

Investing by the Stars

If you base your investment strategy on the acumen of an individual, what happens when that individual decides to quit? It's called 'Key Person Risk' and it's a problem that forever haunts forecast-based investment firms.

Many fund managers base their value proposition for would-be investors on the astute stock picking capabilities of one or two individuals. It makes for a neat marketing strategy as it personalises their offering to clients.

But the notion of building an investment strategy around an individual's acumen also poses significant threats – not only to those businesses but also to the well being of the clients who invest with these managers.

In Australia, we have recently seen a couple of cases where highly regarded money managers ended their association with particular firms. In one case, the individual sold his small business to a US asset manager. In the other, the star stock picker took an extended sabbatical, prompting downgrades by consultancy firms concerned at the impact on the business' investment strategies.

So we can see that star individuals or star teams, however much of an attraction, always pose the threat of walking out the door and taking their talents with them. There are risks worth taking in investment, but this certainly isn't one of them.

Standard & Poor's each six months carries out what it calls a 'musical chairs' report on fund manager movements. Last year in Australia, for example, there were 40 key staff departures from money management firms (source: Standard & Poor's 'Musical Chairs' Report, 2010).

In what is a global trend, the vast bulk of departures (90%) were from mainstream firms to so-called 'boutiques'. These are firms set up by a handful of breakaway staff keen to control their own destiny and hold equity in their own businesses.

While such motivations are completely understandable, businesses built around the flair of a couple of individuals should flag a warning sign to investors about being left open to the risk of the supposed 'key value add' walking out the door.

Of course, investors do have the option of following a star manager from one company to another. But that means selling out of an existing fund – with all the potentially onerous capital gains tax implications – and buying into another.

There is also the risk of being out of the market for a time. An alternative is to just stay put with the existing fund, but then that opens up the chance of the new manager adopting a completely different investment style to the old, thus leaving the investor with a portfolio that may not match his or her risk profile or personal goals.

Either way, the frantic chair-hopping of star managers can prove to be a real headache for advisers and their clients, when the real focus should be designing an appropriate asset allocation for the investor and finding a manager to implement it.

None of this is to criticise the stock-picking skills of certain people. But there is an alternative approach for those made nervous at the thought of their nest eggs being left at the mercy of the lifestyle choices of those who manage their money.

Rather than being built around the talents of individuals (although they play a part), this alternative approach is based on a consistent, transparent and defensible process informed by rigorous academic research and founded on a sound investment philosophy. It's an approach based on evidence and experience, not on some mysterious alchemy, and the skills employed are observable.

This is what jch does – designs portfolios based on a rigorous understanding of risk and return, builds disciplined processes around the management of those portfolios and implements efficiently.

It's important to understand that this is not a "black box" approach either. While there is a clear and transparent methodology involved, the process allows for a degree of flexibility that means managers and traders can exploit market conditions and pricing to get the best possible deal on securities.

At bottom, it's a scientific approach. Or to put it another way, if we're talking about stars, think of it more as astronomy than astrology.

Do not act on this information alone!

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