A Bird's Eye View
Sparrows Newsletter

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John had waited for this meeting with his wealth manager for a while, and felt that each time he had requested a meeting his advisor was deliberately postponing the appointment. He felt that Alan H., not to name him here, had a peculiar way of dealing with his client's request and was cooking something up.

But after the meeting, John was confident. As always, he had enjoyed the Colombian coffee, and the cosy, and probably very expensive, armchair that sits in Alan's office. He also felt strong enough to finally take the step he had been dreaming of for a while and fire his so called trusted adviser! Which is exactly what he did the following morning, over a brief phone call, in the same way his advisor has been disrespectfully dealing with him.

John had had enough. He had been trying to protect his wealth for years, worried about his own health and making sure that the effort he had put in throughout his life to build it would not be destroyed by the next storm, and would be passed on to his children and grandchildren. Unfortunately, that's almost the exact opposite of what Alan had been doing in the last few years. Although Alan was highly regarded by his peers and produced credible recommendations, John was unimpressed. He had watched and prayed when Alan lost a third of the wealth John had entrusted to him, and started to get really angry when Alan told him that he was not allowing any of his investors to access their own money for at least twelve months. In the end Alan had recouped part, but not all, of the losses but had now reverted to the frantic buying and selling that was his trademark.

John had never understood what Alan was doing, but procrastination or inertia stopped him from doing anything about it. Alan even told him one day that investing in China was "a no brainer". So one should buy anything there. However, as Alan once said "let's not be the suckers who just follow the masses; let's be smarter". So he bought a CDS, hedged the currency with a cliquet option, and made a binary bet on some now infamous companies.

That day Alan might as well have dressed in Chinese clothes and spoken fluent Mandarin, since John really didn't understand a single thing his adviser was talking about. It was a scary experience.

John was delighted not to have to deal with all this nonsense any more. It had been a while since he heard about the concept of passive investing and decided that was the way to go. And since passive was passive, he would just do it himself. No need to pay anyone for that. No need to be told off again over the phone or patronised (Alan surely thought of him as a sucker anyway). No need to go through all these reports that he couldn't understand either. Passive investing is simple so I just need to buy a few ETFs and I'll be OK, he thought. "Nothing could be worse than Alan!" he shouted to his wife when she started to worry about the prospect of John investing their wealth. She remembered the years when they almost went bust and John reinvested in their business the only money that was left! She still had nightmares about it.

Many individual investors, including professional experts of course, have taken notice of ETFs. The amount of money invested in these funds has more than quintupled over the past five years. The number of existing ETFs has skyrocketed at the same pace – investors now have hundreds from which to choose. That number is still pretty small compared to the thousands of mutual funds that exist, but it is a lot of growth. And there are hundreds more on the way. John felt that investing in such a growing industry could only benefit him.

About three months later, having finally wrestled his money back from Alan, it was time for John to put passive investing into practice and he started to look at investment opportunities online to build his portfolio. He remembered Alan telling him how finance is changing and how today you can get everything online (probably another excuse to explain why his costs were so high, due to the new internet portal they were building for clients!)

So John opened his iPad and started to google for ETFs. The first name that showed up on the search result was iShares.com, an ETF provider. A few clicks and John realised that you could not directly buy the ETFs online! And between the cookies policy and the pop-up windows that open to ask you to fill in a survey while you haven't even started to navigate the website or bought a single ETF yet, it took him half an hour to finally find the page where they display the list of ETFs available.

What immediately struck him were the names of the ETFs.: "Core", "Alternatives", "Smart Beta", JP Morgan UCITS", "Aggregate Bond hedged", and "Index Linked Gilts" which he liked since he reckoned it was probably related to gold. He had always wondered why the financial industry had a need to create words only they can understand.

Back to Google, he went on to look at the websites of other providers and had the same knee-jerk reaction. Some of the ETF names were truly incredible: ETFS DAILY SHORT LIVESTOCK DJ-UBSCISM, DB ENERGY BOOSTER ETC (which he thought was investing in Energy drinks), PS FTSE RAFI ASIA PAC EX-JAPAN UCITS ETF, SPDR S&P US DIVIDEND ARISTOCRATS UCITETF (was probably reserved for an elite group of investors), SOURCE JPM MACRO HEDGE DUAL UCITS ETF, etc.

After two hours of surfing the web and going through the never ending list of available ETFs, he was relieved when his wife called him for dinner. Of course, his wife then asked him how the passive investing thing was going. He told that everything was under control and tried to change the subject. John was concerned to see that he was now talking to his wife in the same way his advisor had been talking to him. He didn't sleep well that night.

Not willing to give up yet, he spent the following day online again, trying to make sense of all these beautifully designed websites that really say more or less the same thing about ETFs. After going through another list of exotic names, he soon realised that having a list of names and ETFs he would invest in would not be enough. He would also have to figure out how his selected list of ETFs would work together.

As he couldn't pretend anymore to his wife that he was a master in passive investing, John described to her all the issues he had so far encountered. As usual he wasn't surprised to see that she was able to find a very powerful analogy. "Well darling, it's easy! When I cook I have to carefully select my ingredients, where they are from, and pick them myself, and also make sure that I put the right proportion to prepare a great dinner, you'll just have to do the same with your ETFs!". Trouble was, she had been into cooking for years and had even taken lessons from professional chefs!

"Ok I'm going to do this thing" said John to himself. He decided to take a course on financial markets, and registered here. Soon he decided that this one was just way too complex for him, so found another one here.

Months later John was still reading and trying to understand what the Efficient Market Hypothesis was, and what is an asset allocation. He now knew that ETF selection requires an assessment of the provider, methodology, liquidity, basis and tracking error, and yield. He had grasped that an ETF is an instrument which tracks an index so had to read a lot on index providers. He had developed a view that the key aspects of index construction methodology critical to producing a superior index include:

- Objectivity. An index should be maintained according to an objective set of rules that leave virtually no doubt or ambiguity as to whether particular stocks warrant inclusion in the index.

- Adjustment for "float.": an index should weight its holdings in a manner that reflects the amount of a stock's "float," or availability, in the marketplace.

- Approach to market capitalisation. For indices that focus on companies of a particular size, the cut-offs between small-cap, mid-cap, and large-cap companies should be defined as overlapping bands rather than fixed lines.

- Approach to "value" versus "growth". Shares should be analysed for inclusion in a value index or growth index by using multiple criteria.

- Approach to rebalancing. All index providers periodically rebalance their indices by adding or dropping shares to ensure the indices continue to measure their designated market segments. Gradual and orderly rebalancing enables index funds to manage their transaction costs from portfolio adjustments in much the same manner as other investors.

John still hadn’t invested any of his money yet as he was still getting to grips with the complexities of a field he had initially thought was as easy as doing almost nothing.

To Be Continued……

Fahd Rachidy

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