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Opinion

Lazy fund managers lead to lousy returns

Too many have a short-term outlook and fail to properly understand investments

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Much has been said and written about the poor returns achieved by many active fund managers for their clients. Some critics focus on high expense ratios, but my experiences over the past 30 years as a director of seven quoted British companies suggest there is a deeper problem.

Most of the fund managers I have encountered lacked in depth knowledge of my companies, which ranged from members of the FTSE 250 to an Aim-quoted group, because they simply did not exert themselves. Rather than conduct rigorous due diligence before investing, they seldom left their offices. Instead they relied on weak and frequently partisan analysis provided by brokers' analysts, or on a 45-minute sales pitch by the investee company's chief executive and finance director.

I cannot recall even one fund manager asking to visit our operations or meet more executives before investing. They therefore became shareholders in companies that they barely understood. Once in, few fund managers put in much effort to get to know us better.

Although most companies welcome visits by fund managers, most of them are unwilling to leave London — unless it sounds like fun. I recall a quoted engineering group that arranged a visit to an insignificant subsidiary in Kentucky at the time of the Kentucky Derby (a coincidence surely). I heard that it received a higher uptake than a rival had at that time for a visit to its core factories around Manchester. In the case of engineering, most fund managers learnt little from site visits: they appeared not to understand what they saw.

Most investors limit their contact to the "horse-and-pony" shows that companies offer with their results, but some do not bother even with these. Such sessions are much more productive if the fund manager has a reasonable understanding of the business, but since most do not, it encourages management teams to put on a great show. Instead of challenging executives on the key issues, I found fund managers typically concentrated parrot-fashion on rubrics like "increase margins", "cut costs", or "improve cash flow".

Most are awful at appraising management's quality — they tend to work backwards from short-term earnings per share, or even worse from the share price — and their interventions to demand or to block management change are often hopelessly misguided.

At one FTSE 250 business, a recession had increased cash inflow because we needed less working capital. I was asked to meet two fund managers who had a proposal. Instead of recognising that the situation was temporary, they wanted us to repackage the company's debt and sell it to investors, backed by what they thought was healthy long-term cash flow. These were managers of two very well-known retail funds and each had invested several million pounds (of other people's money) in the business.

In recessions, fund managers often demand "decisive action", such as firing irreplaceable skilled people and selling underperforming subsidiaries. Removing a lossmaker immediately increases reported profit, but over time it can cause great reductions in value. When the 2008 financial crisis hit Spain particularly hard, a support services company of which I was a director was pressed to sell or even liquidate our market-leading business there — luckily we resisted and it made an excellent recovery.

The root cause is the very short-term focus of most fund managers. Rather than getting to know the company, they push for rapid hikes in the share price. They tend not to support investment but instead want short-term profits that facilitate increased dividends and share buybacks. Perhaps I have been unlucky, but S&P data shows that 75 per cent of actively managed UK equity funds underperformed over the past 10 years. I think I know why.

The writer is the author of "Tragedy & Challenge, an Inside View of UK Engineering's Decline and the Challenge of the Brexit Economy".