THE AUSTRALIAN

Passive but correct advice wins investment race

STIRLING LARKIN THE AUSTRALIAN AUGUST 16, 2014 12:00AM

Mario Gabelli of GAMCO Investors. 'The free market is at its best when everybody works in a fish bowl and tells you their point of view'. Source: Supplied

ACADEMIA generally does a very ordinary job of assessing current markets and economic trends. It is also grossly inaccurate in predicting future trends and desirable outcomes.

Where it does excel, however, is in the analysis of past trends, performance and realised opportunities. Therefore the following becomes interesting.

Fact: academics have proven that over the past 40 years passive or "buy and hold" investing has over time outperformed the vast majority of active investment managers whether they be fund managers, stockbrokers, hedge fund investors or proprietary traders.

There is now considerable evidence to prove that no one individual investment manager can continually outperform the market on a risk-adjusted basis over the long term.

Even those active managers who are considered to have the Midas touch have but very rarely ever outperformed the markets consistently over the long term.

What they have shown, however, is their abilities to avoid bad markets, nasty events and pitfalls. Therein lays an important distinction between "prophetic abilities" and sound judgment.

Australian and Asian ultra-high net worth (UHNW) investors, however, continue to seek out exceptional active managers through an array of asset classes.

Whether this is hubris confused for optimism or a genuine desire to seek out talented advisers is hard to know, but what is clear is UHNW investors have a penchant for such active advice.

This trend highlights to other investment communities that such advice is valuable because no one

investor or adviser can sit across all different asset classes and at the same time along the entire "capital stack".

A timely example is the attention fixed-income specialists are placing on the tapering and soon to be withdrawal of "quantitative easing" by the US Fed. This withdrawal will likely see the reversion of depressed US Treasuries and Government Guaranteed Mortgage Securities yields.

The active component of this advice surrounds when UHNW investors should rebalance their debt and credit market exposures in relation to the corporate bond markets. Importantly, too, what impact will these revisions have if the European Central Bank belatedly decides to join the party and begin "quantitative easing" in 2014 or even 2015.

A wise adviser would highlight to their clients that, unlike the US, Japan or even Britain, eurozone businesses seek the majority of their credit needs via the banks — not the corporate bond markets — thus negating much of the efficacy of "quantitative easing". This is a current example of where good active advice rewards the proactive global investor. US hedge fund manager Mario Gabelli said: "The free market is at its best when everybody works in a fish bowl and tells you their point of view." He went on to highlight that "hedge funds and portfolio managers may have a right to do this but we've muted the analysts and their presence in the system".

What this says to the proactive investor is that active advice can be crucial in constructing the right portfolio but, once set, conviction then becomes more important than pre-emption.

Put differently, it is better to remain passive on the correct "buy and hold" portfolio than actively manage a poorly constructed one.

The Africans have a proverb which says that if there is no enemy within, the enemies outside can do us no harm.

This profundity reminds us that, as important as it is to ensure our investment portfolios are pointed towards growth and profitability, it is equally important to ensure that they are robust, resilient and positively responsive to shocks, downturns and unforeseen spikes in volatility.

Any investor could have made gains in the stockmarkets over the past 24 months, but the true test of resilience will be how their portfolios withstand volatility when it ultimately returns or even possibly when a correction hits.

As well as undertaking stress testing of investment portfolios, the value of an active adviser should be to sporadically execute internal audits of a portfolio's construction, constitution and dynamic performance.

During the height of the Cold War there were so many nuclear- class submarines in the Atlantic Basin that each side had to intermittently undertake what was referred to as "heavy counter manoeuvres".

These were carried out to ensure that they were not being tailed or in fact going in the wrong direction, which apparently often occurred.

Submarines' baffles — the area in the water directly behind a submarine — were often deaf to hull-mounted sonar.

So as to ensure they weren't being followed, and also that their vessels were heading in the right direction, both counterparts developed their own special manoeuvres.

Known as "Crazy Ivans" by the Soviets and "Yankee Doodles" by the Americans, these manoeuvres involved a hard stop and 180-degree turn to clear the baffles and position their submarine to confront

any followers.

By doing so they also ensured they were heading in the right directions and that their sonars were accurately advising them about their orientation and path ahead.

Unlike passive investment managers, a good active manager will also employ their own “hard” 180-degree manoeuvres to ensure that their client’s orientation is not only risk-adjusted, but also most likely to yield success throughout changing conditions.

In the context of the Australian experience, this means that wealth advisers should ensure clients’ portfolios are not overly geared, especially to any one asset class such as property or the stockmarket.

Additionally, this kinetic process should absolutely ensure that portfolios are positively responsive to eventual rises in both domestic and international interest rates and any likely number of possible shifts in currency exchange rates. A healthy respect for sound judgment in these unusual economic times is more important than ever before.

There remains both an important place for passive investments, which are continuing to prove themselves to be the best performers over time, and also active investments, which are more responsive to what Gabelli referred to as the “fish bowl”.

Whether investing actively or passively, what is becoming crystal clear is that sound judgment and a commitment to conviction trumps abilities, almost every time.

Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments www.larkingroup.com.au

×

Share this story

Facebook *(http://facebook.com/sharer.php?u=http://www.theaustralian.com.au/business/wealth/passive-but-correct-advice-wins-investment-race/story-e6frgac6-1227026055033&t=Passive but correct advice wins investment race)*
Twitter *(https://twitter.com/intent/tweet?url=http://www.theaustralian.com.au/business/wealth/passive-but-correct-advice-wins-investment-race/story-e6frgac6-1227026055033&text=Passive but correct advice wins investment race)*
LinkedIn *(http://www.linkedin.com/shareArticle?mini=true&url=http://www.theaustralian.com.au/business/wealth/passive-but-correct-advice-wins-investment-race/story-e6frgac6-1227026055033&title=Passive but correct advice wins investment race)*
Google *(https://plus.google.com/share?url=http://www.theaustralian.com.au/business/wealth/passive-but-correct-advice-wins-investment-race/story-e6frgac6-1227026055033)*
Email *(mailto:?body=http://www.theaustralian.com.au/business/wealth/passive-but-correct-advice-wins-investment-race/story-e6frgac6-1227026055033&subject=Passive but correct advice wins investment race)*