

Buying What You Understand

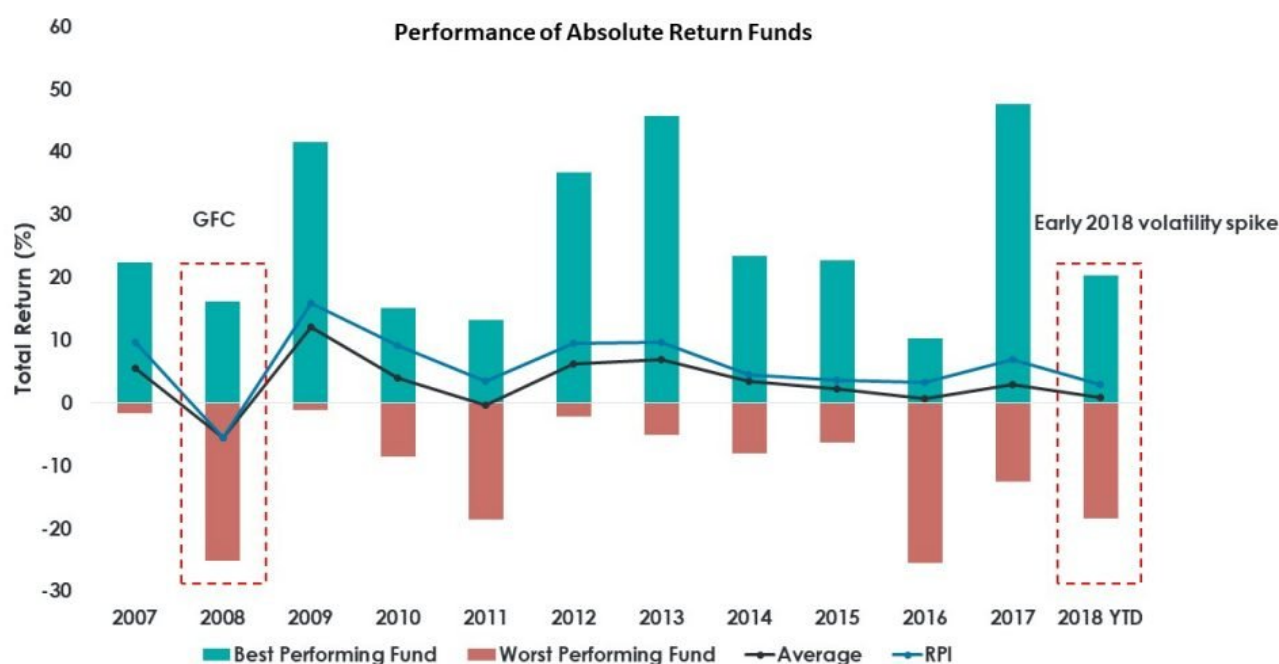
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A black box is an abstract concept. You have some input into the black box, it does some magic and you get a desired output. And the reality is you don't ask too many questions as long as it works. But, of course, the engineer behind the black box knows precisely how it works.

Now take the smartphone. Your regular iPhone is made up of more than a billion black boxes called transistors. The chances of this black box not performing as you'd like are slim and the cost of any failure is also low. You may get a headache if your phone is running slow but happily you'll survive. And the reality is you can replace your phone for a new one and then enjoy a predictable performance.

In the world of investing, absolute return funds (hedge funds) often work like a black box. You put some money in, the manager performs their financial wizardry and you hopefully get a desired output – a real inflation adjusted return.

The engineer who designed the transistor gets it. She understands not only how it works but can predict its performance reasonably well into the future. The manager of an absolute return fund also understands the strategies but can't predict its performance. How do we know this? Well, the answer this time can be found in the numbers.



Source: Tacit Investment Management, IA Absolute Return Sector & Morningstar Workstation.
Total of 121 funds. Earlier years have less funds because of subsequent additions

On average, absolute return funds fail to protect against inflation having lagged RPI since 2007. Of course, you could get lucky and pick the best performing fund every year. However, because there is a swift rotation in the ranks, this is unlikely. The best performing fund in one year quite often finds itself among the worst performers in the next.

Poor performance largely comes from excess fees. The majority of absolute return funds charge an annual fee, front load fees, performance fees and exit fees. This sounds like a lot of fees for not a lot of performance. It's no surprise that they fail to protect against inflation. Frictional costs add up and erode returns for the investor.

Timing which fund will do well in any given year is also challenging because you pay high fees for the privilege of jumping in and out of these accounts.

Most investors look at absolute returns funds as a place to park some cash and get a return in a low interest rate environment. Collectively these funds return better than cash in the bank. But you also stand the risk of making a large loss if you buy the wrong fund at the wrong time.

These are some of the reasons we don't own any absolute return funds in our strategies. Their performance in aggregate is poor and picking the right fund is very difficult because they operate like a black box where the outcome is often unknowable.

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