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To delegate or not? Research is the key

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I can count on one hand the number of direct shares I've purchased over my life. This is an artifact of a simple principle I try to abide by: if you don't understand it, don't do it.

In the case of equities, the risks are far more complex, and the companies difficult to value, than most people admit. That's probably one reason investors were so shocked to see global equities halve in 2001 and 2008.

In this column I want to help you think through the division of labour around your life-time savings. What should you do yourself, and what activities and decisions can be delegated to experts.

I've argued before that I think the future of superannuation, which is where 9 per cent of all employees' income is forced to go, will become cleaved between two solutions: commoditised, transparent, and cheap simple super funds managed on your behalf by banks and advisers; and rapidly expanding self-managed products where you divine your own destiny.

A second, interrelated, maxim to my first complexity principle is that there are substantial rewards, and savings, to be harvested from committing your personal capital to better understanding unresolved questions if you have time to do so.

Unfortunately, the entire finance profession is built on deliberately masking relatively simple subjects in impenetrable concepts. The conflict here is that the more overwhelming it sounds, the higher the probability you will pay someone to make sense of it for you.

Years ago I learnt to embed a rule in my own mental code: if you stumble across financial text that you do not fathom, there is a decent chance that a little exertion will reveal it to be simple stuff masquerading as something more sophisticated.

I used to spend significant time poring over the academic literature in economics and finance. One thing I noticed was how entire careers and millions of pages of research were wasted answering basic questions employing complex methods.

Even then the tools employed by academics to solve non-problems could see them waylaid.

The rational expectations and efficient markets hypotheses are two examples of research that chewed up scarce human resources for too long.

You inevitably start asking yourself, "Isn't the objective of real research to improve our knowledge of the way the world works, not to reaffirm things we already know or muddy clear truths?"

So to restate my second heuristic (there you go!): make the effort to do as much yourself as you possibly can, subject to the rider that you have the time to skill up.

This framework resolves question one: what do I do with my super?

If you are time constrained and don't want to expend energy on determining the path your lifetime savings takes, you will be best served by the simple super route. Find a low-cost fund that offers you a range of risk options – from defensive to growth – and direct your (mandatory) savings into whatever portfolio best fits your preferences.

Here I would focus on how much risk you are willing to tolerate over your investment horizon. I define this as the likelihood of losing money and/or not meeting your return expectations.

Whatever choice you make, review your fund's performance every three or six months while remembering that definitive judgments are easier to form over a period of years.

If you can set aside, say, one to two hours per week overseeing your wealth, then a self-managed super fund (SMSF) might suit.

This empowers you to decide exactly how your savings will be split across the likes of deposits, property, annuities, managed funds and direct shares, and the fees you incur in each. If you do opt for an SMSF, the next issue is what your mix of investments looks like. While this is not easy to answer, it will exert a tremendous influence on your savings outcomes.

I have explained what my own research finds in past columns. Financial advisers can assist a lot with educating you on the basics of asset allocation, but there is no substitute for doing independent homework online. The best adviser in the world is going to be your brain engaged with the unprecedented knowledge now furnished freely on the internet.

Once you have your asset allocations squared away, you need to figure out what to do yourself and what to delegate to professionals.

You should be able to manage your deposits, property investments, gearing (eg, home loans) and insurance yourself.

That leaves the possibility of outsourcing equities, bonds and other more nuanced exposures, such as infrastructure and private equity, to alleged experts.

Here, however, we immediately confront another fork in the road. Do you delegate via an ultra low-cost index manager, which simply buys every security in the benchmark (eg, the ASX/S&P 200), or do you try to pick a manager that can outperform? This is the much-discussed active versus passive debate.

To make the decision even thornier, there is a third option: you manage these investments yourself via direct shares. In this scenario, you must believe you can personally do better than the index.

These questions will be answered by how much time you have and your skill levels. I don't personally do direct shares because I am not an expert at valuing the residual cash flows that equity holders are entitled to. Beyond derivatives, it is hard to find a more uncertain investment than a company's equity.

There are, of course, exceptions where you know a specific business and feel comfortable cutting the manager out.

Accepting this logic leads one into professional manager land. But do you go with an active investor or simply track the index? I have done deep research on this Byzantine subject. The bottom line is there are managers that consistently outperform the index, but they are hard to identify before the event. Many tend to under-shoot.

And while index funds are cheap, the more money that flows into indexing the less efficient asset prices become (as there is less money committed to valuing companies), and the more likely that the active guys will generate superior returns.

The easiest answer is, therefore, to index everything. But if you have time and expertise, and a stronger risk appetite, active management can be rewarding.

Two interesting managers that spring to mind are the Montgomery Fund in Australian shares and Magellan for global equities.

Before doing anything, make sure you understand the punts they are taking in their portfolios. Are they diversified or gambling on a few businesses?

Bonds are simpler and theoretically safer than shares, and you can now invest in the debt issued by many of the same companies that dominate the equity market. For example, the major banks give you the chance of investing in five different parts of their capital structure: deposits, ASX-listed senior and subordinated bonds, perpetual preference shares, and, at the riskiest end, ordinary shares. These assets are the sources of funds that make up a bank.

The problem with bonds is that 95 per cent are not ASX-listed. So managers can play a part. One Australian fund that has done well is Kapstream, which has returned over 7 per cent annually with low volatility. But before you put cash with these people, drill into their mandates to understand the risks they can take with your wealth.

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