MBMG Update

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Making the right investment choices

Financial planning can be a complex business. That may not be the most controversial statement you read today, but it is something frequently overlooked.

To start with, there is no single catch-all solution that will meet everyone's objectives. That's largely because each person has their own financial goals and these are not fixed – they tend to evolve over time. If you add to that the variety of products and solutions on the market nowadays, values fluctuate, plus the complexities of being a global citizen, you start to get a picture so complex that Salvador Dalí would have been proud of it.

Mark-to-Model schemes

Of course, with complexity comes potential minefields: many investment schemes that look like good prospects on the face of it are not nearly as attractive as they first seem. This week our founding partner, Paul Gambles, warned many of the region's leading advisors, bankers and asset managers attending the Asian Wealth Management Forum in Singapore of the risks hidden beneath the surface of many structured products. He quoted the dictum of CFA Institute's Paul Smith that if you can't explain to a 10 year old, in less than 10 seconds, how such a product works, then it probably means that you don't understand it yourself.

Meanwhile new fund offerings came across our desks recently that started alarm bells ringing. They were built around the concept of providing funding to construct residential property. Investors stand to gain based on the rental income and/or increases in the future value of the planned developments.

Shares, bonds, commodities and currencies all have regulated markets with quoted prices which can be verified and referenced live in real time. We call this price discovery. We know at any time at what value these assets can currently be sold.

However, in cases of properties that have yet to be completed, price discovery is somewhere between very limited and non-existent. There is no readily verifiable market value that can be tracked on Bloomberg screens. In the absence of price discovery, the promoters and managers of such funds make projected returns on investment, they use a model. Hence such structures are known as *mark-to-model* schemes. We've written extensive warnings about all kinds of *mark-to-model* schemes in the past.

Recent examples

There have been many such schemes promoted in recent years, promising investors a steady rate of return. Because the return is based purely on the model, the price goes up in a straight line no matter if, in reality, the underlying assets are appreciating or deprecating in value.

Sadly there is rarely any guarantee that the assets will achieve the predicted value, and therefore when investors want their money back, such funds are often unable to meet all the redemption requests. Initially they might try to pay out by attracting new inflows (an idea largely attributed to a certain Mr. Ponzi), if this doesn't work they might temporarily suspend investors' rights to get their own money back and hope the problem blows over. If not the fund may be forced to close, sell the assets at market price and the investors may take very significant losses because of the discrepancy that can arise between the reported value of the investment and its real, realisable value.

Last year's failure of Australia-based LM Investment Management (LMIM) and the mark-to-model funds that it operated caused considerable losses for investors. LMIM's Managed Performance fund (which MBMG had issued warnings about for several years) had invested heavily into real estate development projects on Australia's Gold Coast[1] which were so overvalued in the company's model, that investors are facing losses of 95% or more. LMIM's sales and distribution focus was primarily outside Australia and the funds were widely distributed by unlicensed advisors in Thailand, even though the fund was not authorized for distribution here.

The London Social Infrastructure Fund, which promises, "Assured returns from a world city" is also not authorized for distribution in Thailand. It too aims to generate returns through large scale property development and appears to use an ambitious model that targets annual return of "8-12% inflation proof".

On the face of it, a shortage of housing in a major city sounds like an opportunity to make a good return. However, the residences are not built yet, so there is no past performance to compare with projected future returns and there is nothing to suggest any acceptable level of price discovery.

Not a new concept

Property in general suffers from this issue - student accommodation has also been funded by mark-to-model schemes. It may seem is to calculate how much return will be made, but the model calculation of a student hall of residence ties in with the market value of such a specialized asset that there is little way of making an accurate comparison. By listing on a recognized market as a property company or a Real Estate Investment Trust (REIT), such assets can be wrapped in a liquid structure and can encompass price discovery. Which begs the question as to why you would structure things in any other way.

[1] *The Sydney Morning Herald*, 17 February 2014, http://www.smh.com.au/business/drake-transferred-funds-to-de-facto-as-his-lm-group-failed-20140216-32ttm.html, accessed 7 May 2014.

That said, there are many other examples of mark-to-model schemes other than with property. Some have used litigation funding schemes, where the fund's value increases on the assumption that lawyers will win civil cases that have been funded using money borrowed from the fund. Thus, an investor's return is based on a series of judicial decisions, for which the percentage chance of being successful is unquantifiable. Other mark-to-model schemes have involved involve life insurance policies sold off prior to maturity: put crudely, a bet on how long a selection of people will live. Again, this cannot be compared against a market as practically any result is possible. Many professional and institutional investors might also invest in similar asset classes but not usually through these kinds of structures.

Avoid these schemes

It would be inaccurate to say that every fund of this nature is doomed to failure. However, the survival rate of these structures seems to be very low. All things considered, the best way to avoid any problems with this kind of fund is to stay well away from investments that don't have verifiable, transparent price discovery. If you've seen an interesting investment fund advertised but you're not sure if it is viable, it's best to seek advice from a licensed, fee-based independent advisor.

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