

## **Financial Control Limited**

### **THE INVESTOR**

**March 2003**

#### **Thought of the Month – A dose of optimism**

Given the current state of the world, surely this is a time for some optimism. Not because things are rosy all around, but simply because we all know that things will get better. The Iraq war will come to an end hopefully sooner than later; the pneumonia that has struck down so many people worldwide will be brought under control; and closer to home, traditional equity and other risky markets will rise again! With four children to look after, I often see how happy they are to pick themselves up and continue on even if they have just had a bad fall. But how is a dose of optimism related to investing? Investing often requires patience, courage, and conviction. In times like these, where pessimism and depression has led to tremendous market volatility, remembering that human nature is one of perseverance and triumph despite periodic episodes of complete stupidity or helplessness should give one comfort to stay invested. To be sure, one should have reduced market exposure long ago to maintain the same level of risk. But staying invested in the financial markets will eventually reward investors when the inevitable good feeling returns.

#### **Why is the Sky Blue? Why do investors often forget about fund management fees?**

It's interesting to note that extensive research has indicated that funds with lower management fees tend to perform better over time, yet like many investors, I tend to forget about manager fees when I see a fund that has performed extremely well over time. I start to think about greed and riches and completely ignore any aspect of the fee schedule. After all, if the market average is about 1% per annum, should we care if a manager charges 2% per annum when he or she has consistently returned 20% per annum for 10 years?! In the hedge fund space, I recently heard of a very successful tactical manager with billions under management who increased the management fee to 3% per annum. So what's an additional 1% here and there? Unfortunately, extensive research shows that it is very difficult for managers to repeat their performance over time for a number of reasons, such as, "their luck ran out", "too many new players entered the market thereby eliminating market efficiencies that were being profitably exploited", etc. Accordingly, it is every investor's responsibility to ensure they are not overpaying fund managers. To be fair, investors should also consider the complexity of a strategy, the size of funds under management, the instruments traded, etc., and also ensure that a manager is not under-compensated!

#### **Nourishment - Is agency debt backed by the U.S. Government?**

It seems that each time the U.S. agency debt market (e.g., mainly FNMA and FHLMC)<sup>1</sup> and the institutions that issue such debt return to relative obscurity in the financial markets, someone in congress or elsewhere in the power echelon decides to throw down the gauntlet. This time it was none other than Mr. William Poole, St. Louis Federal Reserve President, when he was

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<sup>1</sup> These agencies provide funding to lower and middle income families in the U.S. residential housing market. Although there are numerous other U.S. government agencies, FNMA and FHLMC seem to have taken the brunt of the political storm perhaps due to their large market share.

quoted as saying “Massive liabilities of Fannie Mae and Freddie Mac threatened the economy.”<sup>2</sup> Grumbling has been going on for years primarily because the fact that FNMA and FHLMC have a line of credit with the U.S. Treasury has resulted in a lower perception of credit risk and therefore lower borrowing costs. There are many competitors of these agencies that would like to see the government abolish the line of credit to put all financial institutions on an equal footing. Some lawmakers have even proposed bills to end the line of credit.<sup>3</sup> The problem for investors is that many funds and discretionary accounts place large investments in agency debt and are thus taking a bet that the U.S. government will never remove the line of credit. Obviously, if the U.S. government suddenly reverses its backing of the agencies, the credit ratings of FNMA and FHLMC could drop overnight, possibly resulting in significant losses on debt issued by these agencies. Investors are encouraged to be vigilant to determine the extent of agency debt in their investment portfolios, and decide whether they are comfortable taking bets on the continuation of U.S. government backing.

### [Feedback](#)

These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others. As always, we greatly appreciate your comments and feedback. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify anything, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at [www.financialcontrollimited.com](http://www.financialcontrollimited.com)

This issue of the newsletter was written by Robert Jones and edited by Ben Vella.

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<sup>2</sup> South China Morning Post, 12 March 2003, page B9.

<sup>3</sup> Ibid.