Big vs Small

Principles of DIY investing

Alan Kohler's

The Constant Investor

Foreword

I started The Constant Investor really for the DIY investor, those with a keen interest in managing their own investments and looking for information that gives them insights into companies they may invest in and the financial and economic markets that may impact them. My aim is to help by providing TCI members with a clear, unbiased and easy to understand analysis that they can use in managing their investments. From time to time I call upon colleagues and friends to share their own expertise with our members. My friend Peter Guy is one of the most successful DIY investors in Australia and has written a very fine, quite long, essay exclusively for members of The Constant Investor.

I've always regarded Peter as Australia's Warren Buffett. He's more of a quiet achiever than Buffett, and certainly not as rich (I think!), but he is definitely the best Australian stock picker I know and the deepest thinker about investing.

He started life as a stockbroker and then went to work for John Nolan's JANA Asset Consulting, before retiring to invest his own money.

I've been trying to get Peter to write for me for years, but he's always been too busy quietly achieving, so I'm delighted that he has taken time, quite a few weeks in fact, to write this essay for us.

A few highlights to whet your appetite:

"Market timing is extraordinarily difficult and asset allocation has been described as 'slow-motion timing'."

"I'm not smart enough to skate to where the puck is going, so I don't invest in manufacturers with short product life cycles."

"...for me the case for concentration is compelling."

"The DIY'er, when listening to talking heads on financial markets TV programs rabbit on about over-weight and under-weight, see that as insto speak and not a guide to how he should think. The DIY'er never has to worry about stocks he does not own. He has no benchmark 'career risk'."

I hope you find it as interesting a read as I did and that it provides some interesting ideas as you travel your own path as a DIY'er.

Cheers

Alan

Disclaimer:
The content provided in this ebook from The Constant Investor is for information purposes only. It is not intended to be nor should be relied upon as financial advice. The Constant Investor does not take into account your objectives, financial situation or needs. Before making any investment decision, you should consider whether it is appropriate for you and read any Product Disclosure Statement or other offer document or seek professional financial advice. For more information please read The Constant Investor's Financial Services Guide in full at www.theconstantinvestor.com/about/fsg."

Big and Small

There are almost 600,000 self-managed super funds (SMSFs) in Australia, with an average size of $1.17 million. That aggregates to $702 billion or about 28% of the total super pool. The other 72% is made up of industry funds, retail funds, public sector funds and corporate funds.

Compulsory superannuation began in 1992 and this has led to explosive growth in the superannuation pools. Especially in the growth of industry funds which are the "default choice" for where the compulsory super goes. "Default choice" simply means that if an employee does not direct where his or her super contributions go, they go to the industry fund related to his or her employment.

The biggest fund in Australia happens to be the Future Fund. Australia's "sovereign" fund. It was established in 2006 and has approximately $160 billion in assets. It is chaired by former Treasurer Peter Costello.

This essay is directed to the beneficiaries of the SMSFs, who I call the DIY'ers. The Do It Yourselfers. I am a DIY'er. Even though $1.17 million is a handsome sum, believe me that you are an investment pygmy in a land of investment giants. The DIY'er whose super fund is largely invested in a property, perhaps leased to their business, might not be much interested in my observations here which are principally directed to DIY stock market investors.

Here are some numbers on the giants. Second to the Future Fund is Australia's largest industry fund AustralianSuper with over $120 billion; UniSuper has around $62 billion, REST $50 billion, Sunsuper $47 billion. HESTA $41 billion, CBUS $40 billion and on it goes. There are huge public sector funds such as QSuper with $65 billion and First State Super $57 billion. The largest of the corporate superfunds is Telstra's with over $19 billion.

To give this some perspective, Australia's largest company by market value is the "Big Australian" BHP with $157 billion, followed by the 4 banks, CBA $140 billion, Westpac $107 billion, ANZ $85 billion and NAB $80 billion.

There are serious questions that arise from the explosive growth of superannuation generally and of industry funds in particular. The questions or issues include board make-up of industry funds (which is inconsistent with how their investment managers are directed to vote on corporate governance), default choice and questions of transparency generally. In October, Peter Costello floated the idea that his Future Fund should become the default choice, rather than the industry funds. He said that the Future Fund benefited from greater economies of scale and had access to superior managers.

Rather than get into any of those issues in detail, there are two purposes of this essay.

