

Financial Control Limited

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Thought of the Month – Does Increasing Transparency Reduce Returns?

As a firm that has the current fortune of being able to access a broad range of hedge funds across different asset classes, the difference in transparency across different fund managers could not be more striking. In some cases fund managers provide details almost down to the position level, whereas others provide the bare minimum. Normally one can infer the level of transparency that will be provided by holding a fund's audit report and if it feels light, you can most likely assume that obtaining information from such a fund will be a long, hard slog. As another example, surely providing comparative figures to last year is as basic an accounting disclosure as has existed in the history of the auditing profession. But sure enough, there are funds out there that provide current year figures only. We all know the reasoning behind those funds with minimum disclosures, especially in the derivatives and short position areas: "I don't want my competitors to know what positions I have on the books in case they try to either copy my strategy or cause me pain by forcing me to unwind my strategy at sub-optimal market levels." This begs further research: Given the wide range in transparency levels offered up by hedge funds globally, by now it seems highly likely that a determination could be made to discover whether increasing transparency is correlated with lower returns and/or Sharpe ratios. Transparency could be judged based on a number of factors such as frequency and level of detailed disclosures.

Why is the Sky Blue? – Why do Investors Invest in Active-managed Large-cap Mutual Funds?

Given the constant media attention to the fact that most active managers fail to consistently beat their benchmarks, why is only a relatively small portion of money allocated to index tracking funds? Surely most institutional and sophisticated family/individual investors know by now that it is very difficult for active managers to beat the S&P 500 or a related MSCI/FTSE index in the large cap space. Is it possibly because investors accept the risk of underperformance for a chance of outperformance? Let's assume that 80% of large-cap active managers fail to outperform their benchmarks. If we proposed in probability terms that an investor has two choices: i) 100% chance to track an index ii) 80% chance to underperform an index and 20% chance to outperform an index, what should an investor do? In practice, it appears that most investors prefer the second choice, which seems to indicate that investors are willing to place their bets with large-cap active managers even though the odds are stacked against them. Perhaps part of the reason is due to human psychology: the idea of having no upside (i.e., other than matching index performance) seems to go against the whole idea of placing a long-term bet in the first place. Of course, there are others who argue that inefficient markets even in large-cap stocks are the basis for investing with active managers, but I haven't seen too many proponents of this line of reasoning. If an investor places a long-term bet in the financial markets, or in any market for that matter (e.g., a business, a commodity, real estate, etc.), he or she always seems to feel more comfortable if there is unlimited upside. One could easily argue that an index has unlimited upside potential, but an active manager could easily counter-argue that he or she must

be able to over-weight particular shares to ensure maximum, unlimited returns! So with human nature on their side, I suppose active managers of large-cap stocks will continue to play a large role in investment portfolios.

Nourishment – Buy Low (but not at the lowest), Sell High (but not at the highest)

In this global bear market, should we sit tight and watch our net worth rapidly deteriorate or should we move a large portion of our assets to cash and wait out the storm? Here are some arguments for and against, but firstly one must decide whether he or she is an “investor” or a “trader”.

In bear markets, successful traders sell and wait patiently for the bull market to return. They do not concern themselves with whether or not they have sold at the top of the market. They consistently sell near the top because when a bear market appears to be forthcoming, they immediately get out, even if a bit premature. Conversely, when economic and market indicators turn bullish, they immediately get back in to the markets and do not waste time asking themselves whether the market has reached a bottom or not. For traders of means, they will short stocks in bear markets, and add leverage when buying stocks in bull markets to further take advantage of market conditions.

Successful long-term investors on the other hand, ensure that they are well diversified globally across a wide range of asset classes so that weakness in one particular asset class will not significantly hurt their portfolios. Furthermore, they will take advantage of dollar-cost averaging to rebalance their portfolios by moving money from winners to poor performers thereby reducing their average cost in the poor performers. Of course, this is in stark contrast to successful traders who would balk at the idea of selling winners and shoring up losers. But then again, investment horizon plays a huge role and so does diversification. Traders are typically in-and-out of markets within days, weeks, or months, and are not well-diversified, as compared to successful long-term investors.

Feedback

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at help@financialcontrollimited.com if you would like a) for us to clarify something, 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

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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.