affinity capital

MAXIMISING VALUE THROUGH EXCELLENCE

Affinity Capital
Liberty House
222 Regent Street
London W1B 5TR

www.affinitycapital.co.uk/contact

020 7297 2816

Death by a thousand scratches: Is mutual fund money going to waste?

Introduction

Investment banking has a fairly short documented history, although the human propensity for preserving and generating wealth goes back many millennia. Today, investors are exposed to a phenomenal range of products and markets through mutual funds, but are these offering the best returns?

In Imperial China, convicts underwent a slow and torturous form of execution known as lingchi - or a 'death by a thousand cuts'. Tied to a wooden frame, prisoners would have flesh cut from their body in tiny portions over a long period of time until they died. It was also known as the 'lingering death'.

What does this have to do with wealth management? Well, investors may feel their experiences with mutual funds mirror this ancient form of torture in many ways. Encumbered with hidden fees, taxes, inflation and under-performing fund managers, investor capital can face a slow, painful and prolonged demise.

In fact, this isn't a death by a thousand cuts; it's a death by a thousand scratches. It is even slower, even more excruciating and less dignified than its historic predecessor. And the worst part is that it is often so subtle and so hidden that we don't even notice it is happening until the septicaemia sets in and it's too late. But what are the alternatives?

This whitepaper will provide a brief overview of the history and current state of investment banking before showing how clients can get ahead of the game by exploring wholesale structured investments.

A brief history of banking

The notion of banking actually precedes the invention of coinage, with the first banks set up in ancient Mesopotamia - an area of land roughly corresponding to modern-day Iraq, Kuwait and parts of Syria, Turkey and Iran.

Royal palaces and temples were used to store grain as far back as the third and fourth millennia. These institutions would issue seed-grain to farmers, who would repay the debt (with interest) from the upcoming harvest.

The Egyptians continued this trend, while also using banks to safeguard gold and other precious metals. In the heyday of the Greeks and the Romans, additional features such as foreign currency exchange and sophisticated money-lending activities were added. However, it wasn't until the Middle Ages that modern-style banks arose in the form of merchant bankers in Italy.

Jewish financiers fleeing Spanish persecution set up benches - bank is derived from the Italian word for bench (banca) - in the large piazzas of Lombardy to trade in crops. The merchants offered a variety of banking services including loans, insurance and holding deposits. Operations of this kind grew in size and expanded across Europe, eventually becoming the large-scale global institutions that we know today.

Understanding investment options

The rise of capitalism in the West has resulted in investment banking becoming a booming industry, within which a wide range of financial products are now available.

Whether it's stocks, bonds, exchange-traded funds (ETFs), mutual funds, derivatives or structured investments, people now have more options than ever before when it comes to wealth generation through investment.

First, it's important to establish what we mean by 'mutual funds' and 'structured investments', as we'll be looking at these two particular investment vehicles in closer detail throughout.

Mutual funds

A mutual fund is a collection of professionally managed stocks and bonds. The company overseeing the fund brings together multiple investors who pool their money and hold shares in various assets.

Mutual funds are usually advertised as a way to offer attractive returns for investors who lack the experience or time (or both) to pursue traditional investment avenues themselves.

Shareholders receive money through a distribution of dividends or interest gained on the fund's holdings. An investor can also earn profit if the value of shares increase and they or the fund manager decide to sell up.

Structured investments

A structured investment - or structured note - is a tailored investment vehicle that typically combines a low-risk bond element with a financial option.

The bond offers total or partial capital protection, depending on the investment, while the option provides a defined return based on the performance of an underlying asset.

Options are often referred to as 'derivatives', as their value is derived from the underlying asset. Derivatives may be linked to the performance of stock market indices, interest rates, currencies, commodities and more, as well as various combinations of these elements.

