher fees will be that you will end up with only £12,000.
- 3) But we aim to do better. In fact, even to match the Fidelity Moneybuilder, we’ll have to outperform the index by an average of 2.4% every year for 20 years.
- 4) In the FSA database of 15,000 funds offered to the public over the past 20 years, only 10 funds have achieved this kind of performance. We aim to be the 11th.”

Of course, not everyone wants index performance, hence the continued rise of the hedge fund sector. But the recent divergence of the asset management industry between low-cost tracker products (now ETFs) and high-cost “market neutral” structures leaves an increasingly awkward-looking no man’s land in the middle of mongrel vehicles of no real underlying merit: funds which at best could track the market but are destined to underperform due to high active management fees. Just as the banking sector is going to see an inevitable compression in returns (if not outright consolidation) as the credit crunch allies with heightened regulation to stifle growth, so the number of managed funds should, if there is any natural justice whatsoever, finally contract as investors become increasingly familiar with both the lower cost exchange-traded proposition and with the higher cost absolute return offering. No man’s land is not a pleasant place to spend any length of time.

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