

*This is an original article written by Philip Loh.*

## **Why are you losing money in unit trusts when returns numbers presented are so compelling?**

### **The problem**

This is one distressing trend in the mutual fund industry that goes largely unnoticed. The fund houses have decided, perhaps also under tremendous pressure from customers, to slice the investment universe into pieces so small that most discretion has been removed. When a certain sector is hot, the fund houses would promote the “compelling” numbers that the funds invested in these hot sectors will show. Perhaps it is under the pressure from customers who continue to demand and crave for superb or unrealistic returns, fund managers are forced to single out some hot sectors, package the products based on these sectors, and market them to the customers.

The problem with this subtle trend is that most customers may be buying into asset bubbles and have to pay a high price for their greed and ignorance.

How much of this problem can be attributed to the unrealistic expectation of the investing public is debatable. Take for example, if a fund marketer shows you two different funds, one demonstrating a historical return of 20% a year for the last five years and the other showing a loss of 20% a year for the last five years, which will you choose? Obviously, if you are a normal rational person, you would choose the former without knowing that an asset class which had been appreciating so sharply for past several years may be on the verge of a major correction. On the flip side, the latter investment with staggering losses may be in an oversold asset class and could be at the brink of a major upturn.

This vicious cycle continues. Investors keep buying high and selling low. Since they continue to lose money even when the numbers presented to them are so compelling, they demand even more compelling numbers. I met an interesting individual the other day telling me 6-8% return a year is simply not enough as many are promising him 10% or more a year with apparently minimal risk. Clearly, it is not only the fund managers, but also the fund advisors who are giving the great lie space to grow.

This hunt continues. The investing public continues to demand miracles from the fund managers, and the fund managers in turn scrutinise the entire universe of securities more closely to slice out more creative or narrower parcels to sell to the miracle-hungry investors. The latest hype of course, are hedge funds, after even the brainiest fund managers fail to find many of these parcels four years after the stock market bubble burst in 2000.

There is no magical formula in hedge funds, just that you can bet on either direction of the markets. In other words, the funds can make money whether the markets are going up or “DOWN”, whereas traditional funds can only make money when the markets are trading upwards. Hedge funds sell because investors are too tired of the fund managers’ use of declining market as an excuse for losses made. To an investor, it’s pointless that his fund is performing above the benchmark when it is losing 30% in absolute return. What investors want to see is absolute return and not out-performance of a particular standard benchmark. I would be equally happy if my fund

underperforms the benchmark significantly but gives me a 20% return. Therefore, the rise of hedge fund shows that investors are too weary with the same excuse fund managers give for losing money.

### **Why we need a solution fast**

The reason for a fast solution is very simple. Looking into the next ten years, we expect a very modest market return. Renowned academics Eugene Fama and Kenneth French, in a 2001 study, *The Equity Premium*, found that the average returns from stocks between 1950 and 1999 were twice of the long term average of 8.5% a year. Feeding the actual dividend and earning growth into even the most optimistic stock market models, they would still fall short of what actually transpired. The authors concluded that investors got lucky with an “unexpected capital gain” which they might be forced to pay back in the next 20 years.

Today, we simply cannot find any significant growth momentum to continue to propel super stock markets returns in the last 60 years after the World War Two. In the 50's and 60's, we see growth related to post-war reconstruction. There was the cold war in the 70's which slowed things down. In the 80's, we had the microchip revolution where computers became more affordable and widely used. This dramatically changed the way businesses were run. One clerk could perform what used to take ten. In the 90's, we had the Internet revolution which again changed the way people ran their business and viewed the world. Looking forward into the next decade, I just could not discern any impending paradigm shift that could dramatically change the way people live their lives. And without such paradigm shifts, which are the key drivers for exponential profits and consequently market returns like in the 80's and 90's, there is no way the markets can grow by much more than 6-7% a year.

As a result of a more modest market return in the coming decades, what it means is that we need to preserve any profits or returns we can generate from our portfolio, taking extra care not to wipe them off with silly allocation mistakes or high and unnecessary fees & charges.

### **The general solution**

Many enlightened investors have concluded that the choice of asset class is far more important than the choice of management. So the fund industry has also responded with the argument that investors should be doing their “allocation” and rebalancing”, or in layman terms, to own a number of funds from various asset classes such they create a synergistic effect on the risk and return pattern. This is hardly an ideal solution because most people simply do not have the expertise or the time to be managing their asset allocation, especially when they are already paying management fees to the fund companies for doing their portfolio management for them. Many investors would like to hire a professional to do this work for them, to get them in and out of asset classes as conditions dictate.

The stock market today is still filled with plenty of arbitrage opportunities. Even in a bear market, certain sectors will perform exceptionally well. The markets are far from being efficient. Human behavioural bias still leads to overbought and oversold markets at various points of time. It is therefore up to the informed investors to capitalise on these patches of opportunities and at the same time identify and avoid the pitfalls. This may sound easy but is extremely difficult to implement, you may

say. Well, the ideal solution for asset allocation or timing the market already exists. Benjamin Graham in his book *The Intelligent Investor*, proposed an automatic rebalancing program that will systematically sell whatever has gone up the most and buy whatever has gone down the most. He advocated some kind of mechanical method for varying the proportion of bonds to stocks in the investor's portfolio. The mechanical system takes away the "emotions" from the investment process, which is many times better than reacting to our herd instincts of conforming to the masses (read: buy when others buy and sell when others sell).

### **The Ideal Solution**

What I suggest is an investment platform where investors could have access to many different funds including a good range of index funds. A professional fund advisor would then be entrusted with the task of managing the asset allocation, rebalancing the portfolio and switching funds when necessary. The fund advisor would charge a performance fee if the clients' portfolios deliver absolute returns above a certain pre-set benchmark. Some of the performance fee could be funded from the cost saving from using index funds rather than actively managed ones. The portfolio management would be a dynamic process which adopts a policy rather than a benchmark. The policy would say in advance how we respond to changes. It would use a combination of mechanical as well as discretionary adjustment strategies. This would shift a great deal of power from the fund managers to selected fund advisors. Many fund managers would initially resist this system, as this new radical approach would reduce mutual funds to commodity status and drastically cut down the fees they can charge. But the verdict is clear, absolute return is what investors want. And history has shown that investors always get their way, given time.