COLLECTIVE INSIGHT

Lessons from the **18th century**

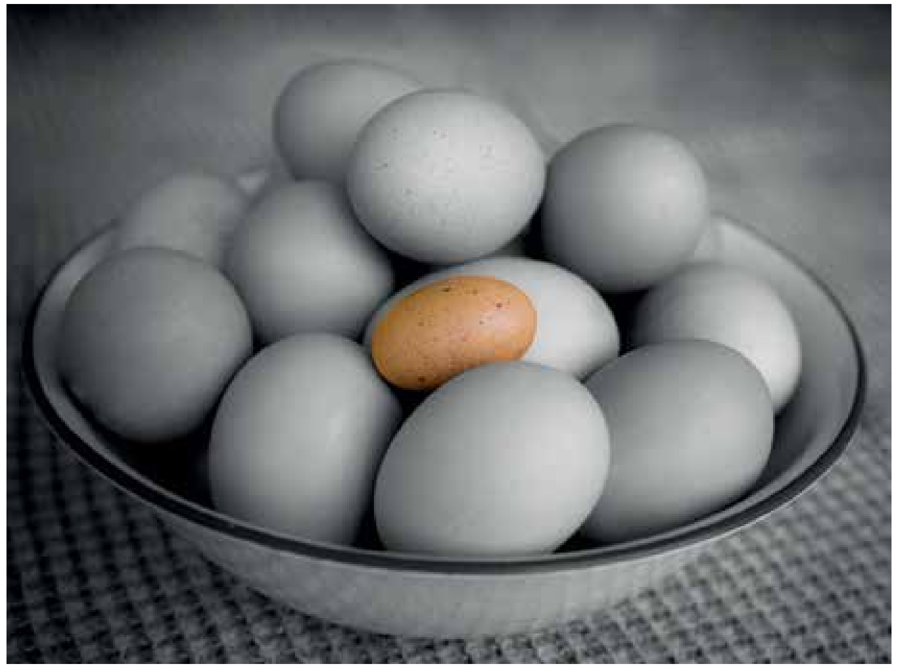
In July of 1774, a Dutch merchant, Adriaan van Ketwich, got a group of investors together to create what became the world's first mutual fund, Eendragt Maakt Magt (which we'll abbreviate to EMM). EMM was a closed-ended vehicle with a mandate to invest in a diversified portfolio of foreign bonds and colonial plantation loans.

Two hundred and forty years on, technological and financial sophistication has advanced by leaps and bounds. But from an investor's perspective, what real progress have modern asset managers made since the world's first mutual fund was formed in Amsterdam?

TRUE INNOVATION

"Eendragt Maakt Magt" translates into Unity Creates Strength. The strict diversification requirements of the fund fulfilled an unmet desire from investors to pool their capital so they could diversify their risk. Van Ketwich was an entrepreneur fulfilling a genuine need from investors for diversification, something they had been lacking following the financial crisis of the two preceding years.

According to the Investment Company Institute (ICI), there were more than 16 000 investment companies in the US alone as of the end of 2014[1]. You would think the last thing investors need is another fund to choose from… and yet over 500 new funds have been opened each year for the past 10 years. Are there really 500 unique innovations each year that improve on what is already on offer for investors? As the saying goes: "In physics, we have three laws that predict 99% of outcomes, but in investing we have 99 laws that end up predicting 3% of outcomes."



SETTING EXPECTATIONS

There was a spirit of transparency in the structure of EMM. Van Ketwich, who formed and administered the trust, was not to be involved in the daily investment decisions to avoid conflict of interest. The fund also published all its holdings in its share documentation, providing full transparency to investors.

And specifically in terms of performance expectations, EMM's prospectus promised to pay a statutory 4% annual dividend. To entice investors, there was additional potential upside through a share buyback scheme, in which the fund would use excess interest income to purchase shares at a 15% premium. But what is most interesting is that these buybacks would be based on a lottery that selected shareholders at random. While the buyback scheme was a clever piece of marketing to raise assets, the outcome was explicitly random. It was set up as a lottery, and it fully acknowledged that the future return for investors would largely be determined by luck.

> PARTS OF THE INDUSTRY HAVE DEVELOPED PURELY TO REPACKAGE COMPLEXITY AND OPACITY AS REAL INNOVATION, TO EXPLOIT FINANCIAL ILLITERACY.

According to a 2014 State Street survey, only 42% of investment professionals believe alpha comes from skill and not luck[2]. Yet today most asset managers use past performance to set future return expectations for potential investors. Track records are vigorously trumpeted as if they carry some sort of meaning, despite the plethora of studies suggesting there is no evidence for persistence in past performance – if anything, one might observe that, on average, the returns in mutual funds have a tendency to revert to the mean. As with the tobacco industry, asset managers have become adept at giving customers what they want, even if that's at odds with what they need.

INVESTOR RETURNS VS INVESTMENT RETURNS

A lot has changed since the 18th century, but one fundamental law of investing is still the same: "Gross Return - Costs = Net Return." Investors keep what they don't pay for in fees.

EMM's prospectus had a stated 0.2% management fee, one twentieth of the 4% statutory dividend payments. In other words, the fund's fees were 5% as a proportion of the pre-tax return (excluding the buybacks). After two and a half centuries, the picture looks dramatically different for modern-day investors. With the average expense ratio for bond funds at 0.61%[3] and the yield to worst on the Barclays Global Aggregate index sitting at around 1.7%, the proportion of return kept by investors has fallen dramatically. More disturbingly, for the vast majority of underperforming active funds whose value proposition is excess returns above a benchmark, managers are keeping over 100% of their "value added".

PROGRESS OR REGRESS?

Van Ketwich originally raised 1m Dutch guilders for EMM, which is about $23m (R286m) using today's gold price (assuming a gold content of 0.6g per guilder). In 2014, Boston Consulting Group estimated the global assets under management (AuM) of the asset management industry at $68tr (R845tr), with profits of more than $90bn (R1.1tr). Investors have more product choice with more data and more financial media to consume than ever before.

But with higher AuM and larger volumes of products come new challenges and areas for improvement. Parts of the industry have developed purely to repackage complexity and opacity as real innovation, to exploit financial illiteracy and promote their speculation as science, and to take a larger portion of investors' returns for their hard work in these endeavours.

So you want to be an asset manager? If you can provide a service beyond that which is available already, with a fully transparent process and a fee structure that passes on the majority share of returns to investors, while you separate candidly the roles played by luck and skill in the potential outcomes… you might just end up being one of the best asset managers since the 18th century. ■

AINSLEY TO
MULTI-ASSET ANALYST,
CREDO WEALTH
To is an analyst for the multi-asset team at Credo Wealth, undertaking cross-asset research in asset allocation, as well as fund selection. Before Credo, he worked at Stamford Associates, Fidelity and Bloomberg. He has been a CFA charterholder since 2014.

SOURCES:
[1] *Investment Company Fact Book 2015,* Investment Company Institute
[2] *The Folklore of Finance,* State Street Centre for Applied Research Survey Analysis 2014
[3] On an asset-weighted basis, taken from ICI's *Investment Company Fact Book* 2015
The Origins of Mutual Funds (K Geert Rouwenhorst, 2004)