The Intelligent Fund Investor: Practical Steps for Better Results in Active and Passive Funds

Review by Lodewijk van der Kroft, Partner at Comgest

Literature on investing exists in abundance and there has been a marked focus, over the past few decades, on the implications of behavioural biases in our investment decisions. However, books on fund (or manager) selection are hard to find and especially those written in a light-hearted style. 'The Intelligent Fund Investor' is such a book. The author, Joe Wiggins, has worked for several years as an analyst and fund manager, and is currently chief strategist for Fundhouse, an independent UK consultancy.

The book offers a guide to the beliefs and behaviours that will help an investor achieve long-term financial goals, while highlighting the dangers and traps that can lead one astray. In ten chapters, each followed by a ten-point fund investor checklist, Wiggins discusses a range of relevant topics, such as the risks of star managers: his advice is to run for the exit when the manager makes frequent, high-profile media appearances or starts to invest outside of her/his circle of competence. And why good stories make for bad investments: thematic investing is usually built on great supporting arguments; unfortunately, by the time the story is strong enough, most of the gains have already been made.

Of particular interest is chapter two *'The death of Active Funds has been (somewhat) exaggerated'*. According to Wiggins, passive management has some strengths but that does not mean active management is doomed, quite the contrary. The fact that passive funds have done much better than active funds in recent years is not only to do with costs.
The market also played a role. Wiggins goes on to explain that over the past 15 years, indices based on market capitalisation have outperformed equal-weighted indexes, especially in the United States. But looking back at rolling five-year returns, the author also identifies periods when you see the opposite: equal-weighted indices then outperform indices based on market capitalisation. This market condition is far more favourable to active management. Unfortunately, Wiggins does not present a crystal ball to anticipate these good times for active management, but does suggest adopting a 50/50 allocation to pure index and selected active approaches, which can be rebalanced yearly. The target weighting should only be altered if two thresholds are met: (1) The performance differential over five years between equal-weighted and market cap-weighted is extreme (+ or –20%) and (2) the valuation gap between the two is evident (a minimum difference of 20%).

In chapter three *'Smooth Fund Performance Conceals Risks'*, Wiggins questions the industry-wide view on volatility as a risk management tool and investing in private equity as a means to diversify away from market risk. He does not deny that there can be good reasons to invest in private equity but he is unconvinced that private equity holds up better during a stock market crisis than listed equities. He argues that the losses will be as severe (if not worse) as those in public markets; they might arrive just a little later – when the valuation models catch up with reality. After all, why should companies that are not listed be less risky than those that are? If they operate in the same sector, they are exposed to the same risks.

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In chapter seven *'Past Performance is a Terrible Way to select a Fund'*, Wiggins states that investors derive too much from past performance in assessing the qualities of active managers. Even the most skilled fund managers will have periods when they do worse than the market. Those periods can be long, sometimes years apart, but underperforming the market does not always mean the manager is incompetent. Smart investors look at the underlying process. Wiggins describes PROCESS as seven interrelated components – Path, Repetition, Objective, Calibration, Edge, Specification and Success – in an amusing parallel with golfing.

Wiggins' book provides ample food for thought, even for seasoned professionals, and can be best described by the quote he uses from Dutch mathematician E.W. Dijkstra: 'Simplicity is a great virtue but it requires hard work to achieve it and education to appreciate it. And to make matters worse: complexity sells better.'