Firstly to give some flavour of the investment landscape in terms of how different players invest in the stock market: DIY'ers, professional funds managers, passive investment funds, the monster funds and their asset consultants. They all look at the stock market through different eyes. And to secondly indicate whether the playing field is tilted in favour or against the DIY'er.

Big and Small

1. The size of one's investment universe, investment choice

It is generally understood that size is the enemy of investment performance, (Mr Costello perhaps dissenting!). There are numerous aspects to the size disadvantage (or small size advantage if you are a DIY'er). There are just under 2,000 companies listed on the ASX. I remember many years ago being struck by a comment from one of Australia's largest funds managers. He said that his funds under management were so large that his investment universe was limited to 35 listed Australian stocks. Accordingly, he was forced to invest overseas. The bigger a funds manager gets, the smaller becomes his investible universe. He will not want to own too many stocks, and as he gets larger he will be faced with liquidity constraints and the ability to move in and out of positions without influencing the price. A famous US funds manager, Bill Miller (of Legg Mason) had a rule of thumb that he should not invest in a company with a market capitalisation less than his FUM (funds under management.)

Think of a funds manager, managing say $30 million. Let's say he owns 10 stocks ($3 million in each) and that he does not want to own more than 5% of a particular company. This means that he can only invest in companies with a market cap of $60 million or more. If his funds under management grows to say $100 million, then he has a number of choices, all of which will likely detract from performance. He could stick with 10 stocks and his 5% ownership rule, thereby meaning he could only invest in companies with market caps greater than $200 million. Or he could expand the number of stocks owned and from his 10 best ideas expand say to his 30 best ideas. Or he could abandon his 5% rule and increase his holdings in existing stocks, likely paying higher prices to do so.

Rob Ferguson, former managing director of BT Australia (at the time BT was a huge force in Australian funds management) used to use a horse racing metaphor to describe the disadvantage of assets size. He said that to handicap horses they put lead in the saddle bag and that the lead in the saddle bag of a funds manager is money.

A wonderful New York investor I know uses what he calls "biblical terms" to describe the phenomenon. "Success begets size. Size begets mediocrity."

Warren Buffett has long pointed out the "huge structural advantage not to have a lot of money." Elaborating, he has said that "the big minus is that our performance advantage has shrunk dramatically as our size has grown, an unpleasant trend that is certain to continue … There are 3 connected realities that cause investment success to breed failure. First, a good record quickly attracts a torrent of money. Second, huge sums invariably act as an anchor on investment performance. What is easy with millions , struggles with billions. Thirdly, most managers will nevertheless seek new money because (of) more fees."

Now take an industry fund which may choose to commit $20 billion to equities. Whether the fund has internal managers that do the investing or whether they employ external managers to do it, or go for a combination of both, they are almost certain to be confined to huge caps, monster caps and be global. That is required by the sheer weight of money. A small cap manager managing say $200 million in small caps, is almost certainly of little interest to the huge fund because the huge fund needs scale to "move the needle". A huge fund would not likely want to constitute a large percentage of an external manager's assets under management. For example, giving him another $200 million would possibly destroy the manager's investment performance and it would create an unhealthy single client dependency. So it is very unlikely. So the big funds almost invariably go for scale. And scale means big cap. Very big cap. And very big cap means a very shrunken investment universe.

Apart from the fact that the DIY'er has a much larger investment universe, the smaller end of the market is the less efficiently priced segment of the market. Dozens of buy side and sell side analysts pour over the large caps which are far more likely to be efficiently priced, meaning fully priced, or over-priced. So, in the share market, the DIY'er is faced with more choice and cheaper choice.

2. Diversification

How diversified should a DIYer's portfolio be? Warren Buffett's mentor, Ben Graham advocated diversification and saw it as the second safety net after the first safety net of margin of safety. Simply put, buy shares at a significant discount to intrinsic value (that is a significant margin of safety) and diversify because you are likely to make mistakes and you insure against mistakes through diversification. Buffett though strongly advocates concentration, and one of his oft quoted comments is: "diversification is protection against ignorance. It makes little sense if you know what you are doing". Which begs the question posed at the start of this paragraph. How diversified should a DIY'er portfolio be? Over-diversification goes beyond the insurance benefit of diversifying, it entails investing in inferior ideas and detracts from management time. Under-diversification simply entails more risk.

