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Understanding financial market buzzwords

Investors hungry for yield must be careful not to pay more for higher risk and lower returns

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HELLO there! May I offer you a pint of alcohol- free beer? Want a drag from this nicotine-free cigarette? Or would you like a cup of this caffeine-free tea perhaps?

Welcome to the world of topsy-turvy marketing that has, unfortunately, permeated the world of financial products.

The average retail investor might not have caught wind of the latest fads like liquid alternatives, smart beta, and actively managed exchange- traded funds (ETFs).

If these terms aren't already a mouthful, try getting to grips with a "benchmark-agnostic unconstrained bond fund" or an "outcome-oriented multi- asset fund".

These jargon-laden phrases, unfortunately, are gaining traction. And we had better start figuring out what it all means before our collective net worths get hauled into them.

What's happening is that fund managers are flipping around perceived shortcomings of a financial vehicle to make it more appealing.

Take liquid alternatives, for instance. To understand them, one needs to know what "alternative investments" are, and what "liquid" means.

And even before figuring out what "alternative" means, one needs to think about what is non-alternative, normal, common or traditional.

Traditional investments are in stocks and bonds. They are generally liquid, meaning that one can easily sell the asset anytime and get cash in the bank a few days after.

Liquidity is important also because prices are more likely to be fair if many people are buying and selling the asset on a regular basis.

Alternative investments reside in more esoteric territory.

They refer to investments in hedge funds, private equity, venture capital, gold, commodities, and - on the fringe - stamps, fine art, and wine.

Infrastructure and real estate investments also fall into this category.

They are usually not as liquid.

A private equity firm, for example, typically owns a collection of unlisted companies. It then implements operational changes that could take many years to have an effect, before selling them to the public markets or to other companies 5-7 years later.

Investors in a private equity fund thus face a lengthy lock-up period, typically up to 10 years, before they can get back their money.

THE ALTERNATIVE ATTRACTION

Yet these so-called alternative investments have a supposed attraction: they claim to offer returns not linked with, or "uncorrelated" with, what is happening in the broader financial markets.

Correlation is important to investors because with an understanding of what assets are correlated with each other, they can figure out which asset classes to diversify into.

The lower the correlation between assets, the bigger the diversification benefits of holding these two different assets at any one time.

For much of the 2000s, stocks and bonds were negatively correlated with each other. This means investors benefit from diversification by holding both. When one goes up, the other goes down.

However, in the past year, bonds and equities tended to go up and down in sync. During the first few months of 2013, stocks and bonds went up together as central banks kept interest rates low and investors rushed for yield.

After the US Federal Reserve hinted that it was contemplating ending its financial stimulus programme - "quantitative easing", or QE - both stocks and bonds declined at the same time. Stockholders were worried that economic growth would stall once interest rates went up, and bondholders were also worried about how higher interest rates would cause bond prices to decline.

Enter alternative investments. In a turbulent financial world, goes the marketing spiel, their lack of correlation with either stocks or bonds becomes more attractive.

Now, ordinary investors usually do not have access to alternatives like hedge funds because they cost a million dollars to enter. You can't walk up to a bank and say you want to invest in a bridge in Myanmar either, unless you are a substantial investor.

But what fund managers can do, and have done, is to package these illiquid assets into a more liquid and tradeable form, like an exchange-traded fund (ETF) or mutual fund. The public can then buy into them for a lower minimum subscription price.

There are already numerous liquid alternatives out there, though they are not marketed as such.

Real estate investment trusts, or Reits, package commercial or industrial properties into a vehicle that investors can buy and sell every day.

Gold ETFs like the SPDR Gold Trust also count.

There are also indices tracking publicly-listed private equity companies, or replicating commodity movements, that investors can get exposure to through an ETF.

THE MUTUAL HEDGE FUND

What is new, and worrying, is how hedge funds are now also being packaged into mutual funds and ETFs.

Similarly, ETFs and mutual funds are adopting hedge-fund-like aspects.

Hedge funds are unregulated investments available to the very wealthy. This is because the wealthy are more equipped to stomach the risks, which are not easily understood.

For example, hedge funds might claim to have lower volatility because they "hedge" their bets. This means their losses tend to be more limited during bad years and their gains tend to be more limited during good years.

