

## Monthly Commentary 3<sup>rd</sup> March 2017

Markets were almost all up in February. Equity markets were strong and bonds joined the party as yields fell. The US dollar was generally stronger, but commodities bucked the trend, with modest falls. As markets kept rising, the chorus of pundits calling for a sharp pullback has risen. But this was the case every month since the November elections. Eventually, they will be proven right.

### **Winton's take of Warren Buffett's wisdom**

It is not usual that we reproduce someone else's commentary but this month we thought it was worth posting David Harding's thoughts on Warren Buffett's view on hedge funds. For those of you who have not heard of David Harding, he is the founder of Winton Capital, one of the biggest hedge funds in the UK, with a formidable track record since 1997:

Warren Buffett has become established as perhaps the greatest investor of all time. Over the past 50 years he has shared many of his views with his investor "partners" through his Berkshire Hathaway annual report, a comprehensive explanation for its shareholders of the progress of the business, as well as of other matters of contemporary relevance to the world of investing.

He is renowned for his modesty and wisdom, his folksy wit, and his optimism, but most of all for his habit of being right. From the early 90s onward he campaigned consistently for the expensing of option grants as a compensation cost when they were routinely granted as an incentive to executives. In the early 00s he warned of the potentially destructive impact of derivatives on the balance sheet of leveraged institutions (banks). In each case his obvious common sense diagnosis of the problem was resisted by many vested interests for many years, but eventually the logic became too strong to resist. Years later, option grants are finally routinely expensed against earnings and we are fast approaching the 10th anniversary of the Global Financial Crisis, precipitated by the highly leveraged institutions whose risks had been concealed by complex derivatives positions.

In his most recent annual report he renews his criticisms of "active investment management" and "hedge funds" in particular. He reminds us of the long-term bet he placed nine years ago that a low-cost index fund would outperform a portfolio of sophisticated hedge funds; a bet that with one year to go he is close to winning hands down. As he has many times before, he criticises "Wall Street" for being fee driven to the detriment of investors. He does not impugn the integrity of money managers, describing them as "... in almost all cases... honest and intelligent people..." But his central thesis is that the high costs associated with active



---

management detract substantially from long run investment returns without, in aggregate, adding any value overall.

He doesn't deny that the potential for exceptionally talented managers to emerge exists; however, he observes that since the vast majority of active managers are doomed to failure, the chances of any investor successfully picking such a future star are slim. His conclusion?

*“The bottom line. When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds”.*

This is withering criticism of the active fund management industry overall, and it is hard to argue convincingly against. At Winton we would make the argument that our directly investable funds have much lower fees than hedge funds are generally assumed to have, and that our historical risk-adjusted returns after fees have been creditable. We would also make the case that we have invested in the creation of a substantial scientific research group with the ability to pursue ground breaking work in the intelligent automation of a long-term investing strategy. Given the advances in many fields over the past 50 years, such as computing and software, it does seem plausible that this sort of research project is worthwhile paying fees to finance.

Investors need to be conscious, however, that they are financing such an expensive and long-term investment with far from certain prospects of success. It is, undoubtedly, something of a gamble whether investing with Winton will be better than investing across the broader industry that Warren Buffett credibly questions the value of. For some investors, it is a gamble worth taking. For others it is one they can't afford. Investors should contemplate all the risk warnings in Winton's documentation before investing or staying invested.

Many readers will already be aware that Winton had unilaterally decided to make a modest reduction to its fees well in advance of Warren Buffett's latest broadside. We had concluded ourselves that our results in recent years have been a little weaker than our 1 and 20 fee structure demands. Please contain your excitement however, as our headline fund fees are only dropping to 0.9 and 16.<sup>1</sup> We are still pursuing ambitious investment in research, data and technology with the potential to lead to new transformative discoveries in finance, such as occur in other fields. In the end, in most markets we are not competing with low-cost index funds and continue to hold out hope that we may just be a future star in the making.

**It's hard to argue against Buffett. Yet, we cannot paint all hedge funds with one brush. At Elgin, many of our clients are exposed to Winton as part of our alternative component. The reason we are invested in Winton and other hedge funds is to manage the risk in our clients' portfolios. We do indeed allocate a large part of client portfolios to equities. This increases as a client's risk profile increases.**



And indeed, we use a lot of ETFs – especially in the US markets where we have been following Buffett’s advice for many years and are invested almost exclusively in broad market ETFs.

Yet, equities need a counter balance in order to manage risk, and fixed income alone might not provide this at today’s very low rates. This counterbalance is what protects the overall portfolio from steep falls when markets fall sharply. **And this does happen.** In fact in 2016 our hedge fund exposure proved two things to our investors. First that it helps to withstand major equity market shocks and second that it has a relatively low correlation to main markets. The maximum market drop of our hedge fund component in 2016 was contained to 2.5% compared to the 13.08% drop for the MSCI World Equity Index and the 8.93% drop for the Global Hedge Fund Index (indicating that we are choosing the “right” hedge funds). For the year, its correlation to MSCI World, US Treasuries TR Index and Global Hedge Fund Index was 0.267, 0.3 and 0.216 respectively, which make Elgin’s choice of hedge funds a true diversifier within a traditional portfolio. And yes, this comes at the cost of some upside.

## Stereotyping in Europe

This has nothing to do with finance and markets, but we thought this bit from the Pew Research Centre was worth exposing.

<b>Stereotyping in Europe</b>						
<b>Who Is Trustworthy, Arrogant and Compassionate</b>						
<i>EU nation most likely to be named...</i>						
<i>Views in:</i>	<b>Most Trustworthy</b>	<b>Least Trustworthy</b>	<b>Most Arrogant</b>	<b>Least Arrogant</b>	<b>Most Compassionate</b>	<b>Least Compassionate</b>
Britain	Germany	France	France	Britain	Britain	Germany
France	Germany	Greece	France	France	France	Britain
Germany	Germany	Greece/Italy	France	Germany	Germany	Britain
Italy	Germany	Italy	Germany	Spain	Italy	Germany
Spain	Germany	Italy	Germany	Spain	Spain	Germany
Greece	Greece	Germany	Germany	Greece	Greece	Germany
Poland	Germany	Germany	Germany	Poland	Poland	Germany
Czech Rep.	Germany	Greece	Germany	Slovakia	Czech Rep.	Germany

PEW RESEARCH CENTER Q44a-Q46b.



---

Make your own conclusions, but we have two observations:

1. Every country except Greece finds Germany to be the “Most Trustworthy” country. Greece, being Greece, finds Greece to be the most trustworthy!
2. Every country finds itself to be the “Most Compassionate”. Surprise, surprise.

The Elgin Analyst Team

### **Disclaimer**

The information in this article should neither be regarded as an offer nor a solicitation to buy, sell or otherwise deal with any investment referred to herein. As a regular rule, the value of any investment may rise or fall. Past performance is not an indicative of future results. Do not take unnecessary risk and always request advice from an investment professional before undertaking any investment.