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Trust, The Critical Investment Appurtenance
By Alan Snyder

Not to beat around the bush, no investment should ever be made without a trusted relationship. Investing, investments, and financial advice are challenging because by their very nature they are intangible. These are forward-looking contracts or expectations without physical presence. In contrast, buying a car or house is a tangible purchase, the here and now embodied in a physical object. Clearly, trust in the seller becomes paramount in the intangible realm.

1. Are my interests aligned with those of the seller?
2. Will the seller choose actions that will take advantage of me?
3. Are there incentives to guarantee the critical efforts for securing that performance (though, sadly, there can seldom be a guarantee of performance)?

Digging deeper in comparing intangible versus tangible purchases teases out how we might protect ourselves and become more comfortable in undertaking our investment decisions.

Purchase Process

Tangibles	Intangibles
1. Physical inspection	Contractual terms and conditions. Even if underlying investment is a hard asset, it may be held indirectly.
2. Comparative evaluation of "like to like"	Comparability limited and challenging because of the multitude of variables including that of human capital.
3. Risks (fire, weather, accident, theft) can generally be hedged by insurance.	Generally, not insurable since loss is from carelessness or business decision.
4. Valuation is relatively easy as of a moment in time.	Except for highly liquid underlying assets, harder, particularly with Level 3 assets[1], found in most private equity and many alternative investments.
5. Generally, the purchase is once and done with little ongoing interaction between buyer and seller.	A continuum – the future benefits are uncertain despite any historical results.

[1] Level 3 assets are assets whose fair value cannot be determined by using observable inputs or measures, such as market prices, and are typically illiquid. Pricing is undertaken using risk adjusted value estimates – or in other words, subject to interpretation.

After examining the above table, it is a wonder any of us invest. Several pithy observations guide.

1. "Trust but verify." Ronald Reagan's aside to Mikhail Gorbachev during their negotiation of the Intermediate Range Nuclear Forces Treaty (INF).
(*Ed. note:* The same one President Trump wants to eliminate.)

2. "Whoever is careless about the truth in small matters cannot be trusted with important matters." – Albert Einstein

3. And after our prior note on Bernie Madoff, "Trust not too much in appearances." – Virgil

Our dreaded conclusion is that due diligence must be done before investing as well as during the investment. Ugh, more work but even salt can look like sugar. Focus is critical. “White lies” that may hurt our feelings can be dismissed but put us on alert. “Black lies” are to our direct detriment.

Past is frequently prologue. Our due diligence checklist enumerates what to look for (Checklist). In short,

1. Evaluate the people and their past.
2. Consider third-party sources like LexisNexis, the web, other investors.
3. Patterns of behavior. For example, if a fund has side letters giving special preferences to large investors, this may be reasonable. It depends on what is given. Fee breaks are logical for sizeable investments and don’t hurt another investor since it is coming out of the manager’s pocket. However, if there is a liquidity preference, i.e., the large investor can exit before anyone else, then the remaining investors could be left holding distressed illiquid assets. Unfair.
4. Alignment of interests. If a manager or advisor is invested side-by-side, there is some additional comfort that they would be unlikely to bite off their nose to spite their face.
5. Quality service providers are essential. Major accounting firms count, not Joe or Josephine on the corner without any peer review. Administration “heavy” should be sought. Look for the administrator to not only prepare the investor accounting but control the bank accounts. Often, an administrator is claimed but their mandate has been highly limited. Beware.

Can a trusted brand be a substitute for direct due diligence? Not really, but it can help. For example, a Fidelity, PIMCO, or BlackRock has many controls to safeguard delivery of a quality service to its investors. That’s the good part. However, scale creates its own problems: conflicts of interest between organizational needs versus any individual investor; the delivery mechanism is generally an individual advisor with his or her own unique foibles. The investor challenge is to ascertain the true skill level of the advisor. The bigger the firm, the more homogenized the investment offering is in order to address the largest possible market, i.e., attractive niche-based opportunities are not a good fit for those firms, but may be outstanding for a particular investor. Way back, when I was managing most of the product areas for a large firm, it didn’t make sense for us to market investments that could not be done in size, circa $1 billion.

Trust basically comes down to making a judgment about your investment, manager and advisor. If you were in a canoe entering some rapids, would you be thrown overboard to make the passage safer or more rewarding for everyone but you? Is there a visible, consistent and forward-facing duty of care for investors? Ultimately, if there are doubts and trust concerns, don’t do it. Suspension of disbelief in that bright, shiny object risks capital. Follow that old adage - never run too hard to catch the bus, there is always another!