Buffett has certainly championed what is called "concentrated investing". He now manages many hundreds of billions but has said that "if I were running $50, $100, $200 million, I would have 80% in five positions, with 25% for the largest". Ben Graham said 10 to 30 was a sensible range. Seth Klarman, a much admired US value investor said 10 to 15. Although I don't much like Buffett's "protection against ignorance" comment, I do like this reference to 5 stocks being 80%. And the largest being 25%. I think that five holdings is too concentrated for my liking but I do like the implicit 20% "other" basket because I tend to have a number of small positions consisting of beginning positions, stale positions, and stocks where the price has gotten too high resulting in an under-sized stake. I also think 25% in one stock is a bit too concentrated, too risky for me, but ***I am very much in accord with unequal weighting in diversification, meaning simply that all ideas are not equal and you put more money in your best ideas.***

Having said all that, which gives you an indication of the degree of diversification advocated by three of the all-time greats, it perhaps should be acknowledged that some outstanding investors have managed very large portfolios. Peter Lynch is said to have owned up to 1,500 stocks. A Lynch protégé is current Fidelity funds manager Joel

Tillinghast, the author of recently published "Big Money Thinks Small", a very fine book on value investing in which Tillinghast admits to owning 800 stocks. I have met an outstanding manager who owned 300 stocks. So it can be done but probably only by a manager having sub-managers.

How many hours in the year do you get to devote to a single holding if you own 800? Buffett has said that if you have a harem of 40 women, "you never get to know any of them very well".

So, DIYers can draw their own conclusions and cater to their chosen investment approach and propensity for risk, but for me the case for concentration is compelling.

Now what about the big end of town? Funds such as industry funds with tens of billions to invest will typically start with determining what asset classes they will invest in, then move on to the "allocation" decision, how much to allocate to each asset class. They will then determine how much will be managed internally versus through external managers and then they will appoint and manage the external managers. To assist in this process, they may engage an "asset consultant", such as (Australia's largest) JANA Consulting which advises industry, public sector and corporate funds with some $350 billion in assets.

Traditionally the asset classes were: equities, fixed interest and property. This breaks down to sub-categories such as small cap, big cap, foreign and domestic equities, foreign fixed interest and domestic fixed interest, and investing in real estate directly or via listed REITS, both foreign and domestic. Today there are other asset categories such as infrastructure, private equity, agriculture and a host of other "alternative" categories. That final category of "alternative" might sound vague but I have two such investments which could be so described. An investment in a "water" fund and an investment in a "purpose built student accommodation" fund. And I am contemplating investing in a litigation fund.

Just for a moment consider the enormous complexity in such a widely diversified multi-billion dollar fund, invested domestically and globally across a spread of asset classes. Think of all the global macro economic factors that have to be taken into account making currency and asset class decisions. Market timing is extraordinarily difficult and asset allocation has been described as "slow-motion timing".

Those believing in the "kiss principle" not only might have a leaning towards DIY, but they might even have some sympathy for the big end of town brethren confronting the cerebral challenges of managing a massively diversified global fund!

3. Circle of competence

This expression was coined by Warren Buffett and is hugely important. ***Invest in what you know, in what you understand. By all means try and expand your circle of competence, but above all, know where the boundaries are. If you go beyond the boundaries, you are speculating, not investing.***

I look at investment risk in two parts. Firstly, there are the risks faced by the company in which you invest such as the risk of technological or competitive disruption, the risk of a key manager leaving, the risk of having too much debt. Then there are the risks you take as an investor and there are essentially two. The first is over-paying and the second is investing outside of your circle of competence.

Fidelity manager Tillinghast writes about "circle of expertise" which would be at the centre of one's circle of competence, and he writes about investing out nearer "the edge" of the circle of competence. I like that articulation. A DIYer who is very knowledgeable in residential real estate, for example, might have his fund heavily invested in properties about which he knows a very great deal – an asset class right in his circle of expertise. An investor knowing a lot about aged care might be sensible in having a substantial investment in the various sectors encompassed within aged care.

The concept of circle of competence is also useful when thinking about companies. They too have their distinctive competency or competencies.

