Why You’ve Got a Huge Edge Over the “Smart Money”

Description

***Take Stock** is the Motley Fool Canada’s **free** investing newsletter. To have future editions delivered directly to you, simply **click here now**.*

Our performance advantage has shrunk dramatically as our size has grown, an unpleasant trend that is sure to continue. — Warren Buffett

Dear Fellow Fools,

In the world of investing, bigger does not mean better. For the “smart money” — namely, the professional money managers of the world (think hedge funds, mutual funds, etc.) — nothing could be further from the truth, as Warren Buffett pointed out in a 2010 letter to **Berkshire Hathaway** shareholders excerpted above.

In this week’s Take Stock, we’re going to explore why you and I — the lowly little “individual investor” often derisively called the “dumb money” — actually have a huge competitive advantage over the pros on Bay Street.

A misaligned model

Institutional money managers take a percentage fee of the assets they manage — that’s how they’re compensated. So, then, a manager with $100 billion of assets will collect *far* more in fees than a manager with $1 billion of assets.

How does a fund company that manages $1 billion grow to become a fund company that manages $100 billion, thereby collecting more fees? There are two simple ways.

The first is to park that $1 billion in high-performing stocks or bonds … and let the magic of compounding take over. This, however, would take a very long time.

The second way is much faster: spend time, energy, and money on the sale and marketing of the fund. Gathering more clients/assets is just as lucrative as growing the asset base the old-fashioned way, but takes a lot less time.

This dynamic — growing in size because *the incentives are there to do just that* — is entirely detrimental to the performance of the underlying fund. As individual investors, this is where our advantages begin to appear.

Advantage No. 1

One advantage that the individual has over the professional is **time**. You see, most clients of institutional fund managers hate short- and medium-term losses relative to their respective benchmarks. Institutional managers are therefore forced to think with a very short time horizon. As Henry Blodget put it:

"If you talk to a lot of investment managers, the practical reality is they're thinking about the next week, possibly the next month or quarter. There isn't a time horizon; it's how are you doing *now*, relative to your competitors. **You really only have 90 days to be right, and if you're wrong within 90 days, your clients begin to fire you.**" [emphasis added]

Individual investors, on the other hand, don't need to worry about sitting in a meeting every quarter with our client, coming up with reasons for why we did/did not beat the benchmark over the previous 90 days. Whether we're up or down, all we have to really worry about is that our original thesis is still in place for our portfolio's holdings, and wait.

As my colleague Morgan Housel wrote, "The odds of losing money drops precipitously the longer you're invested." To this I might add — provided we've invested Foolishly.

Advantage No. 2

The other advantage we have over the "pros" is that with our relatively small portfolios (we're not measuring things in billions of dollars, after all), we can effectively **go anywhere** in the market and it can have a sizeable impact on our portfolio. Small caps, large caps, liquid, illiquid — pick the sandbox. We can play there.

It's either immaterial or even impossible for a mutual fund manager with, say, $10 billion in assets to take a position in a super cheap, super exciting small-cap stock with a market capitalization of $200 million. After all, even a position that accounts for 1% of that fund's assets would require the fund to acquire half of the entire company!

As a result, institutions often miss out on what can be the most profitable portion of the stock market. Don't get me wrong — large-cap stocks can offer very nice returns over time. But think of how limiting it would be if your universe of investable companies only included the 60 names on the TSX (out of 1,500 or so) that qualify as a large-cap stock!

To illustrate, back in 2006, while the big Canadian fund managers were figuring out which combination of these 60 or so large-cap stocks might offer their portfolio a chance at outperforming the benchmark TSX Composite, a relatively small company with a market cap of about $360 million named **Constellation Software** would have been completely off their radar. Fast-forward to today, and now that Constellation carries a market cap north of $4 billion, the big boys can finally play.

If we pull up a list of who owns Constellation, we see that one of the biggest asset managers in the world, Fidelity Investments, carries an 11% stake worth more than $400 million … a stake that's bigger than the entire company was just seven years ago.

Fidelity has only been on board for a relatively short period of time, while small investors could have easily, at least from a liquidity perspective, been in from the get-go. Now, to be clear, the Constellation stories of the world are relatively rare, but at least when we find them, we can act!

Let's drive this size advantage home with one more Buffettism:

"The universe I can't play in [i.e., small companies] has become more attractive than the universe I can play in [that of large companies]. I have to look for elephants. It may be that the elephants are not as attractive as the mosquitoes. But that is the universe I must live in."

Foolish Bottom Line

The "pros" want to make it seem like they're the only game in town and that there's no point in even trying to compete. And though there's a lot of great work that comes out of these institutions, because of a flawed alignment between manager and fund holder, in reality, it's in fact they who can't compete with us!

On the site

One of our Fool.ca readers recently asked us to comment on real estate investment trusts (REITs). If these stocks are of interest to you, don't miss Fool.ca contributor Robert Baillieul's three-part series: Why REITs Beat Rental Properties, How to Pick the Best REIT, and 3 REITs Worth a Close Look Right Now.

If you have an investing-related burning question on your mind, drop us a note at CanadaEditorial@fool.com. We'd love to hear from you!

And be sure to follow us on Twitter and Facebook for the latest in Foolish investing.

'Til next time … happy investing and Fool on!

Sincerely,

Iain Butler

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Disclosure: Iain Butler does not own shares in any of the companies mentioned. The Motley Fool owns shares of Berkshire Hathaway.

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Date
2025/09/26
Date Created
2013/11/01
Author
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