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NEWSLETTER

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THREE INVESTMENT IDEAS WHOSE TIME HAS COME AND GONE

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Over the last five years, several investment products have become too popular and in fact are poor investment choices.

WRAP ACCOUNTS are investment portfolios put together by the brokerage firms and marketed by retail stockbrokers. Investors' funds are placed with multiple institutional money managers with an all-inclusive fee varying from 1.5% to over 2%. The wrap account client is told that because there are no commissions on trades, this is a good deal (by comparison, at Baltimore Capital Management we charge 1% and trade for low commissions that seldom add up to another .25%).

In addition to the fees being too high on these wrap accounts, an even bigger problem is that the client is over-diversified. By way of example, if a client is placed with four managers and each owns 50 different securities (not unusual in these accounts), then the overall portfolio will hold 200 different names. With that many names, it would be easier to buy an index fund and pay much lower fees. The problem in owning 200 names is that any particular name, even if it is a great performer, will not contribute much to the account. If the account's total value is $700,000 and there are 200 names, the average holding per name will be $3500, which is meaningless in an account that size.

Lastly, wrap accounts tend not to be tax efficient. Institutional managers aren't really interested in the tax implications of a holding being short- or long-term, but under the current tax schedule it makes a big difference in a taxable account if a security is held for a year.

FUND OF HEDGE FUNDS are pools of investors' assets that are distributed among various hedge funds. Here the problem is similar to wrap accounts in that the portfolio becomes overly diversified and the fees are even higher. Most hedge funds charge at least 1% of assets and 15-20% of profits for the manager. A fund of hedge funds will have an additional fee on top of the fee each manager is paid. A good example of the problem, as quoted in the Wall Street Journal, is an Institutional Fund of Hedge Funds managed by Morgan Stanley, which charges 20% of profits and 2% of assets. Through the end of the 3rd quarter of this year, this pool of money had returned 5%, well below the market's return.

PRIVATE EQUITY FUNDS have been all the rage in the past few years, with the result that they are all chasing the same investments and either overpaying for them or having to leverage the investments so much that they become extremely risky. There will be limited opportunities to exit some of the very large investments these funds are making. In the past, the definition of private equity investing was investing in private companies with the expectation that these companies would eventually become public companies through Initial Public Offerings (IPOs). Currently, however, private equity seems focused on borrowing huge amounts of money to buy large public companies, take them private, make some changes and then take the company public again. It is hard to tell how this bubble will end, but at the very least it will evolve into much lower returns than the investors are expecting.

As with any investment, if it becomes too popular it is probably too late to make money in the sector. Additionally, any investment with high fees is handicapped from the start and not likely to be as profitable as advertised.

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