Do you want to keep your financial cleft lip, forever?

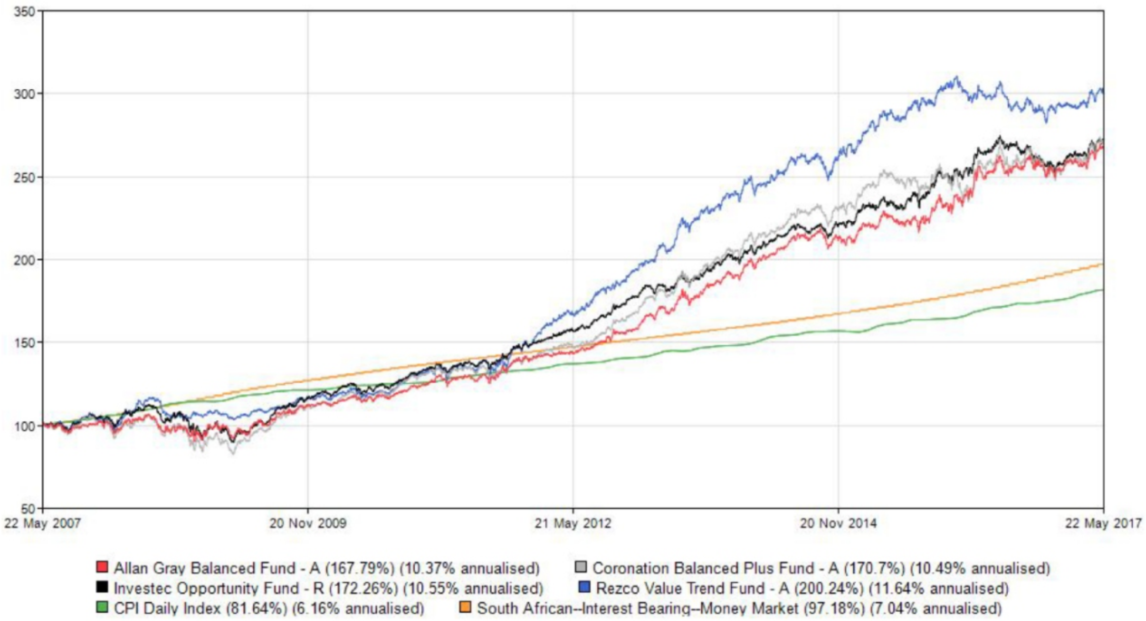
It takes about 45 minutes in surgery to repair a cleft lip. For the experienced surgeon, the procedure is relatively straight forward, but for the semi-dizzy, semi-nauseous bloke standing in the back of the room, the progress of the operation seems a bit discomforting. Even though the child that was brought into theatre had a malformed lip, 30 minutes into the procedure the child's face is now even more tattered, the skin on a big part of his face cut away and split apart. At this point in time, the promise of a new look with a repaired lip seems like an illusion.

Similar to my experience above when I first witnessed the process followed by a plastic surgeon to repair a cleft lip, investors (often those who invest in funds for the first time) experience the same kind of panic when their "operation" doesn't look like it is going according to plan. Referring to the last **12 months'** performance (or rather the lack thereof), my colleague received the following email from one of our clients, and I quote: "Is the monthly deductions from the fund managers justifiable, especially if they remain anonymous and I get ZERO growth on my investments? Do these people even know what happens to their clients? This "investment" story is just a money-making scheme, at the expense of the investor." I have a suspicion that these type of questions are doing the rounds quite frequently in financial advisors' offices the last couple of months. The emotions that investors feel however, are not rare or uncommon.

The investments that the client is referring to, is **Multi-Asset Class Funds**. There are currently around 169 funds in this specific category (South African Multi Assets with high equity exposure) and only a few were able to outperform cash over the last 12 months. This is also the unit trust category where you will find all the "big guns", i.e. The Allan Gray Balanced Fund, the Coronation Balanced Plus Fund, the Investec Opportunity Fund, etc. These are also the funds that most investors use for their pension savings. The average return of these 169 funds over the last 12 months (before advisor and platform fees) was a mere 3.43%. If you were invested in the top 4 funds in this sector (25% each) you would only have generated a dismal 3.36%, before fees. After fees, that would have been a return of around **2.36%** over the last **12 months**.

Back to the operation analogy. If the child's parents stormed into the theatre 30 minutes into the procedure, at the time when I almost fainted, and demanded that the surgeon stop what he was doing, on account of what they saw in front of them, what would the outcome have been? Unfortunately, with regards to investments, this is the behaviour that we encounter far too often from investors, irrespective of how many articles or in-depth discussions on the topic. To finish the story of the operation… During the last step of the procedure the surgeon starts to attach the three loose pieces of flesh and when he attaches the outer part of the lip (the part that was cut loose initially) it is like a zip that is being closed and voilà… The child's cleft lip is perfectly repaired. The precise outcome that the surgeon promised has realised even though a bystander, witnessing the operation for the first time, experienced disbelief at times.

Investments, or rather goal specific portfolio construction, work more or less in the same way. The long-term outcome is relatively easy to predict (in so far financial markets allow us) even though **short term movements** are **totally unpredictable** and can differ substantially from what we thought it would have been or what was indicated to us by our advisor or fund manager. If you have invested funds during the last 2 years, you are probably nodding your head as you read this. The graph below illustrates this point quite well.



Source: Allan Gray Research Tool

If you invested funds in the top 4 balanced funds a decade ago, after 4 years, you STILL would have thought that fund managers (and even advisors) aren't worth the fees that they charge, since these funds produced similar returns than a money market fund, but with a LOT more volatility. You'd be forgiven to have written a letter to your advisor similar to the one mentioned earlier. It is ironic that most so-called “long-term investments” are measured over short term performances, but if you can look beyond these returns and stick to your guns, the long-term picture (10 years +) looks quite different. These funds generated returns in excess of inflation + 4%, INCLUDING the meagre returns of the last 12 months. Should you have stayed the course with these managers you would have created significant wealth, whilst the opposite would be true if you switched your funds into money market 4 years down the road.

The following points are far from fresh, but STILL applicable in the times we are experiencing at the moment:

- If your portfolio has substantial exposure (more than 25%) to growth assets (like shares and property) you CAN expect to have frequent periods of declining values. These periods can be as long as 1 year, sometimes even longer.

- The larger your exposure to growth assets, the greater the impact and length of these periods of decline.

- Periods of decline are not avoidable by moving in and out of asset classes, except if you know when the decline is going to start and when it is going to end. There is no way around it, the only way is through.

The expectation that you can beat inflation over the medium to long term without experiencing periods of declines (which can last for a year or 2) is like thinking you can do a 500 km roundtrip without ever having to go up a hill.

Feel free to contact the Author, should you have any questions or comments on this month's article in the TwoCents.
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Just as the parents had to trust the surgeon's expertise, you have to trust the person that you appoint to manage your funds. The alternative is that you fully educate yourself so that you don't walk with a financial cleft lip for the rest of your life.

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