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Why I'm still not Wilde about fund managers

By Matthew Vincent

Am I too hard on fund managers? Of late, I seem to have devoted most of my columns to berating them for some failing or other: not disclosing their total charges, imposing too many charges, using meaningless names, lacking any discernible skill, and producing inconsistent investment returns.

I had begun to worry that all this withering disdain was making me sound like a disapproving maiden aunt. I suppose they are only human, after all.

Then, just as I was trying to look more kindly on the industry, I was sent a new study of the fees and returns generated by fund managers in the UK. It came from Swiss firm Insch Capital Management and was titled, intriguingly: "The Importance Of Being Earnest: A Trivial Comedy For Serious People". That subtitle was the second one used by Oscar Wilde for his 1895 play – the original was "A Serious Comedy for Trivial People". But, given the seriousness of Insch's critique of fund managers folly, I think they should have gone with the earlier version.

For the study, Insch analysed 108 funds run by six major UK firms: **Schroders**, **Henderson**, Jupiter, **St James's Place**, **Aberdeen** and **F&C**. It found that, for the period January 2000 to May 2011:

●36.5 per cent of the funds failed to achieve average annual returns of more than 2 per cent;

●99 per cent of the funds are "in a drawdown" (a euphemism for making a loss).

I was willing to be indulgent, as the FTSE 100 index was down by 5 per cent over the same period and the average tracker fund by more.

Then I read on . . .

●60.8 per cent of the funds made more in fees for the manager than they did for investors with a one-year investment horizon;

●25.7 per cent of the funds made more in fees for the manager than they did for investors over the entire period.

How can this be acceptable? While the study made no further reference to Wilde's work, to me, the subtext was clear: "To lose one investor money, Mr Fund Manager, may be regarded as a misfortune. To lose most of them money looks like carelessness." But, realising that this recast me as the Lady Bracknell of financial journalism, I preferred to leave the disdain to Insch chief executive Christopher Cruden: “Traditional asset managers are paid a sales charge and a fee that is a percentage of the funds under management. It is why they are always urging investors to put new money into their funds. This appears not to be in the best interests of investors.”

Quite. Before harrumphing into my handbag, though, I wondered if this was the whole story. Turning the page, I came across this apparently trivial line: “The report also shows that the inflows and outflows of managed assets follow performance.” Rather like Wilde’s matriarch on encountering Ernest’s childhood governess, I thought something about this looked troublingly familiar.

A few days earlier – in response to last week’s column on fund managers’ inconsistent returns – I had received a note from award-winning financial planner and author Stuart Fowler. He said: “Evidence about the distribution of relative returns from active managers and the evidence about persistency tell us that the game of picking stocks is near enough all luck . . . The game of picking stocks is mirrored in a game of picking managers. Because most investors playing this game are doing so because they believe past performance is predictive of future performance, rather than random, they will naturally tend to select new holdings from the sample of managers that have performed better than average over some recent period. If, on the other hand, it really is random (or even much less predictable than they thought), there is a very high chance of disappointment.”

It is then the investors who earn disapproval: “They will now tend to sell, because they will assume that they made a mistake or that the manager in question has lost his/her touch – in other words, the new performance is predicting more of the same. Because they have not changed their beliefs, they then go through the same exercise to select the replacement fund. And so it goes on, turning random underperformance of holdings into a non-random string of portfolio underperformance.”

Analysis of fund flows in the US suggests that playing this “loser’s game” – putting money into past performers and selling when they falter – costs investors between 5 and 6 per cent a year. That’s far more than the costs of the funds, which range between 0.6 and 2 per cent.

As Fowler politely puts it: “There is some evidence that the behavioural effects are potentially as important as the costs of playing the game.”

Knowing this, what disappoints me is that the industry doesn’t offer funds that address this failing: low-cost tracker funds, whose shareholdings are weighted by their relative undervaluation rather than market capitalisation. That way, we would all stop buying high and selling low – and understand the vital importance of being consistent earners.

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