Now turning to the concept of circle of competence and the huge multi billion dollar funds. This is a different ball game. But the concept remains relevant. Before making a few points about circle of competence at the huge, monster fund end of town, I perhaps should give some brief information on my background, and the vantage point I had in observing the behaviour of large funds and large funds managers.

The largest asset consultant in Australia is JANA Consulting. It is named after John Anthony Nolan, its founder over thirty years ago. I was its co-founder and a director at its inception. I remained its second largest shareholder until it was acquired. John was my business partner from the mid-80's until I retired in 2010. We shared offices that whole time. Now I make no claim whatsoever for the success of JANA, but I had a ring side seat and am well placed, perhaps even better than anyone else other than John, to understand why it became massively successful, at least at the start.

In the early days, John had excellent advice from two first class people. One was Bruce Cook, the then head of an actuarial firm which became Mercers. In the 1980s, superannuation was dominated by defined benefit corporate funds, and Bruce headed the biggest "liability consultant" in the country.

Then there was Budge Collins, an American who evaluated funds managers in the US where funds management was far less concentrated than Australia. There were many hundreds of boutiques in the US and Budge toured the country evaluating them for the benefit of his large institutional clients. Budge had devised a checklist scoring approach to assist in the comparison of funds managers and supplementing that of course he considered a host of qualitative aspects. John accompanied Budge on some manager visits, as did I. The importance of experience in investing cannot be exaggerated. Budge's experience, combined with his huge generosity, was invaluable. And I am thrilled to say, I still benefit from that today.

John criss-crossed Australia, one by one securing many of Australia's largest corporate funds as consulting clients. The ground work of an extended client base was in place by the time compulsory super, which gave rise to the monster funds we have today, was introduced in 1992.

At the time of JANA's founding I was a stockbroker, but one who was far more interested in investing than in broking. John arranged for me to become equities consultant to one of Australia's largest superannuation funds, one that John had chaired before leaving to start up John A Nolan & Associates. This fund invested through both internally employed funds managers and external ones. The fund had three external consultants, one a fixed interest specialist, one a property specialist and yours truly as the equities specialist/consultant. I use the term "specialist" because I don't much like the term "expert". Subsequently, John urged me to become a funds manager, which I did, eventually within a boutique funds management firm where John worked after leaving JANA.

Of the many things I learnt watching JANA evolve and succeed, there are two quite simple but important observations that should be made that are relevant to the "big versus small" theme of this essay. I loved and was passionate about investing in equities, had only a moderate interest in property investing, and found fixed interest investing mind numbingly boring. John, however, was that rare bird who was intensely interested in all asset classes. If I sat in on a discussion on bond duration, I'd be struggling to stay awake; John would be riveted.

Another important observation is that John (essentially) was not an investor, he was an evaluator of investors. The same could be said of Ken Marshman, the brilliant successor to John and today's JANA Chairman.

I think of two analogies to illustrate this. Think of an art critic who may not be a great artist himself, but who is a great evaluator of art. Or a conductor of an orchestra. The conductor may not be able to play all the instruments in the orchestra, but he certainly understands the quality of each member of the orchestra, as well as how they must blend together. This is not to suggest that John and Ken could not be hands on, direct equity managers for example. But that was not their career paths. In the more than thirty years since JANA's founding, John has flown around the world countless times, evaluating managers of all types. I am as sure as I can be that his breadth of knowledge of global funds management is unmatched in Australia, although Ken may by now be his equal.

They have extensive knowledge on all asset classes and vast experience in the evaluation of funds managers. Which is different from having been a funds manager.

How does this relate back to the subject of huge superannuation funds and circle of competence? I'd make two points. Firstly, the number of people who are highly skilled across multiple asset classes are very thin on the ground. And secondly, whether a huge fund chooses to manage money internally or use external funds managers, or a combination of both, those managers (internal and external) have to be evaluated, appointed and managed. Hugely challenging, but vital competencies to have.

4.The complexity of technology and global macroeconomic forecasting.

There are some investing expressions which you might find irksome because they make you feel inferior. Canadian Wayne Gretzky is apparently the greatest ice hockey player who ever lived, but he is not well known in Australia where the game is not played. Which has denied us common use of a cliché. "I skate to where the puck is going to be, not to where it has been". A line used by no less than Warren Buffett. Another expression is "ahead of the curve". And there is "technological illiteracy". I have been told that the new financial illiteracy is technological illiteracy.

