

Trust Not

This year was not an easy one for investors. No matter where you invested, this was a year of deep losses. Even if you stayed clear of equities, commodities, bonds and entrusted your savings in a traditional bank account you will probably see your returns on a serious diet. What can we all learn from this? A few things:

a) Your money and investment distrust. No one is more concerned about your money than yourself. We tend to spend a lot of time in taking small decisions like buying which toothpaste or which shampoo deserves a place in your shopping list. Yet investors, even less millionaires, spend too little time in planning and understanding their investments (Stanley and Danko, 1998). Regardless of your strategy you should spend time in understanding where you are investing and why. Don't expect your advisor to know better than you do;

b) Small is big: Smaller banks with good capital and personalised services are often better than big ones. If you look at the international banks, there is basically not one that has come untouched. Many banks are highly leveraged (i.e. they invested money they have borrowed) and cared more about their profits from proprietary trading than their clients' needs. The "big is better" concept has now been proven wrong;

c) Avoid buying high: Would you buy a new car when the price of that particular model/brand has doubled or tripled in the last year? Probably not. Yet many investors insist on entering the market after several years of high returns and at the all time highs. Ironically now, despite the more favourable valuations, many investors are staying away from the markets. What is the reason? Why do we tend to buy high and sell low? We tend to buy on emotional euphoria: if it went up so much, it is meant to go up even more. If the share price goes down, we panic and sell regardless of the market conditions/situations. (Lynch, 1997). Picking your own shares might give you the feeling that you are in control. But often you will be hostage of your own fears and sell low. Emotional investing has to be avoided as it normally leads to disaster (Miles, 2004).

d) Bubbles burst: From equities to commodities, bubbles burst in every asset class. We have seen oil reaching almost \$150 a barrel and then falling to four year lows of less than \$40 per barrel in just a few months. When something, a share or a commodity, increases so dramatically in such a short amount of time, beware - you might be buying just before this bubble bursts. (The current bubble is government bonds.)

e) Keep Investing, but: Keep investing in good and bad times, but there is nothing wrong in dumping investments that have been proven detrimental to your portfolio or you don't understand, and starting afresh. The essential point is having a good, coherent strategy and, even more essential, to invest only in things you understand. Even if you buy an actively managed mutual fund you should keep a close eye on it. Read the monthly and annual reports. Understand your investment before committing and, once you do, stick to your strategy unless something major happens (e.g. if you had invested in financial institutions like AIG or Lehman Brothers changing strategy would have been perfectly appropriate!).

f) Avoid leverage: No matter what, invest only the money you have and stay away from investments that can magnify your losses. This is an essential rule for all investors.

Devil's advocate

Among the things I have learned in law school there is an important lesson: to be a good lawyer you need to be able to argue a case from both sides. To really understand a case you need to play devil's advocate.

In my previous letter I have discussed the benefits of exchange traded funds vs. actively managed funds. This month we are going to look at the other side of the argument. Given that few fund managers actually beat the index, is it worth to invest in actively managed funds vs. index funds or simply exchange traded funds? Yes, and here is why:

Beating the Average

According to Lowenstein (2008) many mutual funds betrayed our trust. They cared more increasing their assets under management (and hence increasing their profit) than the welfare of their clients. This said, there are active managers doing better than the market (and your dear plain vanilla index fund) year after year.

While several experts like Vanguard founder John Bogle (1994) openly affirm that index funds are on average doing much better than actively managed funds (that is mutual funds managed actively by a fund manager: a human and not a machine like the case of the index), other academic evidence like Wermers (2000) suggest that this is not entirely correct. In many cases even high turnover funds do indeed beat the index considerably.

But let's take some practical examples. Thanks to the fund research company "Morningstar" it is quite easier to pick some low costs mutual funds that did much better than the index. This year is an excellent one to run this kind of study. We can easily see who is a good active manager during a bad time. We can see where the "human touch" managed to do better (and in some cases) much better than the relevant index.

True, given that the majority of funds do not beat the index, it is difficult to spot the good ones. But this shouldn't discourage you. Picking well managed funds is by far easier than picking good shares. Here is what to look for:

a) No load/entry fee: this is not a universal rule as there might be excellent funds that charge a load (entry fee) but take good care of your money. Nevertheless, a high entry fee is usually enough to keep me away. This because there are so many good funds with no loads/very low ones that I can see no reason to pay 3-5% to let a manager deal with my money;

b) Track record: past performance is not a guarantee of future ones, but a less than exciting performance for many years is unlikely to be a good indicator. Past performance, particularly in a difficult year like 2008, gives you a good idea on how the manager is dealing with disaster. Check the performance carefully and make an effort to understand what went wrong/well in the fund strategy;

c) Read, read, Read: you should read the monthly report, annual report, and prospectus carefully. If you can't understand what the fund strategy is, where it invests and how money is being made, stay away.

d) Stay away from unregulated funds - hedge funds. That's right. Here is my take: if your business is not regulated and I cannot see where you invest, I don't see why I should be part of it. This year has shown that no fund can produce good results regardless of market conditions. It was an illusion.

Fairholme fund (FAIRX)

This fund has 6.69 billion US\$ under management. The total expense ratio is 1.01%.

According to the literature *"The investment seeks long-term growth of capital. The fund primarily invest in equity securities of public companies, including but not limited to common stocks, partnership interests, business trust shares, convertible securities, and rights and warrants to subscribe for the purchase of such equity securities without regard to market capitalization or other categorizations. It holds a focused portfolio of no more than 25 equity securities. The fund may invest in securities of non-U.S. companies. It is nondiversified"*

It is basically a value fund (looking for undervalued companies, similar to Warren Buffett's strategy) concentrated on few shares.

Let's see how it did in 2008:

Fairholme Fund -33%

S&P 500 Index -39.53%



So by investing in the Fairholme fund you would have lost 6% less than by investing in the index though an index fund like the Vanguard S&P 500 Index that would have lost 39.53%.

Luck ? Let's see in the last 5 and 10 years:

5 years performance

Fairholme Fund +17.05%

S&P 500 Index -18.98%

Fairholme (MUTF:FAIRX) - [Add to Portfolio](#)

21.34 +0.39 (1.86%) Dec 19, 4:00PM EST



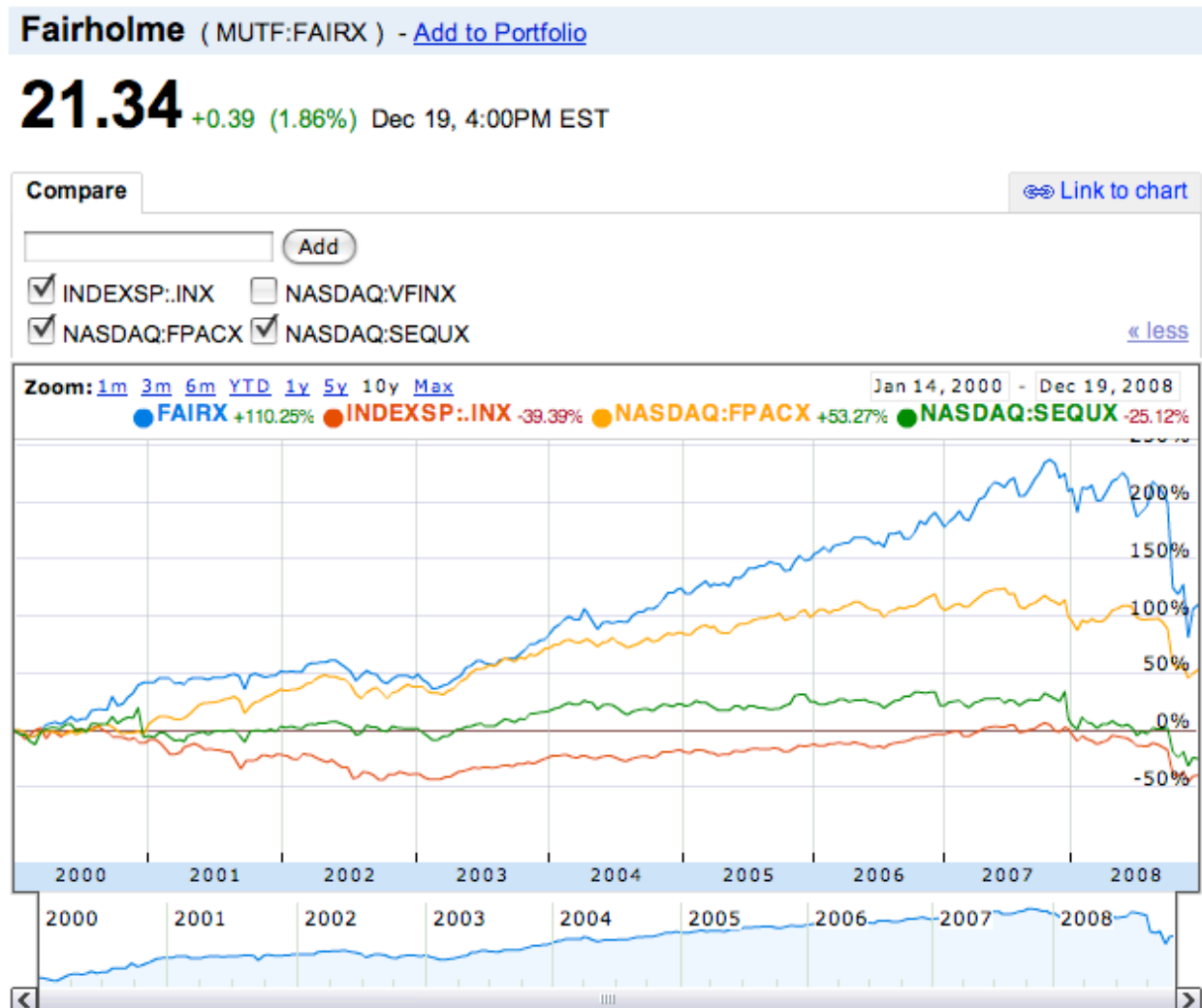
If you had invested 5 years ago in the Vanguard S&P 500 Index or an ETF linked to the S&P 500 Index and adopted by "buy and hold strategy - the markets knows better right"? You would now be poorer. Your \$10,000 invested in the S&P 500 Index fund will now be a mere \$8102 (actually less, as you need to deduct some expenses) but your FAIRX would have turned your \$10,000 into \$17,050. A more than respectable return if compared with the market average.

But let's look at 10 years. Let's even add some further value funds like the FPA Crescent fund (FPACX) and the Sequoia Fund (SEQUX)

10 years performance (With other actively managed fund to show that it was not just one fund outperforming the index)

Fairholme Fund +110.25%
FPA Crescent Fund +53.27%

S&P 500 Index -39.39%
Sequoia Fund -25.12%



With the acclaimed Index investing strategy your \$10,000 will have now, 10 years later, shrunk to \$6061. With Fairholme you would be, despite the big 2008 hit, sitting on over \$22,000. With FPA Crescent, another value fund, you will be at \$15,327, not bad either. Sequoia would have disappointed you, but still less than would have the index. None of these funds charge an entry fee or anything outside the management fee. Their holdings are transparent and can be seen on google finance (finance.google.com) or any major financial website.

Good Funds exist: find them

This very quick "on the field" research demonstrated that good funds capable of doing better than the index (year after year) do exist. No matter if the average isn't up to this mark. You need to do your homework and find the good funds managed by talented individuals and build a successful portfolio.

Whilst these examples are U.S. based there are plenty of similar cases in Switzerland. Strategy funds (these that invest only a fixed percentage of their asset in shares and allocate the rest in bonds) are not doing badly either. The Mi-Fond (Lux) Eco invests only 40% of its holdings in equities. The remaining 60% is invested in bonds. It has lost "only" 19.66% (Migrosbank, 2008) vs. over 30% of the Swiss market index due to its smaller exposures to equities.

Bond funds did well too. The Mi-Fond SwissFrancBond A returned a 2.94% profit this year (Migrosbank, 2008), once again a signal that bonds deserve a place in your portfolio. In the case of Migrosbank there is no fee to buy/sell funds if you are a client of their bank. This helps in keeping costs low and buy more units as often as you want.

This is particularly relevant to small investors: by buying every month a fixed amount of money in a fund (e.g. \$100 or \$200) you will benefit even in market downturns (as the fund quotes will be worth less you will be buying more units for the same amount of money).

Madoff Scandal

My "investment distrust" title was inspired by the latest financial scandal: the Bernard Madoff admission that his money management business was nothing more than a "big lie". Madoff wasn't taking the money directly from mere mortals like me and you. He was dealing almost exclusively through Hedge Funds like the Fairfield Sentry Ltd. Have a look at the performance of this hedge fund from 1990 till today:

	Fairfield Sentry Ltd.												
	Jan	Feb	Mrz	Apr	Mal	Jun	Jul	Aug	Sep	Okt	Nov	Dez	Jahr
1990												2.77%	2.77%
1991	3.01%	1.40%	0.52%	1.32%	1.82%	0.30%	1.98%	1.00%	0.73%	2.75%	0.01%	1.56%	17.64%
1992	0.42%	2.72%	0.94%	2.79%	-0.27%	1.22%	-0.09%	0.86%	0.33%	1.33%	1.36%	1.36%	13.72%
1993	-0.09%	1.86%	1.79%	-0.01%	1.65%	0.79%	0.02%	1.71%	0.28%	1.71%	0.19%	0.39%	10.75%
1994	2.11%	-0.44%	1.45%	1.75%	0.44%	0.23%	1.71%	0.35%	0.75%	1.81%	-0.64%	0.60%	10.57%
1995	0.85%	0.69%	0.78%	1.62%	1.65%	0.43%	1.02%	-0.24%	1.63%	1.53%	0.44%	1.03%	12.04%
1996	1.42%	0.66%	1.16%	0.57%	1.34%	0.15%	1.86%	0.20%	1.16%	1.03%	1.51%	0.41%	12.08%
1997	2.38%	0.67%	0.80%	1.10%	0.57%	1.28%	0.68%	0.28%	2.32%	0.49%	1.49%	0.36%	13.10%
1998	0.85%	1.23%	1.68%	0.36%	1.69%	1.22%	0.76%	0.21%	0.98%	1.86%	0.78%	0.26%	12.52%
1999	1.99%	0.11%	2.22%	0.29%	1.45%	1.70%	0.36%	0.87%	0.66%	1.05%	1.54%	0.32%	13.29%
2000	2.14%	0.13%	1.77%	0.27%	1.30%	0.73%	0.58%	1.26%	0.18%	0.86%	0.62%	0.36%	10.67%
2001	2.14%	0.08%	1.07%	1.26%	0.26%	0.17%	0.38%	0.94%	0.66%	1.22%	1.14%	0.12%	9.82%
2002	-0.04%	0.53%	0.39%	1.09%	2.05%	0.19%	3.29%	-0.14%	0.06%	0.66%	0.10%	0.00%	8.43%
2003	-0.35%	-0.05%	1.85%	0.03%	0.90%	0.93%	1.37%	0.16%	0.86%	1.26%	-0.14%	0.25%	7.27%
2004	0.88%	0.44%	-0.01%	0.37%	0.59%	1.21%	0.02%	1.26%	0.46%	0.03%	0.79%	0.24%	6.44%
2005	0.51%	0.37%	0.85%	0.14%	0.63%	0.46%	0.13%	0.16%	0.89%	1.61%	0.75%	0.54%	7.26%
2006	0.70%	0.20%	1.31%	0.94%	0.70%	0.51%	1.06%	0.77%	0.68%	0.42%	0.86%	0.86%	9.38%
2007	0.29%	-0.11%	1.64%	0.98%	0.81%	0.34%	0.17%	0.31%	0.97%	0.46%	1.04%	0.23%	7.34%
2008	0.63%	0.06%	0.18%	0.93%	0.81%	-0.06%	0.72%	0.71%	0.50%	-0.06%			4.50%

Did you notice anything wrong? This fund was never down a single year. Never. Not even during the tech bubble or this tumultuous year there was any trace of red ink. But it was all fake: this performance was the one declared by Madoff's unregulated money management business and it was nothing more than a fraud scheme.

Old investors were paid with the money of the new ones and there wasn't a real portfolio behind the investment - just a pyramid scheme. With alleged fraudulent losses of \$50 billion this is by far the biggest Ponzi scheme ever seen.

It was a rather sophisticate one. Even white gloved Swiss private banks, that are essentially promising to protect your asset, like UBP of Geneva, Benedict Hentsch in Geneva, Neue Private Bank in Zurich, and Reichmuth & Co in Lucerne have lost a combined \$5 billion in this fraud.(Walters, 2008). Many rich families from Palm Beach to New York, Zurich, Tokyo and Abu Dhabi lost a considerable chunk of their fortune in this deal.

What is stunning is how these hedge funds, like Sentry, ended up investing 100% of their money in one single money manager: Madoff. Diversification is such an elementary rule that it cannot be disregarded.

This could have only happened to unregulated Hedge Funds - regulated mutual funds cannot invest all their money in one single share or a single fund. We can expect a hasty law to regulate hedge funds, probably as an overkill as Sarbanes-Oxley.

The investors in the Madoff scam are all guilty, to a degree of another, of trusting a single hedge fund or a single money manager that disclosed little, if anything, about his business. It had a nice story on how money had been made but that was about it. No one bothered to ask. After all Madoff was a former Nasdaq Chairman. His fund was apparently making good money, year after year, and it was paying back promptly.

The media coverage of this story is so huge that it doesn't make sense to repeat all the details in this newsletter. But the big lesson is that if profits are too good to be true there might be something wrong.

As Ronald Reagan once said "Trust, but verify" and it fits perfectly this situation.

Final Words

My final words for this year are in invitation to all my readers to reflect. To reflect on their accomplishments this year and try to see, whatever happened, in a positive light. If something didn't go as you expected in 2008, set a new plan from 2009. A new year is an amazing opportunity to do better and to outperform yourself.

An important suggestion to all my readers is to never give up on learning. This isn't exclusively limited to higher education but learning in everything we do, particularly investing. You can learn a lot from your mistakes. There is no way to learn something about investing without some failures. In terms of investing I have discussed good mutual funds, because I have seen too many small investors losing their money in the stock picking game. Life is too short to be consumed on the tiring and stressful exercise of day trading.

Pick an investment strategy that doesn't interfere with your life. Buy some good mutual funds, bonds or simply park your money in a saving account, but whenever possible spend some of your money for yourself. Book a holiday, with your family or your loved ones and enjoy life, because investing is about enhancing the quality of your life. In this regard a holiday or a gift for yourself or your loved ones is certainly a very good investment.

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