A typical long-short equity fund tries to hold ("long") shares it thinks will appreciate, and borrow shares to sell them ("short") if it thinks they will drop in value.

But some hedge fund returns are asymmetric. This means that a fund does not have an equal chance of making or losing, say, 10 per cent of its value in any year.

Some funds, like those involved in merger arbitrage, may constantly make a little bit of money in normally calm markets, but might stand to lose a lot in occasionally turbulent ones. This is a strategy referred to as "short volatility" or, more colloquially, "picking up coins in front of a bulldozer".

Other hedge funds use large amounts of borrowed money to achieve their objectives. Catastrophe results when negative returns get magnified and the fund has to sell assets at a loss to meet margin calls.

Still, hedge funds claim to offer lower volatility and steadier returns. That is why institutions like pension funds allocate a bit of their money to them.

Unfortunately, it is far from clear if hedge funds are a superior investment. Certainly, it wasn't clear to Calpers, California's retirement fund for its public workers and the largest pension fund in the US. In September, it announced that it was terminating its US$4.5 billion hedge fund portfolio, citing its complexity and costs.

Yet these new hedge funds for the man in the street are becoming popular. Money has poured into these "liquid alternative" funds. A Wall Street Journal article in March, citing fund tracker Lipper, noted that the assets of mutual funds with hedge-fund-like strategies swelled from US$41 billion at end-2008 to US$286 billion by end-2013. Another count by investment management firm Morningstar came up with slightly slower but similarly impressive growth.

DailyAlts, a site tracking liquid alternative investments, counts about 70 such funds set up this year. These funds mostly have a management fee of 1-2 per cent. Most are mutual funds, though there are a handful of ETFs.

Investors have to be careful about paying more in fees for a hedge-fund- like vehicle they do not understand, compared to other forms of investing that they do.

Not all "alternatives" offer complete diversification from the market, or a diversification that comes at a reasonable rate of return and expense level.

Moreover, stocks and bonds, interestingly, appear to be correlated with each other at certain intervals. The old diversification story still holds at some points in time. A November 2013 study by bond fund manager Pimco pointed out that from 1927 to 2012, the correlation between the S&P 500 and long-term US Treasuries moved from positive to negative, or vice versa, 29 times. Correlation has ranged from negative 93 per cent to positive 86 per cent.

Stocks tended to be negatively correlated with bonds in the short run. In the long run, while bonds diversify stocks, the correlation is stronger and can even turn positive, the study noted. And even while inflation shocks might lead to both asset classes falling in tandem, weak economic growth might still result in a flight to safety. This means that in times like now, stocks can still go down and bonds go up. Diversifying your stock investments with typically safer bond investments might yet be a valid investment thesis.

After all, bondholders still have first cut of a company's assets when it goes bankrupt. Shareholders are often left with nothing.

As long as you stay away from bonds issued by small companies pursuing risky business strategies ("junk bonds"), you should be fine.

MUTUAL FUNDS VS ETFS

Let's move on to actively-managed ETFs and smart beta.

They are essentially different sides of the same coin. The move towards "actively-managed" and "smart" just means one thing: more fund managers, more active management, and more fees.

To understand actively-managed ETFs, one has to understand the difference between ETFs and mutual funds ("unit trusts", in the Singapore context).

These are two regulated fund structures that investors have access to. Both have a low minimum investment, and both have a high degree of transparency and a limited use of leverage. The difference is in how you buy them and how much you pay for them.

Mutual funds usually have sales charges when you buy in, and redemption charges when you sell. You can buy them effectively once a day, because their price is based on the previous day's value. The fund company needs to tally the assets it owns and update the fund's net asset value every day. Mutual funds also disclose their holdings to the investor only every quarter.

TRUST THE MANAGER'S SKILL

Most importantly, mutual funds tend to have strategies that require active management. Investors have to trust the skill of the manager when investing in mutual funds.

ETFs, by contrast, refer to funds that investors can buy and sell on a stock exchange every day, just like stocks. Their holdings are also disclosed every day, making them very transparent. They do not typically require expensive fund managers.

ETFs were originally meant to be low-cost ways of tracking an index. They either own the underlying assets of an index outright, or use derivatives in circumstances that make it difficult to own the underlying assets. (Some mutual funds are also low-cost index funds, so there are cheap mutual funds around.)