Belabouring the point, do you have a handle on blockchain, bitcoin, robotics, 3D printing, nanotechnology and artificial intelligence? We are indeed in a world of rapid disruptive technological change. It's also worth noting that disruption can occur, not just from new technologies, but from the adoption of existing technologies within new business models, Uber and Airbnb being two examples.

A Hong Kong based funds manager, who I believe is very good, made the following comment to his clients in a recent "outlook" review. "As investors, we try and take the long view and use the best information available to intuit the disruptive technologies that are coming, and how they will affect the incumbent leaders of industries". He did not say "forecast". He said "intuit". Maybe he is technologically very savvy and maybe he is highly intuitive, but it is still a robust claim.

Extending from technology to the global economy, were you concerned about Grexit and Brexit at the time, have you considered the implications of the US Federal Reserve increasing interest rates four times in the next 12 months? Is this the beginning of interest rate normalization after many years of central bank manipulation of rates to historic low levels? And to what level might rates rise in Australia and over what time frame?

So do you skate to where the puck is going? Are you ahead of the curve? Are you technologically illiterate? Is your global macroeconomic crystal ball in good nick? If you are a DIY'er and your answers were: no, no, yes to a significant degree and no (which are my answers), be aware but do not despair. (If you a director of an investment fund investing tens of billions, you might sensibly have serious concerns about the technology and economic environments, and your "intuiting" competence).

Amazon has just begun establishing warehousing and distribution infrastructure in Australia, bringing a huge new competitive threat to many established retailers, with Jeff Bezos salivating at their profit margins. One observer described the arrival of Amazon in Australia as like a new species being introduced into the Galapagos. Which is ironic because a simple quote from Jeff Bezos is pretty good advice for the prudent DIY investor. "Because technology changes a ton, what I focus on is what won't change".

I'm not smart enough to skate to where the puck is going, so I don't invest in manufacturers with short product life cycles. One can see technology companies enjoying great success, but, as a US funds manager recently put it, "nothing endures in tech" and they have "unknown life spans". Now it may well be that companies like Alphabet (which owns Google), Facebook, Netflix and so on have such embedded customer bases with powerful network effects so that they are impregnable to competitive threat and erosion. But to own those FANG stocks, as they are called, grouped with Amazon, one has to pay huge multiples. An internet search told me that Amazon's P/E is 224.

What won't change? I think owners of certain infrastructure assets such as roads and airports are pretty safe. Many service businesses will be less prone to change. For example, funeral services. A never ending supply of inventory. And people will continue to die irrespective of a booming economy or an economy plunging into recession. Businesses in aged care and pet care have to adopt new technologies, but they are not faced with imminent technological obsolescence. People have to eat and drink; food and alcohol businesses may prove to be resilient choices.

They are businesses that in large part are insulated from technological obsolescence. I also like the expression "insulated from the macro" meaning a business should prosper irrespective of global or domestic economic conditions. There are many businesses which are largely non-cyclical and which will continue to survive and maybe prosper in all economic conditions. So I tend to see "the puck" metaphor, in reverse, as one of economic, competitive and technology threat, not as an opportunity.

So for me it makes sense to skate to where the puck is not going. Get out of the road. Invest in what you know. Play it safe.

Now back to big versus small. The small DIY'er, with his 10 or 15 stocks has flexibility, manoeuvrability to try and position his portfolio to be insulated from the technology and economic unknown. This is not to say that a DIY'er should put his head in the sand and not pay attention to economic and technology developments. He should try but simply be realistic about the enormous difficulties in economic and technology forecasting.

The monster funds with their tens of billions are simply less flexible and cannot escape having to try and forecast the unforecastable. They can tweak their asset allocations but they simply cannot eliminate exposures and confine investments to safe havens as can the small fund individual investor.

5. Mind-set: absolute return investing versus relative return investing.

Funds managers are typically benchmarked. Which means their investment performance is measured against an appropriate index. It might be the Australian All Ordinaries Accumulation Index. Or a smaller sub-set of it. Under-performance against benchmark can result in loss of FUM and out-performance can garner more FUM, and the fees that go with it. Funds managers sometimes refer to this as "benchmark risk"; it has also amusingly been described as "career risk".

Now let me describe two hypothetical funds managers. These are not descriptions of any actual manager. They are for illustrative purposes only.

