Will We Ever Learn?

Every year brings stories of investors who have been somehow relieved of their wealth by the dishonesty or incompetence of those who they entrusted to look after their investments. In some cases these people will be advisers and managers and in other cases they will be businessmen running the enterprises into which their funds have been invested.

It is a long time ago now, but I recall as if it was yesterday, that Estate Mortgage failed spectacularly. For days afterwards there were TV current affairs programs parading investors who had lost everything. This is exactly what I am talking about. These investors had chased the highest yielding investment in town. And they had put all – that's right, all - of their capital; into it. This is really dumb. In fact how much dumber can you get? Or should we say how much more greedy and dumb can you get?

I can also remember Pyramid Building Society in Victoria, where again we saw interviews of investors who claimed to have lost "everything". Luckily for them, the Victorian Government bailed them out. More recently, we have had similar stories of losing everything in the Westpoint failure. Moreover, there is a steady stream of stories every year of investors losing everything in a corporate failure or fraud situation.

It is my contention that to a large extent, investors who lose everything in corporate failures and frauds have largely themselves to blame for their predicament, yet they will be crying out that it is not their fault.

Just a moment though. I said one of the causes was dishonesty. Surely, I am being too harsh in blaming the investor when their adviser or manager has been dishonest? But no, I said investors who lose "everything" have only themselves to blame, because it is true that all investors have the chance to protect themselves to a large extent from losing everything even when fraud and dishonesty are involved.

The widely publicised situations I referred to above should have taught every adult Australian two simple but important lessons. The first one is that you should never, ever, put all of your capital into one investment. No matter how safe it seems to be. In my lifetime a number of banks have failed in Australia and so long as I live another decade or so, I am sure it will happen again. "Safe as a bank?" Nothing could be more wrong. Any business can fail, no matter how big, if incompetent managers get to run it. The very first lesson in investing is to spread your capital over a number of investments, such that if one of them goes belly up you are not ruined.

The second lesson is that risk and reward are inversely related. Not perfectly, but in general terms. Whenever someone is offering a yield that is higher than anyone else, you can be pretty certain that it is one of the riskiest investments in town. Riskiest here means something special. The academics define risk as the variation in returns. This sounds nice – returns can vary in any one year, say between +60% and -20%. So, even if you have a bad year, there will be good years to make up for it. But the risk we are talking about in the highest yielding investment in town is not a variation in return like this, but risk of total and absolute loss of capital. If you have all your money in such an investment there is a real risk that you could lose "everything".

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This does not mean that we might not invest in high-yielding investments from time to time. But the combination of the two lessons is that if we do invest in one of them, it should be only with a small part of our capital and there not be too many such high-risk investments in our portfolio.

In the Weekend Australian Financial Review December 23-27 2005 Mungo MacCallum wrote an article describing his experience in losing much of his capital. In short, the story he told was that he had found an adviser/manager who he personally got on very well with. Over the years this adviser managed his capital for him and grew it substantially. Then he changed employer suddenly. Then the adviser's behaviour started to change. Finally, late in 2005 Mungo found out that the adviser had gone off the rails and lost a large part of Mungo's capital playing options unsuccessfully.

Mungo drew two lessons from this story. The first was what he called the obvious one, which was to trust nobody. Good lesson Mungo, you have hit the nail right on the head. Money is like blood in the water, it attracts sharks. Sooner or later anyone can let you down if they find themselves under enough pressure.

The other lesson Mungo drew was that "those entrusted with the money of others should be careful and responsible". Yes, sure. And motherhood should be respected too. This, in my humble opinion is rubbish. It is rubbish because Mungo seems unable to fully recognise that he is totally complicit in his own financial demise. For one thing he had all of his wealth with the one adviser/manager. More importantly, at one point in the story he says "Every so often [the adviser's firm] would send a sheaf of paper covered with lines of figures, which I forwarded straight to my tax accountant." Then "the irony in this is that I … boast to my colleagues that my training meant that politicians and bureaucrats couldn't bluff me with figures and statistics and that I could recognise bullshit at 40 paces." Surely this is the real lesson – that he had taken his eye off the ball. Why was this not one of the lessons listed at the conclusion of the article? Was it too painful to accept and admit that he was responsible for the size of the loss he suffered?

Over the years I have read countless accounts of how advisers had defrauded investors. The common thread through many of them is that the investor left the paperwork to the adviser. Maybe they did not look at it, as Mungo admits. More insidiously, many stories involve the adviser suggesting to the investor that they have the paperwork come direct to the adviser. The most important lesson to understand when allowing an adviser or manager to run your affairs is that every single piece of paperwork about the investment should come directly to the investor. The investor has the responsibility to examine it and understand what is happening. If they do not understand it, they should keep asking questions until it is explained to them. If they cannot get a satisfactory answer, they should seek another adviser who can explain it.

Alright, that is clear, but what if the investor simply cannot understand the investment, because it is too complicated? Should they just trust their adviser? Absolutely not. Warren Buffett has some good advice here – never invest in anything you do not understand. He did it himself in the 1990s. He could not understand how a company could sell at a huge price, yet it had not made a profit and its losses were growing year after year. He kept right away from these technology and internet start-ups and survived the great bubble market. The key lesson is to stay right away from complex investments or investments that seem to you to defy common sense.

So, it comes back to the investor. All Investors ultimately get the results they deserve. If they follow the simple rules from the lessons that are given in the newspapers and on TV all the time, they should succeed. However, the penalty for breaking the rules can be catastrophic, especially the rules about diversification and monitoring your financial affairs.

The key point here is that the investor who loses everything by dishonesty or incompetence is as much to blame as the incompetent or dishonest person. If an investor sticks to the rules, particularly to diversify and watch the eggs in their basket carefully and responsibly, even a dishonest or criminally incompetent adviser or manager should not be able to steal or lose "everything" you have.

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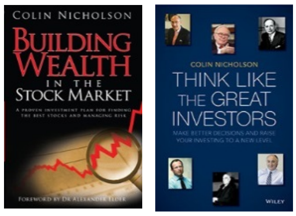

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