If an investor who believed in the US stock market just held a low-fee, diversified, passively-managed ETF like the SPDR S&P 500 ETF (expense ratio 0.09 per cent), he would have made impressive returns in the last three years. As at end-September, the three-year return was 22.8 per cent a year.

But what if you bought the SPDR Straits Times Index (STI) ETF instead, say, at the beginning of 2013? You would have a grand price return of exactly zero by the end of the year, and even be in negative territory during some moments this year.

This was because of the underperformance of stocks like the Jardine conglomerate as well as commodity stocks like Wilmar International.

Now, investors are thinking, it sure would be nice if the Singapore market ETF allocated more to DBS Bank, up more than 20 per cent since end-2012, and ComfortDelGro, up 40 per cent. Perhaps there can be a structure that trades on stock exchanges but functions like a stock-picking Singapore mutual fund?

TYPICAL MUTUAL FUND STRATEGY

Thus actively-managed ETFs were born. They are ETFs that, as their prefix suggests, have a portfolio manager to deviate from their underlying index as they see fit in order to generate better returns. The most famous among such ETFs are Pimco's Total Return ETF and Enhanced Short Maturity ETF. Both are still relatively small, with net asset values of a few billion dollars each.

Active ETFs have a problem. Because they are required to publish their holdings every day, other funds could "front-run" their trades. This means their strategies could be easily copied by others, leading to higher purchase prices once the trade is disclosed at the end of the day.

Fund managers BlackRock and Precidian Investments both tried to create a new type of actively-managed ETF that disclosed its holdings only quarterly. This arguably defeats the purpose of ETFs being transparent, low-cost products that investors buy into.

(Why don't they create a mutual fund instead? This could be because anything with an "ETF" attached to it proved to be overwhelmingly popular. Assets under management in the ETF space have grown from a mere US$74 billion in 2000 to US$2.5 trillion at end-September, according to research firm ETFGI.)

However, the two fund houses' applications were rejected two weeks ago by the US Securities and Exchange Commission, which worried that the public would not know what they were buying into. The story of actively-managed ETFs is not over, however. Other funds are also pursuing their cases for non-transparent active ETFs.

As for smart beta, well, this is the sort of name that confuses more than it enlightens. Beta refers to returns provided by the market. It is contrasted to alpha, which all fund managers seek. Alpha refers to excess returns above a market benchmark.

A "smart beta" ETF describes ETFs that attempt to make smart "alpha" returns while constructing a market benchmark, the "beta". This is something fund managers have sought to do for decades.

Following beta has problems. Benchmarks like the Straits Times Index (STI) are "capitalisation-weighted", placing bigger importance on the mega-cap stocks like SingTel and the Jardine stocks. If these stocks are overvalued, big falls subsequently could make the Singapore market appear worse than it actually is, and vice versa. The STI is not as accurate or representative as it could be.

Smart beta ETFs are still passive followers of an index. The "active" management comes in the construction of the index. A savvy fund manager could design indices according to fundamental factors like dividends, revenue, book value or cash flow.

So a "smart beta ETF" is somewhat more intelligent (read: expensive) than a boring index-tracking mutual fund or ETF.

An actively-managed ETF is even more actively-managed than a smart beta ETF. This is because managers don't just design an index and sit back to reap the rewards; they are involved in stock or sector picking, like they would be in a typical, non-index- tracking mutual fund.

How's an investor to make sense of all this?

Investors dream that other people can manage their money better than them. But this dream comes at a cost. Professional fund managers sound good in theory, but not so much in reality.

Active management began to lose its shine after the global financial crisis, when numerous managers underperformed their benchmarks - usually set against an index or indices that passive ETFs could easily replicate. Passive ETFs continue to see huge inflows.

Perhaps this is why fund managers are now going for "unconstrained" bond funds and "outcome-oriented" funds which do not have a benchmark to follow or a preset sector or asset class. Focusing on the entire world and on all asset classes, rather than limited areas, can provide more stability and freedom at the same time, they say. When life is tough, shift the goalposts.

Ultimately, when evaluating newfangled financial products, investors should still scrutinise whether they are paying more fees to take on more risk and complexity than necessary, for returns that might just be as elusive.

Shakespeare's Juliet once pondered whether a rose by any other name would smell as sweet. Investors looking for their Romeos should take note: a complicated financial product by any other name would smell just as bad.