Internal Memo

From: Gregory, April 2023

Subject: Deploying new inflows, Getting the right clients, and Assessing fund managers performances

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Deploying new inflows

Our fund's assets have grown considerably since inception. More than 90% of the growth was derived from a manner we most preferred i.e., organically. From day one, AGT Partners has been a performance-oriented fund management company rather than an asset-gatherer, and we will always stay so. We must aim for this standard even though it is uncommon in the industry. Had we adopted the industry standard of market-and-accept as much assets as we can, our fund will be considerably larger but the returns worse and quality of investors meaningfully diluted. Lately we have attracted some new clients, mainly high net worth individuals, that I believe will stick with us for a long time. Should our investment process remain rational and our performance measures up, I believe more money will come. However, there are two important questions we must first answer. How should we correctly deploy these new inflows? And more importantly, which type of clients/investors do we want to attract?

To answer the first question, I believe there are 3 ways to think about it.

A. Accept subscriptions as they come and keep them in cash (Or short-term liquid deposits) until suitable investments can be identified. The main problem with this approach is 1) Inevitably money is likely to come when investors' sentiments are buoyant and/or exuberant, coinciding with generally high valuations and not-low equity prices. 2) Even during normal times, money can also come much faster than our abilities to uncover good investment ideas. If being pushed, I believe one good long-term investment idea in a quarter is a pretty good rate (and we are not likely to achieve it). This may thus lead us to "force" new ideas generation that are not necessarily attractive, just to deploy new money. Both problems inevitably result in either dilutive consequences for existing investors and/or poor returns for new investors. Reminds me of a saying by Warren Buffett (Some people treat new money like how they treat a full bladder. They just need to pee it out.) It is important we resist the temptation of investing (or spending) just because we have new money.
B. Accept subscriptions as they come and buy a little of all existing holdings to replicate exactly the current portfolio. This approach makes good rational sense when prices have fallen (Assuming intrinsic values remain intact) but is again suboptimal when prices are high. If we have initially purchased a security at 70c that has intrinsic value worth of $1, buying it subsequently at 80c must be less attractive than the initial purchase, as it offers lower prospective returns. Such constant adding as prices increase, threatens the integrity of our investment process (namely the careful consideration on purchase price) and is bound to lead to mediocre returns over time.
C. Match subscriptions to new ideas or fallen prices of existing holdings with a right to draw down pre-committed capital and/or defer subscriptions as necessary. Fixed management fees will not be charged unless new capital is deployed. This is a much better and fairer approach that result in win-win scenario for all parties. Firstly, fund managers will not be compelled to make suboptimal investment in a period of rising prices as they know new money is available for intelligent deployment when valuations inevitably correct. This helps to cultivate a good mindset that falling prices are good news for a purchaser of long-term values. Secondly, new subscribers

are more likely to get better results from 1) better fund managers' behaviour 2) postpone their investments especially during a period of buoyancy and exuberance. To illustrate, suppose the same $1 worth of intrinsic value falls to 60c after our initial purchase at 70c, we will then be able to make purchases at lower price than the existing investor. In this case, not only do the new subscribers achieve good results, but they also bring something to the party by improving the overall value to price ratio of the portfolio.

What is then required for us to achieve Option C? Trust and patience. 1) Investors' trust in fund managers that delaying their subscriptions when prices are high or when opportunities are lacking and making purchases in a period of falling prices (Which could coincide with a period of widespread fear and depressed mood) are likely to produce good outcomes. 2) Fund managers' trust in investors that their new subscription will come through even in period of dire straits. To earn such high level of trust, fund managers must first demonstrate the presence of superior money management skills (Good outperformance and not just beta-like market returns after charging of fees). Next, patience from new investors knowing that their new subscriptions may need to be staggered over several quarters or longer etc. Here a high level of investors' sophistication and understanding are important. We must constantly remind them that "It's no use running fast if you are running in the wrong direction."
While we subscribe to the notion that Time is more important in the market than timing the market, but time in the market does not equate to buying the market regardless of valuations. Common sense and simple maths dictate that there are periods where investors should prioritise defence/fear of commission and other periods where focus should be attack/fear of omission.

Right client right capital

This then leads us to the next important question "Which kind of investors do we want to attract? In short, an absolute return, performance-oriented fund like ours should prioritise long-term value creation through compounding, over short-term profits and losses. Our fundamentals driven strategy owns concentrated positions and active trading strategy employs moderate amount of leverage. We believe these choices make good long-term sense but also imply the possibility of relatively high volatility. Volatility in returns is to be accepted as a necessary cost to enjoy the eventual long-term returns of owning high quality businesses that increases intrinsic value substantially over time. The investors we want should thus view risk NOT as volatility arising from temporary market quotations/swings in sentiments BUT as the permanent loss of value; likely resulting from us investing in subpar quality businesses due to poor investment judgement and/or severe overpaying. Having a base of investors that view risk in this manner allow fund managers to deploy capital into long term investments that takes time to work out and to also make intelligent purchases during a period falling prices; not having to worry that investors may redeem their investments at the most inopportune time.