Funds manager A is a Fifty Leaders specialist. He will only invest in stocks in the 50 Leaders, and he must remain fully invested, or close to it, at all times. So if he believes the market and his stocks are over-valued, he is not free to go into cash. He is mandated to remain by and large fully invested. The decision to go into cash is taken by his, typically large, institutional investors and they would do that at their investing fund level. So if the investing institution thought the share market was over–valued, it might redeem from the funds manager, not ask him to go into cash.

He will unlikely invest in all 50. He will look very closely at the index weightings of all 50 stocks and he will juxtapose his portfolio against the 50 Leaders portfolio, closely monitoring his "over-weight" and "under-weight" positions. He lives and breathes overweight/ underweight.

For example, the 4 banks comprise over 30% of the 50 Leaders Index, which like all of the Australian indexes, is market cap weighted. Will he be over-weight or under-weight the banks as a class and how will his individual bank holdings perform, relative to index. If he chooses not to own CBA, the largest of the banks, and to only own the other 3 banks, his performance will be hurt if CBA is the outperformer of the 4.

If the 50 Leaders Index has a bumper year and is up 20%, and the funds manager is only up 15%, his 5% under-performance is serious and could result in loss of FUM. If the 50 Leaders are down say 15% in a financial year, and funds manager A is only down 11%, then he has significantly out-performed his benchmark and this might attract more FUM.

I have seen funds managers ask each other after a big monthly move in the market – how did you go? And the question was implicitly – how did you go relative to index?

On an annual basis, would a benchmarked manager rather have a +15% against benchmark of +20% or would he rather have -15% against a -20% benchmark? You decide the answer. He is motivated to make relative returns, not absolute returns.

Contrast that with the DIY'er. You say to your wife: we just had a great year. We were only down 10% when the market fell 20%. Let's celebrate. We only lost 10%. Celebration would more likely occur with a 15% gain, even if the market was up much more. DIY'ers seek absolute returns. DIY'ers are typically highly loss averse. They will (perhaps I should say "should") sensibly go into cash if they believe the market is over-priced.

There is another huge difference between the benchmarked (relative return) professional funds manager and the DIY'er. The benchmarked funds manager will worry about stocks that he does not own.

"I don't own Woolworths, and it is the best performing stock in the 50 leaders. My zero weight non-position is killing me", might be a lament of a benchmarked, relative return funds manager! The DIY'er simply does not worry about what he does not own.

Funds manager A also has to keep a sharp eye out for index composition changes. The indexes get adjusted quarterly, and if a current position is removed from the index, he is forced to divest. He also has to research new companies that he thinks are set for index inclusion.

One also has to ponder how Funds manager A copes when he believes he owns a lot of stocks which are overpriced and should be sold. Being required to be fully invested, he can't go into cash. Weighting the portfolio to the least over-priced stocks would seem a logical response.

Now consider funds manager B, who is benchmarked against the Australian Small Ordinaries Accumulation index. As mentioned, there are almost 2,000 stocks listed on the ASX. 489 are in the All Ordinaries Index. The ASX 300 is the next broadest index. In market cap terms the 50 Leaders Index is 76.9% of the market cap of the ASX 300.

The ASX defines as "Small" the bottom 200 of the ASX 300. That is stocks 101 – 300. Stock number 300 would be the smallest stock in the Small Ordinaries Index, but note that there are hundreds and hundreds of many smaller companies listed on ASX but which are not included in the "Small" Index. They are sometimes described as "micro". So there are lots of companies with market caps around or in excess of $100 million which are not included in the Small index.

So funds manager B is benchmarked against the Small Ordinaries Accumulation Index. Stock number 101 at the time of writing is Auckland International Airport Limited. It has a market cap of $A7.3 billion. Hardly "small". However, its inclusion in the Small Ordinaries Index is based on the market value of what is deemed the portion of the company owned and traded in Australia. So it has a current "weighting" of $487 million in the index. This illustrates the point that there are some biggies in the Small index. I counted 66 out of the 200 with market caps in excess of $1 billion. The smallest (Stock number 300) had a market cap of $135 million.

