

'How are you f***** us?' - The Big Short

ON a recent flight back to Singapore I had the pleasure of watching the movie *The Big Short*. After more than 20 years in the finance industry and having read the book on which the movie is based, I was intimately familiar with the movie subject, but there were still some great takeaways about the money management business that investors can learn a lot from.

The quote above comes from one particular scene which stuck in my mind long after the film ended. After a banker's pitch to sell short (that is, bet that the value will fall) an investment product based on sub-prime mortgages, this is one of the first questions a hedge-fund manager asks. The money manager likes the investment product, but by first replying with this simple question, he encapsulates all the fundamental conflicts of interest in the world of money management.

In an ideal world, investors would completely align their personal interests with their broker/banker/adviser's incentives. The legal term is fiduciary duty, essentially a duty for a person to act in the best interests of their client. This is the strictest duty of care recognised by the legal system, and fiduciaries may only profit from this relationship with the clients' express informed consent.

The world of finance and money management is, however, full of conflicts of interest. Hedge-fund managers know this better than most, as they are keenly aware that the institutions that they trade through can profit from the knowledge of these transactions, to the detriment of the hedge fund that is a client.

Individual investors would be well served to also express the same level of scepticism and take steps to protect themselves by always fully understanding what they are being pitched as an investment opportunity or product, and identify where the sellers' incentives are. This is especially true in the world of complicated structured products with complex payoffs subject to many variables. Reading some of the more complex investment product payoffs is like placing a bet on whether it will rain at midnight on the winter solstice a year from now.

From a legal standpoint, brokers and bankers are not held to the standard of being fiduciaries, they are instead subject to a much lower duty to ensure suitability. A knowledgeable investor with years of investing experience, who understands the risks in hedge funds and private equity, would be "suitable" for pretty much any and every investment product available. This means you may well end up getting sold the highest margin investment products that are in the sellers' best interest, not yours.

While conflicts of interest in money management can never be fully eradicated, investors would be well rewarded by ensuring that they are at least minimised. Charles Munger, Warren Buffett's less famous partner in Berkshire Hathaway, put it perfectly (and less crudely than *The Big Short's* hedge-fund managers) by saying: "Show me the incentives and I'll show you the outcome."

Leading up to the 2008 crisis, banks figured out that securitising mortgages meant that they could sell the risk to a third party, pocketing a fee for originating the mortgage, and another one for the securitisation. Therefore, if a housebuyer was eventually unable to pay the high interest on their mortgage, the bank would not have to take a loss on the loan, since they didn't own it anymore.

Banks no longer had an incentive to ensure the

individuals taking out a new mortgage could afford to do so, and they actually made more money by originating more mortgages. The inevitable end result was that these additional properties with mortgages were actively sold to people who could not afford them, by requiring zero down-payment.

In more extreme cases, some mortgage applications were outright fraudulent, with income statements on mortgage applications left blank, or even completely fabricated with no background checks being done. Many years of these bad incentives led to the final outcomes that culminated in the 2008 crisis.

The 2008 mortgage crisis is nothing new in finance – for investors who wish to learn more about financial institutions' excesses, other than Michael Lewis' books, I would highly recommend Frank Partnoy's 1997 *Fiasco*, which describes the excesses of late 1990s investment banking, where many risky over-leveraged investment products were sold which ultimately resulted in the default of sovereign countries in Latin America.

Despite the inherent conflicts of interests and incentives in finance – where a broker or banker has an obligation to their employer to meet revenue targets and product pushing – a good broker or banker who values long-term relationships in his career would automatically try to act as a fiduciary as much as possible towards their clients, if not in the strict legal sense, at least in recommending only investments that they genuinely believe are the best for the client in achieving their goals. It would be in every investor's self-interest to actively seek out these individuals as the people they do business with in managing their investments.

Another lesson

There is another important lesson for investors from *The Big Short* movie. The money managers who correctly identified the imbalances in the US housing market and eventually profited from their positions were all early in their assessment. They all suffered mental anguish, caused by monetary losses and angry investors, before the positions were eventually vindicated.

Being early is the curse of the money manager, as it is often seen as the same as being wrong. Even Mr Buffett suffered the same (temporary) humiliation in 1999, when he actively avoided exposure to the technology sector, by then the most expensive sector the world had seen. This foresight proved prescient two years later, but Mr Buffett had to undergo the infamy of being called an old dinosaur that did not understand the new growth in the Internet, where "eyeballs clicks" were more valuable than actual profits.

It is the duty of every asset manager to ensure that every client understands the reason for every single investment in the portfolio. If, as they should be, these reasons are all based on objective reasoning backed by well-researched financial historical precedents, many times these investments will be underwater for a while before they finally turn a profit.

The Big Short shows that even professional investors have the unfortunate tendency to focus on short-term performance only; investors who are willing to give more time for the investments thesis to fully unfold, and use investment advisers that act like fiduciaries, will end up with significantly better results. **W**

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Beyond the call of duty

Investors who use investment advisers that act like fiduciaries will stand to gain in the long term

