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Safety in numbers?

Tim Farrelly | farrelly's | 24 March 2014

There is a new alternative asset on the block. Performance has been great. The story is sound. The research houses are backing it. The institutions have been investing for a while now. More and more savvy advisers are getting involved. All the ducks are in a row. Time to invest?

When conducting our recent review of alternative assets, a pattern kept resurfacing in asset class after asset class – a rapid increase in funds inflow followed by very poor performance. It seems that widespread acceptance of the validity of an asset class is a massive warning signal!

For example, the huge increase after 2000 in funds under management for hedge funds coincided with performance compared to cash dropping from 8% per annum to around 2% per annum. We also looked at a subset of hedge funds – CTAs – and found the same thing: brilliant performance during the GFC, followed by big increases in inflows and then disappointing performance. You see the same pattern with commodity index funds; a huge increase in funds under management was almost immediately followed by a rapid disappearance of performance. Past performance counted for nothing.

Other alternatives have died a slower death. In particular, where inflows drive up the prices of the underlying assets, there can be longer periods of terrific performance – for as long as inflows continue. Gold is a great example. During the period from 2000 to 2005, gold performed strongly. Before long, the first gold ETFs were launched and, after a while, the funds really started to flow into them. In our view, eventually the flows into gold ETFs started driving the price of gold where previously it was the soaring price that was driving inflows. For example, in a three-month period in 2010, gold ETF inflows soaked up 40% of all new gold production, much the same impact as if 40% of gold mines closed. Then, the price fell and gold ETF inflows turned to outflows. Recent outflows have been equivalent to 60% of gold production. The impact now is the same as if the amount of gold production was suddenly increased by 60%.

The point is this – when any investment and, in particular, an alternative investment begins to be considered mainstream with attendant big inflows, the end is generally nigh.

Safety in numbers? It's nuts and you can clearly see it's nuts.

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