McInroy & Wood

PERSONAL INVESTMENT MANAGERS

"Will they yet look after thee?
Wilt thou, after the expense of so much money,
be now a gainer?"

Merry Wives of Windsor

It is the absence of hurry that is so refreshing about the Western Isles. Nature's cycle imparts a steady rhythm to island life and the raw force of the elements seems to blunt the edge of human appetite, not just in the crofters and fishermen who work among them, but across the community. Expectations are still shaped by the genetic thread of a culture that has changed but slowly. Islanders share an awareness of the natural pace of things which helps arrest the march of consumerism and, like caulking on a leaky hull, holds at bay the incursion of a corrosive environment.

Life on the mainland, by contrast, generally involves working in highly structured jobs and a more fevered atmosphere. We are apt to overlook any natural rhythm that could temper ambition, and most of us simply want to get on with making the most of life's chances as quickly as possible. As paid employees that means broadly one of two things: getting better at the job and earning extra rewards; or exchanging jobs for another one governed by a higher pay structure. Likewise as investors, it means getting better at investing, or finding a new investment field that provides better returns than the current one.

Probably most employees and investors know roughly what return to expect in the ordinary course of events from their labour and capital: employees, a basic wage plus maybe 4% a year for inflation and productivity gains; investors about 5% a year from fixed-interest stocks and about 9% from shares in the very long term. Returns for both groups hinge on long-term economic trends, particularly the growth of national income, company profits, and the course of inflation, and they govern the average annual returns that can reasonably be expected in the natural run of things. Yet while the natural run of things may suffice for those who wait long enough, it hardly satisfies the human urge to earn more today. Furthermore, investors have their own reasons to try and improve, or at least protect their likely returns.

They invest their capital up front and, unlike employees, don't get paid a return on their investment on a pay-as-you-work basis. Their actual annual return doesn't move in a straight line but veers erratically from year to year. Over short periods the return on a quoted investment is governed not by effort or the application of reason, but by mood swings more typical of a children's pantomime than an orderly market.

Secondly, in trying generally to improve their investment technique, investors have to face the uncomfortable truth that they can't all outsmart the herd and outstrip the averages simultaneously. The arithmetic defies them.

Thirdly, there is a real risk over short periods that an investor will not merely get an unsatisfactory return, but that his capital itself may be depleted.

Faced with these uncertainties, many are prepared to grasp any expedient that promises to free their expectations from the dead weight of the financial averages, and to bend the inflexible framework of long-term economic trends in their favour.

Enter, centre stage, an alchemist brandishing strangely labelled bottles of elixir. Each advertises a claim to provide just those qualities that investors have long searched for: investment techniques that give access to a whole new universe of financial opportunity; accelerated gains; positive returns even when markets are falling; best of all, big profits without any exposure to market fluctuations. We are looking at the world of Alternative investing.

The labels on the bottle may be largely unintelligible – "Derivatives", "Structured Products", "Hedge Funds" and "Private Equity" among others. No matter. Financial journals invariably describe all these mixtures as "highly complex", so no one need bother to peer too closely at the ingredients. Yet the ingredients do matter, if only

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because Alternative investments as a group now affect virtually everybody. Hedge funds alone account for some £1¼ trillion of global market value and the pension pots belonging to millions of individuals invest in them.

One ingredient that needs to be examined early on is their name since, far from occupying a remote world of their own, "Alternative" investments are inextricably joined to the familiar conventional markets and exchanges that underlie them. Those underlying markets are the dog which wags the Alternative tail.

Actually the original purposes behind most of the Alternative jargon were perfectly simple - to protect a profit or limit a loss (Derivatives); to obtain a relatively predictable return over a defined period (Structured Products); to widen the field of investment opportunity to the maximum, for instance by exploiting market falls as well as rises (Hedge Funds); and to detach, for a time, business opportunity (and risk) from the vagaries of the stock market (Private Equity). Risk avoidance and financial protection ("Hedging") were once purposes common to virtually all Alternatives whose role was similar to that of an insurance policy – in their case to insure against specified financial rather than physical outcomes.

Alternatives retain an element of this defensive character. Many hedge funds, for example, seek to attract investors' interest by holding out – and in some cases justifying – a claim to safe-harbour status by generating exceptional returns in all market conditions. But that defensive role has now been eclipsed and Alternative investments have assumed a very different character.

Since the late 1980s, low and relatively stable inflation had (until recently), made money cheap and easy to borrow; and borrowed funds have played a central part in the development and exploitation of Alternative investment channels. Secondly, the financial sector has become increasingly dominated by large financial institutions focused on new business development rather than professional service and their legions of salesmen and distributors require new, packaged financial products to market. Thirdly, the advance of computer software has facilitated trading in volatile financial instruments. Lastly, the media impact of equity market falls in 1987, 1998 and, especially, 2000-2, heightened investors' appetite for financial packages offering "guaranteed" protection against market swings and the risk of loss. Together, these developments have reshaped what was once an ancillary investment facility into a primary investment conduit.

Regrettably however, the overall effect of promotional activity by a growing host of sponsors and distributors of Alternative investments has been to detach their attributes from the investment principles underlying them. That has tended both to mask the risks for the unwary and, on the other hand, to divert attention from the valuable function that Alternatives can potentially perform.

Promotional activity will inevitably play a part in the development of any useful financial resource. But that makes it all the more important that investors themselves have a proper grasp of the potential risks, especially the double-edged effect of financial "gearing" with borrowed money, as well as the true costs of any unfamiliar channel presented to them. Without it, many buyers of Alternative investment products, like others who bought split-level investment trusts a few years ago, may find themselves lost in a fog of misunderstanding and disillusionment.

Ultimately, of course, it all comes down to people, not structures. Even if, over the last 5 years, the average hedge fund has delivered an annual return far below that of the UK equity index, there are undoubtedly able managers of hedge funds, private equity, and other Alternatives to be found. With care and effort investors may indeed succeed in spotting one who can consistently convert glints of dust in the ground into gold bars of extra investment return. For most, however, hard reality and the law of averages will reassert themselves, as they have for countless investors down the ages who have imagined there is an 'Alternative' device, formula, technique or structure that will, of itself, raise their return, at no cost or risk, beyond the natural yield of the financial market averages. It does not exist.

If any would suppose otherwise, a spell in North Uist watching the tide go in and out should restore an appreciation of the difference between rational expectation and wishful thinking. One can no more find an Alternative route that bypasses all market forces than escape from the eternal flux of nature itself.

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