Assessing fund managers' performances

To earn such high level of trust from clients, fund managers must first demonstrate superior money management skills. Investors need not rely on sophisticated quantitative techniques to judge their performances. Consider the following fund managers' returns (Nett returns - After fees charged). Assume this pattern of returns are over a substantial period and thus representative of the manager's superior investing skills or lack thereof.

Market performance		+10%	-10%
Manager A		+10%	-10%
Manager B		+5%	-5%
Manager C		+20%	-20%

Manager A obviously does not add value and investors could achieve similar results by purchasing low-cost index fund themselves.
Likewise, to replicate results achieved by manager B, an investor can just deploy 50% of his capital into an index fund and keep the remaining 50% in cash.
Manager C may seem to possess alpha generating abilities from first glance by outperforming market by 10% points during strong years. However, the manager subsequently underperforms the market by 10% during poor years. This indicates an aggressive fund manager but nonetheless possesses no superior money management skills.

An investor who is conservatively biased, may choose manager B, seeking comfort that losses were lesser than market during down years. At the same time telling himself that while the manager could not beat the market during good years, but at least positive returns were generated. An investor who is aggressively biased, may likewise prefer manager C, placing heavy weightage on stronger than market returns during good years, but turning a blind eye on poorer than market returns during down years. However, both investors' faith was misplaced as both fund managers do not possess superior money management skills or in industry's parlance, No alpha.

Market performance		+10%	-10%
Manager D		+15%	-5%

Next, we consider manager D's returns. This manager achieved market beating returns during good and bad times. He was aggressive enough during good years but managed to somehow tone down his aggressiveness during bad years and/or successfully put on hedging strategies to minimise downside. Assuming again that this pattern of returns was over a substantial period (8-10 years and beyond), this fund manager should achieve strong cumulative returns over time as market tends to move up over time.

Seeing this, investors should then undertake the following 1) Ask around extensively among the investment community to find out manager D's reputation and character 2) Perform careful due diligence to validify figures' accuracy. 2) Seek to understand adequately the fund manager's investing philosophy and strategy 3) Confirm the investment professionals responsible for this set of market beating returns are currently still the same team 4) Invest as much and as long as you can and finally 5) Persuade the fund manager to not attract too much capital to the point of losing his edge.

Although simplistic, we believe this is a good starting point to think rationally about one's choice of a fund manager. Other important considerations that investors should consider include 1) Leverage usage and 2) Capacity constraint of strategy etc.

Without superior investing skills, active management adds no value. Indeed, managers A, B and C do not add value and hence deserve no fees. They are not an uncommon specie of professional fund managers that charge high active management fees whilst delivering index-like (i.e. non-active performance) Although a few percentage points below market returns may not seem much initially, but over a period of 30 years it matters a lot. A million compounded at 10% (S&P 500's average annual returns since 1926) for 30 years turn into approximately $17mln, but at 12% (Say, Manager D), it turns into almost $30mln.

If you subscribe to the notion as I do, that investing abilities/skills should improve over time due to knowledge and experiences accumulation, then why do so few fund managers fare better as time goes by? Leaving aside the fact that size acts as an anchor against continued good fund returns, we suspect 2 other key factors at play.
As assets grow in tandem with initial good returns, fund managers find it difficult to deploy efficiently as before due to 1) Unwillingness to concentrate position due fear of being wrong (Career risk) hence 2) Leading to investing in less attractive investments for diversification purpose. Over time, this accept-as-much-capital as we can policy inevitably leads to having too much capital leading to over-diversification. Indeed, we think the massive over-diversification that is commonplace in the industry has more to do with marketing, making clients feel comfortable with the smoothing of results than it does with investment excellence. At the same time, with an increase in assets (and obviously fixed management fees), fund managers typically find ways to increase their fixed operating costs, better offices, more analysts, better repute law firms and auditors etc.[i]
If left unchecked, ever increasing fixed operating costs likely mean that the preservation of assets (and revenue from fixed management fees) becomes crucial in maintaining the overall viability of the business. When fear of losing (instead of pursuing for investment excellence) becomes the over-arching focus of fund managers, we think the outcome is likely that of continued underperformance.

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[i] If you start seeing signs of us developing such spendthrift habits, a timely reminder will be most helpful.