News

TWELVE INVESTMENT AREAS TO AVOID

By Dominic McCormick on 10 September 2010

After 25 years in the investment and financial services industry, one would have spent a lot of time putting forward investment ideas or strategies to pursue, with the aim of enhancing and preserving investors' wealth. Not all ideas can be expected to add value and a problem in practise is that these suggestions are sometimes ignored, misunderstood or poorly implemented by investors and advisers.

When talking about general investment strategy, perhaps a more helpful approach is to come from the opposite perspective. That is, defining guidelines around the investment areas and strategies, which investors should seek to avoid, at almost all costs and at all times. Such guidelines are necessarily general and may result in the occasional missed opportunity, as well as the possibility other investment errors will occur. However, if followed, I suspect creating a set of guidelines will significantly shrink the universe of possible mistakes investors (and advisers) might make in building investment portfolios, in addition to decreasing their stress levels along the way.

With this in mind, here are my guidelines on 12 areas to avoid:

1. Retail capital guaranteed products.

Through unnecessary or expensive capital guarantees, excessive fees and/or lack of exposure to the total returns from the underlying assets, these products are recipes for disappointment. Inflexible structures and limited or lack of access to capital often results in a significant opportunity cost. Yes, there will be the odd offering which is acceptable or relatively harmless but, on average, investors will struggle to beat the return on cash in most capital guaranteed products.

The investment banks that create these simply have the wrong mindset and incentive structure to make money for investors. They make the majority of their money the minute the deal is done, irrespective of whether investors make money over time. 100 per cent gearing into most capital guaranteed products (for supposed tax benefits) is gambling, not investing. See guideline two.

2. Any product sold largely or primarily on its tax benefits.

Investors should have learnt the lessons from this one well, considering the failure of some agricultural managed investment schemes, but history shows most other tax driven investments such as film investments have also failed investors. Yes, again, maybe there is the occasional acceptable product but the odds are heavily against finding these.

I don't include gearing or margin lending here because I see it simply as a tool, and not an investment in itself. Consider gearing if you understand the risks and have some good investment ideas — not to reduce your tax. However, if a client is coming to an adviser in the first place, then they probably don't understand the risks nor have their own investment ideas. They should not be gearing.

3. Initial public offerings (IPOs) of Listed Investment Companies (LICs) and LICs at a premium to net tangible assets (NTA).

Newly minted LICs pushed to investors will almost always move to a discount to NTA. Disheartened investors will become frustrated and sell, accentuating this movement. Those trading at a premium to NTA may remain there for some time, but the odds are against them remaining there longer term.

4. A sector or niche where a number of big brand name managers are enthusiastically launching new funds.

This would have kept investors out of, or encouraged them to sell early, the technology funds in the lead up to 2000 and the global real estate investment trust (REIT) funds in the lead up to 2007. This guideline is certainly not precise on timing and you may miss some strong initial gains from such funds, but the odds of keeping them, if investors hang around, are low. After the party, these are the funds that will typically languish on the bottom of the performance tables for years.

5. Funds that grow dramatically in size in a very short period of time.

Funds that go from a few million to billions in less than a year or two should be avoided. Most successful managers take a number of years to build support. This one might not kill investors but it will almost certainly end up with them chasing the funds that ultimately underperform.

6. Any fund that has won lots of industry awards from the media and/or research houses recently.

At worst, these are funds ready to blow up (think Basis in 2007) or at best are likely to be setting up for a period of poor/under performance (especially if they are growing too quickly - see point five). Excessive popularity is usually bad for future returns.

7. Investing in contracts for difference (CFDs).

Trading CFDs may suit some experienced active participants who understand the risks they are taking — and that what they are really doing is (hopefully) intelligent gambling.

For investors, CFDs are an expensive, tax ineffective (since one typically doesn't get franking credits) and often, a dangerous way to get medium to long-term exposure to assets.

8. Fund managers or fund structures that earn massive fees for poor results and/or over a very short-term period.

Fund managers should be able to get very wealthy by delivering good returns over the same long-term time frames most investors have. If they can get very rich in the short-term, then either their fee structure is probably flawed or they have too much in funds under management (see point five). In either case, avoid these funds.

Higher fees for higher added value are fine, but the structure and alignment needs to be appropriate. Too many boutiques and hedge funds have been set up as a lifestyle choice or remuneration scheme, not because particularly good investors manage them. Losing your job at an investment bank is not a valid rationale for setting up a hedge fund.

Importantly, investors should always ask their managers where they have the bulk of their own wealth — if the answer is largely in the management company and not the investments that they are recommending to their clients, then it is best to avoid.

9. Active managers who say it is 'process' not people that matters most.

It doesn't. A few of the pure quantitative managers have a case to argue that process matters most but good qualitative, active management is primarily about good people and their judgment. Good, passionate investors can sometimes train other smart, passionate individuals to be good investors but, if most or all of those people leave, leave with them.

10. Any product promoted by someone you've never heard of and can't find out anything (positive) about from people you trust.

Be initially sceptical of anyone who turns up out of the blue with a new fund or new idea. They have probably already tried it and failed elsewhere.

11. Economist predictions are good for explaining where the world is at and how it got here.

Some are even good at telling jokes. Unfortunately, these skills are next to useless in telling you how investments are likely to perform and how to build an investment portfolio.

12. Perpetual optimists or pessimists.

The world is almost never as black or white as these extremists purport and importantly, they lack the flexibility to change views and take advantage of opportunities. They may occasionally be spectacularly right (which is when they garner most support) but are likely then to be spectacularly wrong or at least miss numerous opportunities as they dwell on their past glory. The world is full of shades of grey. Learn to live and profit from it.

Of course, there are still plenty of mistakes outside these areas and investors (and advisers) have demonstrated a remarkable ability to seek out and make new types of investment mistakes over time.

Moreover, sometimes making mistakes is valuable. Passionate, engaged investors are probably best off making some of these mistakes for themselves given it is one of the best ways to learn about investing.

However, for those less engaged investors/advisers or those who don't want to spend a big chunk of their lives thinking about investment issues, I suggest you just take my word for it and avoid these areas. After 25 years, I have already made a number of the above mistakes myself and know many others who have done the same.

One question, which often does the rounds is "if someone is such a good investor why aren't they fabulously rich?" Part of the answer is, a good investor starting with nothing - even if adding funds from other income over time - still requires many years of good returns and perhaps some luck to build significant assets, particularly with the pressures to deploy wealth on essential and non-essential lifestyle expenditures. However, the other point is the development of most good investors involves a considerable number of mistakes along the way, a fair number of which might fit into the above categories.

As a result of following the above guidelines, you will almost certainly miss the occasional good opportunity but you will surely avoid many more poor and possibly disastrous ones. You will also have a lot more time on your hands as the need to review product disclosure statements, read research reports, and meet product manufacturers would reduce significantly.

What then to spend the additional free time on? Well, there is still the not insignificant issue of actually searching for investment ideas to build a portfolio or finding someone who can help investors do so. But, if the above guidelines are followed, at least investors or their advisers are now searching in a smaller, potentially less dangerous, opportunity set.

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