finexis
ASSET MANAGEMENT
汇信资产管理有限公司

INVESTOR LETTER
October 2019

Dear Investors,

After a strong first half of the year, the third quarter saw markets largely choppy and directionless. After all fees, our global multi-asset FGO and FGO+ funds returned 6.81% and 9.72% year to date, not much different from the start of the quarter. Our all-equity FAM Asia Fund which enjoyed a strong rally earlier, experienced a pull-back, closing 3.33% year to date. Recall that Asian equities tend to be more volatile, hence being up 12.7% YTD in Q2 and down 8.3% in Q3 is to be expected.

In the previous letter, I discussed how fund managers took for granted that investors knew that investments were an essential part of personal finance. In this letter, I cover another assumption that managers took for granted: that investors receive the same net returns as the funds they invest in. This time, returns "after all fees" takes on a new dimension as it was increasingly clear that investors were getting much less than the net returns of the funds they invest in. In bad years, they can even lose twice that of the funds. This gap is so substantial that addressing it far outweighs the search for any outperforming fund.

When should I get out?

This topic should be of interest after last quarter's discussion on "when should I invest?". Let's start by looking at what's happening i.e. when investors invest and get out. The chart below shows investor flows relative to market performance. We see that the highest inflows are at market highs (zone of maximum joy) and outflows at market lows (zone of maximum fear).

Source: FactSet, Investment Company Institute, Standard & Poor's, J.P. Morgan Asset Management.
Mutual fund and exchange-traded funds (ETF) flows are through 30/09/19.
Guide to the Markets – Asia. Data reflect most recently available as of 30/09/19.

Prices of investment assets tend to go from bottom left to top right, with a respective volatility and resultant return rate. What happens when investors buy more at the highs and sell more at lows? We wanted to find out what the result was in terms of such investor response.

Dalbar Inc has studied the effects of investor decisions to buy, sell and switch into and out of mutual funds since 1994. These are measured from the investor's perspective and do not represent the performance of the investments themselves. Results over short- and long-term timeframes show that the average investor earns less than the fund performance reports indicate.

Dalbar found that when the S&P 500 index dropped 4.38% in 2018, the average investor was a net withdrawer of funds and received a loss of 9.42%[1]. Within 2018, the average investor underperformed in both good and bad times. Dalbar noted that "investors sensed danger in the markets and decreased their exposure but not nearly enough to prevent serious losses. Unfortunately, the problem was compounded by being out of the market during the recovery months."

What about the results for investors who actually find top performing funds? Consider the CGM Focus Fund, a diversified mutual fund that gained 18% annually, and was Morningstar's highest performer of the decade from 2000 to 2009. The average investor in the fund lost 11% annually over the same period[2], a whopping difference of 29%. The CGM fund was known to be volatile and go through years of underperformance. Yet investors continued to be enticed by the prospect of catching the upswings and avoiding the downside.

The longer-term results also indicate that the average investor underperforms the intended investments as shown in the table below.

	Average Equity Fund Investor	**S&P 500**	**Average Fixed Income Fund Investor**	**Bloomberg Barclays Aggregate Treasury Index**
20 Year	5.29	7.20	0.44	4.60
10 Year	4.88	8.50	0.48	3.31
5 Year	10.93	15.79	-0.40	1.27
3 Year	8.12	11.41	-0.05	1.40
12 Month	20.64	21.83	1.52	2.31

Source: Dalbar 2018 Quantitative Analysis of Investor Behavior for period ending 31 Dec 2017.

I can hear the reader thinking "You teased me by dangling a tip on when to sell, and now you tell me to hold on!" We have heard comments that managers' persistent call to "invest now, not tomorrow" and "always stay invested" was self-serving; that it was to grow AUM. Is all this a marketing spiel just to scare and convince investors to park their money with us? Certainly, most managers will benefit from higher AUM. However, our incentives are driven not by management fees, but from performance fees with high watermark. That is, if investors go into an initial loss, we need to recover those losses before we earn fees. Hence, we work closely with clients to ensure that their selected investments match their needs and capacity to take risk. Otherwise, they will get a fraction of our funds' returns, and it is a lose-lose situation for both parties.

How do we mitigate a lose-lose situation?

Ideally, there should be an equivalent amount of pain ascribed to a loss vs happiness from a same amount of gain. It actually took a Nobel prize winning economist to show that this was not true; that indeed humans derive more pain from a loss than happiness from a similar gain. This was expounded in the prospect theory developed by Daniel Kahneman and Amos Tversky in 1979. This asymmetric pain-happiness response is also what drives the counterproductive investor action discussed above.

