INVESTOR'S NOTEBOOK

Lessons from the fall of a superstar fund manager

What other investors can learn from those who put their funds in Neil Woodford's hands

John Kingham

I'm sure you will know that well-known fund manager Neil Woodford has recently fallen very much out of favour with investors. Reputedly in the wake of withdrawals by some big investors said to be worried by poor performance, he even suspended his flagship fund in June, barring savers from accessing their money. There are many lessons to be learned from this, applicable to a wide range of investors.

Lesson 1) Don't blindly follow superstar investors

Many investors bought into Woodford's funds because of the Woodford name, and that's entirely understandable. It is natural to assume that someone with an exceptional track record will continue to be successful. But that is often an incorrect assumption, not least because luck can play a surprisingly large part in an investor's success. However, that's not really my point.

My point is that having only a superficial understanding of an investment – such as that it's managed by this or that superstar – is a serious weak point. When the investment inevitably hits its first bump in the road, this lack of understanding is likely to turn into fear in much the same way that a dog's incomprehension leads it to fear thunder.

Not only is it unpleasant in itself, but fear has important investment implications: first, strong emotions and investment success rarely go together; second, fearful investors often sell at precisely the wrong time.

So rather than blindly following the latest superstar's lead, most active investors are better off putting their money where they have a reasonable understanding of the underlying assets they're investing in, whether companies or properties.

Lesson 2) Don't buy or sell because of short-term performance

While some investors bought into Woodford's funds because of his name, others did so impressed by their initial outperformance.

For example, Woodford's main fund produced annual returns of 20% to mid-2015, compared with just 6.5% for the FTSE All-Share. As a result, it attracted many short-term performance chasers and these inflows helped the fund balloon in size from £1.6bn to £6.7bn in just over a year.

But as with investors who follow superstars unthinkingly, those who blindly chase performance lack a deeper understanding of what they're investing in. This leads to similar problems when the investment inevitably underperforms at some point. Performance chasers have little to go on other than the market price of their investment, so when that starts to fall they assume the intrinsic value of their investment is also sinking. If that assumption is correct (which it very often isn't) then the rational thing to do is sell, and that's what many of them did in this case.

As Woodford's fund fell from the top of the performance tables in 2015 to the bottom in 2019, large numbers of investors jumped ship. Many of those that bought in on the way up were now locking in significant losses on the way down, and that is not a good way to make money.

Personally, I have no idea whether Woodford's fund will outperform over a reasonable investment timeframe, such as five or ten years. What I do know is that most people who buy investments that have recently outperformed and sell those that have recently underperformed are unlikely to achieve satisfactory results.

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So, what should investors focus on instead of short-term price movements? The answer, as before, is the companies and properties they're investing in and their prospects for the next five, ten or 20 years.

Lesson 3) Don't be a forced seller of hard-to-sell assets

I won't belabour this point as it has already been covered at length elsewhere, but this is where things really went wrong for the Woodford fund.

The short version of the story is this: Woodford's fund ballooned in size, largely thanks to his name and excellent initial performance. That size allowed him to take substantial positions in unquoted private companies, which are hard to buy and sell quickly because they are not listed on the stock exchange. That was fine, as long as the fund's investors didn't all want their money back at once.

But eventually that's exactly what they did want. The fund underperformed for a year or three and, since many investors are overly focused on short-term performance, a few years of bad results was more than enough to scare investors away. As nervous investors sold, prices were pushed down, which led more investors to sell. Woodford was unable to unwind his illiquid investments quickly enough, so the fund was forced to lock investors in. And that only caused more panic.

The lesson here is clear: Only invest using money you won't need to access for a few years, and never invest in illiquid assets such as private companies or property unless you are absolutely sure you won't need the cash back in a hurry.

Otherwise you'll soon find out that trying to sell illiquid assets in a rush is like getting out of a crowded burning building through a tiny fire escape: very stressful and with a likelihood of getting badly burned.

Lesson 4) Don't be too different from the crowd

All investments go up and down; it's the nature of the beast. But *when* an investment goes up and down is just as important as *how much* it goes up and down by.

For example, Woodford's old Invesco Perpetual fund fell off a cliff in 2008-09, but Woodford's reputation was largely unharmed because everything else fell off a cliff in 2008-09 too.

The difference today is that Woodford's fund has fallen significantly while the rest of the market has headed upwards, and that is something the vast majority of investors just cannot accept.

While I'm in favour of being contrarian, there are limits. If your strategy is so contrarian that your portfolio tanks (even just for a year or two) while everyone else is making gains, it's going to be very hard to stick with that strategy even if its long-term returns are likely to be exceptional.

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