Manager B, benchmarked against this index, which is market cap weighted, decides to lessen "benchmark risk" by choosing 85% of his portfolio from those 66 $1 billion+ market cap stocks, and stock pick for the remaining 15% of the portfolio from the sub-$1 billion group. This is a hypothetical "example", described solely to illustrate how a benchmarked manager might, in striving to beat his benchmark, be heavily influenced by index weightings in his stock selections.

Are benchmarks appropriate if they distort stock picking? Of course benchmarks are appropriate. Buffett benchmarks his Berkshire Hathaway performance against the S&P 500. But he does that as a reference point. You would never in a blue moon see him saying he is "over-weight" Coca Cola or "under-weight" Microsoft.

So too the DIY'er should compare his performance with a benchmark, but never to influence the composition of his portfolio. The DIY'er, when listening to talking heads on financial markets TV programs rabbit on about over-weight and under-weight, see that as insto speak and not a guide to how he should think. The DIY'er never has to worry about stocks he does not own. He has no benchmark "career risk". Finally, if a DIY'er is considering placing funds with a professional funds manager, he should look at how the funds manager is benchmarked and if he is agnostic towards index stock weightings in his stock selection. Being agnostic is good. Being influenced is not good. The DIY'er above all seeks absolute returns, not relative returns.

6. MER's and index (passive) investing

A brief discussion of management expense ratios (MER's) is relevant to both huge funds and DIY'ers. The MER is the cost of managing money. If a $100 million fund costs $140,000 to be managed (all costs: staff, rent, everything) then its MER is .14% If it cost $1 million to run the fund then the MER is 1%.

There is of course a spectrum of fees/ MER's that one sees in funds management. At the bottom end tends to be the Vanguard funds. Vanguard pioneered index fund (passive) investing. They claim that their average MER for the mutual funds and exchange traded funds (ETF's) is .12%. Which is the bottom end of the range.

Also close to the bottom end is the MER of Australian Foundation Investment Company, (ASX code: AFI) which listed in 1936 and at last balance date (30.6.17) managed $6.9 billion with a MER of a mere .14%.

AFI is Australia's largest listed investment company (closed end fund). It should be pointed out that AFI's portfolio is actively, not passively managed, and that Vanguard specialises in passive investing.

At the high end of the fee spectrum is the standard "2 and 20" fee of actively managed funds meaning a base fee of 2% of assets (versus the .12% and .14% cited above) plus 20% of profits.
Now if you read Warren Buffett's comments in the 2016 annual report of Berkshire Hathaway, he devotes a fair bit on this subject of MER's and he comes down heavily on the side of very low fees and Vanguard. However, I beg to differ with his advocacy of passive index investing.

An index fund invests in stocks solely on the basis of index inclusion. There is no analyst assessing what business the company is in and whether the company is managed by people of good character.

It makes no difference if the company makes hamburgers, widgets or airplane engines.

If a stock leaves the index, it must be sold. If a new company is admitted to the index, it must be bought. That happens mechanically. Within groupings of stocks into indexes will almost inevitably include companies that are cyclically challenged, and companies that have huge technological or competitive threats lying ahead. Let alone companies that have as CEO, or on the board, people of poor character. Quite apart from those qualitative factors, and most importantly, value does not get factored in to the equation on the inclusion/ exclusion decision for an index fund.

I was amused recently when speaking to the manager of a listed REIT which only became part of the ASX 300 in the past 12 months. I asked what percentage of the REIT was now owned by index funds. He thought about 10%. I asked if the investors behind the passive funds were Australian or foreign and he said he did not know. "There is nobody to talk to", to ask, nor is there anyone involved with the index fund that has an iota of interest in what the REIT is doing. Here he was talking to me because they had reported their half yearly result and he was out and about speaking to their investors. But there was one door they could not bang on – the passive door.

If I wanted exposure to Australia's 50 largest stocks (which represents 76.9% of the ASX 300), I'd rather have a sensible, value oriented active manager, picking and choosing from the list. Going the passive index route will be cheap though. But cheap can be expensive and expensive can be cheap.

When I was a funds manager I charged a 20% performance fee. Today in retirement I have invested with 8 funds. 7 have performance fees. My MER would be lousy! 5 of the funds charging performance fees are invested in equities. All of those invest in the true small end of the share market. The really small (micro) cap end of the market. Many of the stocks held would not be in the ASX 300.

There is a hugely important point to be made here. A funds manager who does not have a performance fee can only grow his income by increases in FUM. A funds manager with a performance fee can make himself rich by outstanding performance and earning the performance fee. He is not dependent on FUM growth for income growth.