[1] DALBAR study shows the Average Equity Fund Investor lost twice the money of the S&P in 2018

[2] https://blogs.wsj.com/experts/2015/12/07/how-a-mutual-fund-can-win-but-its-investors-still-lose/

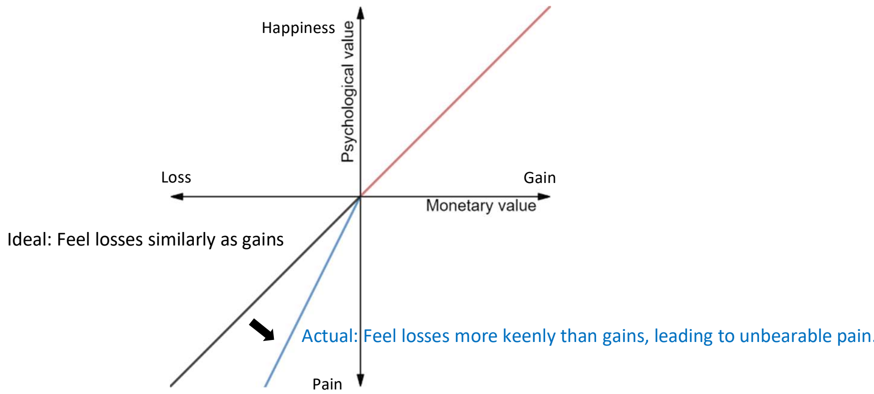

Figure 1 Typical pain-happiness function

The FGO funds were designed for investors who feel more pain in losses than gains (which is most of us). With lower expected downside losses, investors should be able to experience a "bearable" amount of pain that would not result in them missing out on the upside.

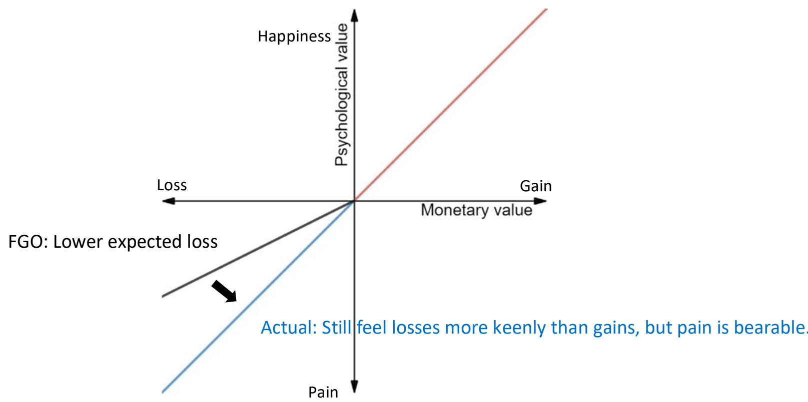

Figure 2 FGO pain-happiness function

The FAM Asia Fund is for investors who want higher returns and have a higher pain threshold. By investing in Asian companies with higher return on capital, better balance sheets and cheaper valuations, it is expected to compound better than Asian equities in general. It is not for the faint-hearted but the outcomes will be worthwhile.

How are we different?

Creating a portfolio structure to manage the downside (actual and psychological) is down to technical design and implementation. Despite this, we do not see many portfolio structures similar to FGO in the market. For those who are interested, have a chat and we'll be happy to elaborate. There are other technical approaches we adopt to manage the portfolios to reduce inefficiencies such as reducing the exposure gap from selling and waiting to buy another security, and having trading costs that put us well ahead of the average institution.

Other than technical capabilities, a key ingredient is a culture of aligned ownership. We have our own capital in the funds so that we feel the pain and happiness alongside investors. It also means that everyone is putting their best resources and ideas into the funds rather than being distracted by personal trading accounts.

Our team members rarely experience the daily evening rush hour crowd. It's because we have a schedule that is not unlike the 9-9-6 system, even doing 15-hour days is not unusual. Yes, this is hardly the work-life balance one would expect for a white-collar job in Singapore. Yet, there are no protests (we are grateful to loved ones for their support). Team members have confidence to take long vacations, and extended leave to care for loved ones, while others cover for them.

One might be surprised to hear that team members tend to be paid more than their peers. Why not? They work harder and deliver more than their average peer. They can also see that each incremental effort leads to better outcomes. It would be foolish to underpay these outperformers and lose them; conversely an underperformer with misplaced expectations would find it hard to thrive in our environment.

I had a school teacher who taught us "no pain, no gain". He also expounded on the theory of "what goes down must come up" (he was not as famous as Newton but this lesson certainly helps for investments). Regardless of whether you are less willing to take pain, or more willing to bear the pain for higher gain, the most important part is to assess your pain threshold accurately, and find a way to help keep yourself invested. We have had success with some of our investors in working with them to find the right investment solution so that they do not end up underperforming due to buying at the top and selling at the bottom. As long as you can go through the pain, you will have the gain.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer