Investment Strategy

Selecting a managed fund

For many investors, managed funds offer an attractive way to obtain exposure to a particular asset class that would be very difficult to access directly or to obtain in a diversified form. Examples that come to mind including commercial property, international bonds, hedge funds and emerging markets shares all require scale. Individual office buildings are expensive, corporate bonds have minimum face values of $500,000 or more and hedge fund strategies require large minimum investment amounts. So it makes sense to pay a for a professional investment team to manage these funds for you and to pool your money with other like-minded investors to enjoy the benefits of scale.

But how do you select a managed fund from the thousands on offer in Australia and internationally? It's common to see unsophisticated investors choose managed funds based on the expense ratio (fees) or investment returns over the past one, three or five years or the size or brand of the fund manager. While these factors may be useful in assessing a fund, they have been shown to be relatively poor indicators of future performance.

It's often useful to think of managed funds in the same way as a share investment in a listed company. You wouldn't necessarily want to select a share investment based on how little the CEO and management team is paid. And picking stocks based on which companies had the largest share price rise over one, three and five years is also unwise as you may be buying an expensive company at its peak. Picking stocks based on company size and brand recognition may also lead you to companies with much lower potential growth compared with smaller, more nimble companies.

So what should you look for when assessing a managed fund? It usually gets down to what is referred to as the eight "Ps"": People, philosophy, process, performance, parentage, product, pricing and pipeline depending on the type of fund being managed.

People

When you are buying an investment in a managed fund, you are essentially buying the investment skills of the investment team which is a combination of their experience and education, how well individuals work together as a team and how motivated they are to perform.

Fund research firms will often interview the entire investment team, obtain references and conduct background checks, attend investment committee meetings to observe the team dynamics and form opinions on the calibre of the investment team. They will also consider staff turnover, succession planning and remuneration structures to ensure that the investment team is cohesive and their interests are aligned with investors in the fund.

Philosophy

The investment philosophy is how the investment team thinks about the markets in which they invest. For example, what is their investment style and do they think that markets are inefficient and that securities can become undervalued and overvalued at times? Do they perform in-house fundamental research and analysis or use other research tools and sources? What is their investment horizon, how do they seek to manage investment risks, how do they generate investment ideas and what is their investment edge relative to competing investors?

Investment firms should be able to clearly articulate their investment philosophy and demonstrate that they adhere to it. In this regard, fund research firms will often conduct analysis to ensure the fund manager is true to their philosophy and for example hasn't engaged in "style drift" over time.

Process

The investment process is the way the investment firm sources and identifies investment opportunities, researches opportunities, decides to invest, decides how much to invest and then decides when to sell. Often it's not so much the decision to buy that is important but how much to hold and when to sell which can have a larger impact on the fund performance.

Performance

Past investment performance has very little predictive power as to future returns so why is it relevant when assessing a managed fund? It's useful to understand whether the investment manager has stayed true to label over time, has been good at managing risk in the portfolio and how the fund performed in different market environments. Past performance is also useful in discussions with the fund manager about specific decisions that worked and ones that didn't, and what the fund manager learned. Analysing past performance is also useful in assessing whether good performance was due to skill or luck.

Parentage

The term parentage is really meant to capture the resources and financial backing of the investment firm. A lone investment manager working out of a garage may have less resources and future longevity compared with an investment firm that has significant capital. When looking at the parentage of the firm, this is not to say that large firms are better but rather there is a degree of confidence that the fund manager has sufficient capital and resources to continue operating and paying staff over the medium term.

Strategy

Selecting a managed fund (continued)

Product

Questions about the product tend to be about the terms and conditions of the actual fund. How often can you buy units in the fund and how can you get out? What is the minimum investment size, how often are distributions paid, what is the tax status? Can the manager suspend redemptions? What investor protections are available? For many funds, answers to these questions are the same – there are industry standard terms and conditions, but it doesn't hurt to read the fine print in the offer document to make sure there are no unusual terms or traps.

Pricing

Whilst the management expenses are not the basis for an investment in a fund, the total or management expense ratio of the fund should be assessed for reasonableness relative to other competing funds and to the potential net returns that the fund can earn. Are you paying a fair fee for the work being done? The fee structure can also be relevant to ensure there is a strong alignment between the fund manager and investors – for example through the use of performance fees.

Some asset classes are also very expensive to manage. For example, private equity firms typically charge 2% per annum on amounts committed (but not necessarily invested) which seems very expensive. However, if you are expecting to receive net returns after fees of more than 20% per annum the fees aren't so bad. In addition, most private equity firms have expensive cost structures which will eat most of this management fee given cost of the teams needed to source, evaluate and bid on potential investments.

Pipeline

Pipeline refers to the pipeline of attractive opportunities within the asset class that the fund is investing in. Is the fund investing in an area where there are likely to be numerous attractive investment opportunities over the short to medium term or is everything in the sector overpriced or the flow of opportunities likely to dry up? For example, a fund investing in distressed debt is only likely to have a strong pipeline of opportunities at certain times in the business cycle.

Conclusion

Selecting a managed fund is complicated. There are a lot of issues to consider and questions to ask before choosing to invest in a particular fund. In many respects investing in a fund is similar to picking which individual shares to invest in. Many of the factors are common to both decisions. And, as with shares, there are financial advisers, independent research reports and investment tools which are available to make the job of choosing, comparing and picking the best funds much simpler rather than relying on past performance, brand recognition and fees.

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