

Fund managers still your best bet

Even in a downturn, having a good steward for your investments is the way to go, argues **DAVID LEE**

DURING Medieval times, lending money on interest was considered a mortal sin for Christians. Money lending was a philanthropic activity in a poor community whose aim was collective survival. Today, investors are flocking to Treasury bills, willing to lend to the US government at virtually no interest. This is not a philanthropic act in a poor community but a collective act of survival for the world economy!

More interestingly, the Federal Reserve is engaging in quantitative easing: where long-dated government debt and debt guarantees will have close to zero yields as well. How long will this bubble in government bills and bonds last? I believe it will be short-lived and inflation will appear sooner than anticipated. Meanwhile, this has serious implications for the fund management industry.

Last year, over half the world's fund managers did not make money. By November 2008, university endowment funds such as Yale and Harvard, considered the world's best asset allocators, suffered over 20 per cent losses from mid-2008. Equity mutual funds saw huge redemption with losses averaging over 30 per cent. Hedge funds lost an average of 12 per cent, with short-selling bans by the authorities, forced deleveraging by redemptions, and prime brokers pulling credit lines. Funds of funds registered losses of 18 per cent and are experiencing their share of redemption and deleveraging. Private equity, Reits, and real estate funds are showing even larger negative returns, facing re-financing risks and higher spreads. Money market and fixed income funds are also suffering losses, even if these are painful now due to the bubble in Treasuries.

Most funds which profited are unlikely to soon repeat their performance using the same strategy. Funds that shorted mortgage-related securities and stocks, or that employed the Black Swan Insurance Strategy, outperform only in a crash. Seemingly, only macro, arbitrage and multi-strategy funds registered positive returns because of their flexible and scalable strategy that enabled them to short liquid instruments.

Given the huge losses and redemptions, assets under management as well as management and performance fees have shrunk significantly. This has led to the largest number of firms closing down their funds globally and in Singapore. When investors anticipate that asset and price deflation will persist, demand for fund management will decrease. Who needs a fund manager who charges fees but does not perform?

Investment is like studying or visiting a doctor. It is hard to know what one is into or if the suffering from treatment is worthwhile, until after the fact. You must believe that the teacher and the doctor know what is best for you. Similarly, you can only hope that your money will grow when parked in a fund whose manager has a good track record and who is a co-investor. However, there is no guarantee, that is, there is no investor sovereignty in the financial world.

The argument in the fund management industry has always been that individual investors will always lose out and that only managers will gain. According to David Swenson of Yale Endowment, unless individual investors have access to the best managers, facilities and services, they are likely to lose out, especially if they invest on their own. Weekend golfers may beat professional golfers for a hole or two but cannot beat them over 18 holes!

Searching for PQ

Yet, this crisis has challenged almost all traditional investment concepts. Such tested concepts as diversification, risk measurement, and smooth returns have failed. For example, investors found out that long periods of smooth returns may be scams (as in Madoff's alleged case), and that one short period of large negative returns can wipe out most of their principal.

The reality is that the best and honest managers also make mistakes, except that they make fewer and smaller mistakes than individual investors. Investors should feel safer that their managers make small mistakes, and that for now at least, the probability of the fund being a scam is lower.

There is no substitute for independent thinking and critical enquiry. It is essential to understand what investment strategy is all about. It is also important to understand that wealth can only be accumulated through compounding. This is easier said than done, however, because most investors are victims of herd behaviour and believe that when everyone else is making money, they too would by buying into the same fund or strategy.

Investors are entitled to be unhappy and to feel disappointed. When a product is overly institutionalised, it is bound to disappoint. This is because making money is not about high IQ or EQ but about PQ. IQ ensures that products are designed in the most well liked manner, while EQ ensures that the products are well sold. PQ, or Performance Quotient, is the ability of the fund manager to seek new opportunities, knowing that they must think out of the box to make money for the clients consistently. Fund managers with high PQ will most likely manage their own money and be selective about their client base to ensure alignment of interests.

Misfortune and regret

Clearly, it is now essential that structure must not put a fund in a situation where "misfortune" can occur. A fund that is too inflexible and does not hedge can suffer great losses or lower returns over time because of compounding. However, a structured fund with too much leverage, concentration, illiquid assets, and no cash flows could potentially be disastrous. A fund that allows short-term investors to cash out at the same time will affect the interest of the remaining investors. This, lock up periods as well as redemption restrictions become important factors in determining returns.

Another important factor is to "minimise regret" when one has invested in a fund with the wrong managers. Given the current situation, it is likely that the regulations for third-party investment will be tightened, requiring end-investors to have direct contact with fund managers rather than only through intermediaries. It does not make sense to invest in funds whose managers are hours away by flight or who you hardly know or have access to.

The four golden rules of Young Kuan Sing, the first Asian who made it to the board of directors of a US-listed human resource multinational firm, apply here. In searching for good fund managers, it would be useful to adopt his Trip principle. Only invest if the manager

- ◆ Shows Transparency to build Trust;
- ◆ Respects the market, rules and regulations;
- ◆ Has Integrity; and
- ◆ Demonstrates Professionalism.

While easy to understand, Trip's execution requires investment of time and effort. There is no substitute for

hard work in a world with no free lunches. Fund management has a bright future in Singapore, with its sound protection of ownership rights for investors, a savvy regulator, seasoned and efficient legal and accounting professionals, a conservative and confidential banking community, and clear regulations. The industry will grow under the Singapore branding of trust and efficiency, with an execution power matched only by Hong Kong.

This crisis will create many opportunities for the fund management industry in Singapore as investment banks trim their skilled workforce worldwide. Singapore is geared to attract more talent to extend its "efficient frontier". It is important that Singapore continues to have its pro-business and tax policies for foreign funds to locate here and a liberal immigration policy for foreign professionals, while others tighten their regulations and invoke protectionism under political pressure.

Investors need only travel to the Central Business District, where a wide variety of fund management skills are now available.

Lambda in a Madoff world

Returns have traditionally been split into manager skills (Alpha) and market returns (Beta). Searching for returns is thus like searching for Alpha and Beta. Yet, there is a third source of returns, Lambda, which stands for luck. Investors can increase their Lambda by searching for the right person to manage their funds. More importantly, they must also be lucky enough that the selected manager accepts them as his client. Lambda has never been more important in determining returns than in today's world of Madoff!

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Financial peace: It is important that Singapore continues to have its pro-business and tax policies for foreign funds to locate here and a liberal immigration policy for foreign professionals