Even investing with funds managers with performance fees (which reduces their incentive for pursuing FUM growth), I keep a close eye on the quantum of funds under management, ready to exit, being ever mindful, to re-quote Buffett, that size "acts as an anchor on performance".

So I have my own internally managed portfolio, and invest with a number of managers. My MER for internal would be very low. My MER for the externally managed funds would be high.

One final point about index funds/ passive investing. John Bogle, the founder of Vanguard was the pioneer of index funds. He is widely admired. He introduced this type of investing, not out of belief in efficient market theory (EMT), but to bring to market low cost investing, observing correctly of course that just as returns compound, so too do costs. I won't digress into EMT, which is a load of baloney, a fact which is well understood by, I would think, all accomplished active investors at street level. Even so, EMT adherents would be attracted to index investing on the basis that you can't beat the market, so buy the market, and do it through the cheapest vehicle, an index fund or through cousins of index funds, Exchange Traded Funds (EFTs). John Bogle himself has said : "don't try and find the needle in the haystack. Buy the haystack". A pretty cute line.

Wall Street has a habit of taking a good idea, a good financial product, and taking it to an extreme where it becomes a bad idea. Credit default swaps and collateralized debt obligations for example. Is passive investing headed to an extreme? Today there are trillions of dollars invested in index funds and ETF's. And because they are typically market cap weighted, this has channelled massive amounts of money into the huge market cap stocks. Look at the market caps of these giants (in USD): Apple $824 billion, Alphabet (Google) $773 billion, Amazon $689 billion and Facebook $553 billion.

ETFs have become "bespoke". I was highly amused by this comment in Barron's. "Exchange traded fund providers are taking on the role of Saville Row clothiers, tailoring ETFs to the unique specifications of large clients. That's great news for the parties involved in the transaction, but when retail investors try on the same ETF, they can end up looking like they're wearing dad's old suit".

All of the index haystacks contain some bad hay. And I suspect, some of the ETF haystacks are just plain bad-hay haystacks.

What about actively managed listed investment companies such as AFI, previously mentioned? Australia's largest LIC. It has no management agreement siphoning of fees and its MER is extremely low. It has been around for many decades and its huge size reflects great success.

However, I would have two caveats about investing in AFI. Firstly, like all closed-end funds you buy in at a discount or premium to asset backing. So the performance you will get will be a function of their investment performance combined with a movement in the discount/ premium. A large discount in historical terms would be an attraction. (I could not invest at a premium to asset backing under any circumstances.)

The second caveat is size. Its huge size means large cap stocks and I have my bias towards small caps. Even so, I'd have a big preference towards investing in the actively managed AFI than an index fund which is passively managed.

My conclusions for the DIY'er investing in the stock market.

You have the enormous advantage of small size. With just under 2,000 stocks listed in Australia , you can choose from the lot, and go "small" where better bargains generally lie.

You can have sensible diversification with under 10 stocks. You can manage your portfolio knowing that one or two new ideas a year is fine.
You can invest in what you understand, within your circle of competence, and position it to minimise technology and economic threat.

You do not have to be a futurologist when it comes to technology and economic forecasting.

You can have an absolute return mind-set and simply look at whatever benchmark you choose as a reference point.

And if you choose to invest with professional funds managers, you can again "go small" and invest in small, active stock picking funds managers specialising in the small sector of the market.

And if you do that, I suggest you be open-minded about fees and MER's , because by and large you'll get what you pay for.

Warren Buffett recommends that "know nothing" investors invest in an index fund. This paper is directed to "know something" investors. But my bias against passive, which I trust is blatantly obvious, is such that I could never recommend an index fund – period.

Managing multi-billion dollar funds is a whole new ball game and one of great complexity. Since the GFC interest rates have been manipulated by central banks down to miniscule levels and this has created an asset pricing boom and a tail wind for big end of town performances. Tail winds can become head winds when such trends reverse but it is beyond my capacity to even hazard a guess about the timing of such reversal.

A US news letter writer once said: "I'm not a bull. I'm not a bear. I'm a chicken."
I hope a few fellow DIY'ers (who might also like me be chickens), have learnt something from these ramblings.

The Constant Investor

www.theconstantinvestor.com