Affinity Capital
Liberty House
222 Regent Street
London W1B 5TR
www.affinitycapital.co.uk/contact
020 7297 2816

The mutual fund space

While it is difficult to accurately pinpoint the exact time at which mutual funds were invented, the idea of pooling resources and attempting to spread risk had become well established by the end of the 18th century.

Over the next 100 years, investment trusts - an early form of closed-end fund - were popular in European and US markets. The first open-ended mutual fund was introduced in Boston, Massachusetts in the 1920s.

However, the stock market crash of 1929 wiped out many of the highly leveraged closed-end funds, allowing the smaller open-end mutual funds to survive. Figures from the 2014 Investment Company Fact Book show there were $30 trillion worth of assets in the global mutual fund industry in 2013, half of which were held in the US and 31 per cent in Europe.

According to the latest Ernst and Young (EY) Global Wealth and Asset Management report, the mutual fund space reached an all-time high in 2013 due to capital appreciation in equity and balanced/mixed fund segments. On the surface, at least, mutual funds appear to be thriving - but is this the whole story?

Investors losing out

Given the popularity of mutual funds over many decades, many people may be surprised at how poorly they have performed against the market. Standard & Poor's Dow Jones Indices Versus Active (SPIVA) shows a staggering 86.44 per cent of US large-cap fund managers missed their mark in 2014.

Over five- and 10-year investment horizons, 88.65 and 82.07 per cent of fund managers respectively failed to deliver the returns they promised over the benchmark. The data for mid-cap and small-cap managers was nearly as disappointing, with 66.23 and 72.92 per cent falling short of one-year targets.

Meanwhile, investors are forced to pay a variety of hidden fees and costs that offset the gains mutual funds make. A 2011 Forbes article calculated that a non-taxable account generates costs of 3.17 per cent per annum, climbing to 4.17 per cent when tax is levied.

Facing underwhelming fund performances, pernicious fees, encroaching inflation and lacklustre professional management, it's no wonder EY's report also highlighted a drop in investor confidence.

What other investment options are there?

Structured notes can be considered the new kid on the block in the investment world. They became active in the UK, for example, during the early 1990s and have developed quickly in the intervening years.

As the market matures, structures now boast a variety of features designed specifically for investors who want the combined benefits of risk reduction, wealth preservation and access to major equity markets.

High-net-worth individuals, family offices and other institutional investors could be maximising their potential returns by exploring wholesale options in structured investments and derivatives.

Structured notes are incredible vehicles for achieving portfolio growth, and using the right skills, resources and industry partnerships, clients can experience significant benefits from this asset class.

Aren't structures and derivatives toxic?

The word 'derivatives' often conjures up images of the Lehman Brothers collapse, the Enron scandal and Warren Buffett's famous description of them being "financial weapons of mass destruction". Other common complaints are that structures are overly complex, too expensive and highly leveraged.

In fact, the media's depiction of structured investments and derivatives has been almost universally negative in recent years. Unfortunately, some of this bad press is deserved - like any investment class, structures can be structured inappropriately and mis-sold.

Structures first reached a peak in popularity in the UK between 1999 and 2001. Known as reverse convertible income products, they were originally sold as extremely low risk investments at a time when equity markets had been booming.

However, the FTSE 100 hit a bear market that began with the dotcom bubble bursting in 2000 and the index reached rock bottom in 2002. Investors who had previously been sold structures on the premise they were safe now saw some or all of their capital disappear as the underlying index plummeted.

At this point, the media ominously began calling these products 'precipice bonds’. The term referred to the steep edge that many investors found themselves looking over as their capital approached its risk limit.

Why invest in structures?

Understandably, given this toxic past, investors may be wondering why they should consider structures rather than other forms of investment? It's a fair question.

Firstly, since the global financial crisis and the collapse of major banking institutions such as Lehman Brothers, there has been a large-scale overhaul of how risk is assessed across many asset classes, including structures.

The Bank for International Settlements calculates there were $690 trillion worth of outstanding over-the-counter derivatives traded as of December 2014, showing they remain popular despite negative media attention. Mr Buffett's own Berkshire Hathaway portfolio received derivatives gains of $4.3 billion in the 2013 financial year.

Clearly, there is a disconnect between the popular perception of structures and derivatives in the media and the behaviour of the world's most successful investors who continue to make money from them.

A report by respected French higher education institution the EDHEC Business School states that structures should make up between 10 and 90 per cent of any investor's holdings, depending on their risk profile.

"Only the most risk-seeking investors would have a zero allocation for a structured product and invest 100 per cent in stocks," the school stated.

Avoiding a death by a thousand scratches

Educating yourself is a key part of becoming an informed and successful investor. Why pay the 3.17 per cent average annual fees for an equity mutual fund when nearly 90 per cent of fund managers are failing to meet their promises?

In many cases, there are hidden expenses tied to administration, advertising, taxes and transaction costs that make mutual funds an even less favourable investment over the long run. This is a death by a thousand scratches, as your wealth is insidiously eroded through encroaching fees and poor fund management.

On the other hand, investors with the right access to tailored financial services, strong partnerships and wholesale structures can avoid many of the pitfalls inherent to mutual funds.

Getting in at wholesale levels is crucial for HNWIs, family offices, insurance companies and other professional investors who want to benefit from the greatest returns.

Not only can you enjoy lower fees by cutting out the various middle men, trading structures allows you to benefit from pre-defined terms that can deliver positive results over a range of scenarios. This includes up, down or even sideways markets, with structures providing crucial protection in today's volatile political and economic environment.

Who can benefit from structures?

Many clients are missing out on the massive opportunities that structures present. This could be because they accept negative media coverage that the asset class is opaque, dangerous and plagued with hidden fees.

The reason may simply be that institutional investors feel they lack the in-house skills, technical knowledge and industry partnerships to approach structures in a confident, meaningful way.

In fact, senior decision-makers sometimes have very little experience in the structured investments space. This is because notes only came to prominence in the 1990s - decades after many top executives started their careers.

Unfortunately, when senior managers are not familiar with structures and have no colleagues in the industry with relevant experience, this can sometimes lead to an avoidance strategy that could hamper client portfolios.

However, don't be afraid to keep up with the times. Outsourcing expertise in the area of structured investments can be a key way to benefit from the asset class even for those lacking the skills internally.

A safe pair of hands can provide essential support that helps investors overcome many of the problems they face when dealing with structures. The right partner will act as a guide that can structure a bespoke offering, handle key administration needs and negotiate the best terms with issuers.

Affinity Capital specialises in the world of structures and derivatives. We deliver true value to clients through a combination of extensive experience, the latest IT infrastructure, state-of-the-art pricing models and key relationships with the world's biggest investment banks.

We are in the very fortunate position of being able to select the strategic partnerships that we prefer to work in and typically our choice partnerships tend to be with family offices, discretionary fund managers, private banks and high-net-worth professional investors.

Affinity Capital
Liberty House
222 Regent Street
London W1B 5TR
www.affinitycapital.co.uk/contact
020 7297 2816

Conclusion

Investment banking has a rich and storied history, with mutual funds experiencing significant growth over the decades. However, underperformance, inflation and a multitude of hidden fees mean these funds regularly fail to deliver on their promises to clients.

Despite negative media coverage, structured notes have remained popular among some of the world's highest-profile investors over the last 25 years. In the right hands, this nascent asset class can provide significant advantages for those who want to manage risk while still growing their portfolio.

Furthermore, investors who have access to the best advice, wholesale pricing and lower fees can achieve even more success with structured investments by benefiting from outcomes that are pre-defined, transparent and tailored to unique investment profiles.

Why suffer a slow and painful death by a thousand scratches when you can start growing your wealth and optimising your investment portfolio today?

Affinity Capital
Liberty House
222 Regent Street
London W1B 5TR
www.affinitycapital.co.uk/contact
020 7297 2816