

Tony Yarrow's Investment View

WHY ACTIVELY-MANAGED FUNDS DON'T BEAT THEIR BENCHMARKS



(except when they do)

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We all know that actively managed funds, particularly ones that invest in shares, don't beat their market benchmarks. We know this because the financial media keeps telling us so, despite clear evidence that there are many excellent funds which out-perform consistently and over long periods. After deciding to write this blog, I came across a good example of the type, in the Investors Chronicle, December 16th, entitled 'Funds' Failure – Fund Managers can beat the market in theory, but do not do so in practice'.

As with all generalisations, there is some truth in the accusation. Several hundred billion pounds are invested in this country in large, underperforming collective funds. The amount of money invested in the 'dogs' (funds whose performance has been below that of the average fund in their sector over each of the last three years) grows larger every year. There are structural forces at work, which conspire to keep investors' money in these poor-performing funds, and we'll look at some of them below.

The index with which most of us are most familiar is the FTSE-100 index. The 'Footsie' tracks the share prices of the UK's hundred largest companies by value. It is a weighted index, which means that the largest company has a much greater influence on the movement of the index than the smallest company. You can invest in the index through an index-tracking fund, giving you exposure to many different sectors (oil, mining, banking, insurance, pharmaceuticals, tobacco, and so on) in a way that isn't biased by any human judgement. So why not just invest in the index, and live happily ever after?

History has given us the answer to this question. At the beginning of the 1990s, there were just two TMT (technology, media and telecoms) companies in the FTSE-100 index, BT and Vodafone. By the end of the decade, at the height of the TMT bubble, there were at least twenty, all vastly over-valued as investors tried to gain exposure to the coming internet revolution. In the period 2000-3, the share prices of the TMT companies collapsed, taking the index with them. The index had its greatest exposure to TMT at the very moment when the sector was at its most over-valued.

The same pattern was repeated in the 'noughties', this time with mining companies. In 2000, there was only one mining company, Rio Tinto, in the FTSE-100. By the end of 2010, there were sixteen. The miners were all priced to benefit from the 'commodity super-cycle', which was expected to last into the mid-2020s, but had in fact already ended. Once again, the fashionable share prices collapsed, and once again they took the index with them.

The structure of the index guarantees that this pattern will continue to repeat itself in the future. Investing in the FTSE-100 is by default a momentum strategy, which invests an increasing amount in companies as their share prices go up. It is a strategy which, as we have seen, works very well - until it doesn't.

All weighted indices, which is to say, nearly all indices except one or two very old ones, behave in the same way as the FTSE-100 index.

Given the way the index works, you would imagine that the task of an active manager is straightforward. Invest in all companies except when there is a good reason not to. Avoid expensive, fashionable stocks, especially ones in cyclical industries that are coming to the end of their cycles. Side-step companies which are taking over other companies too fast to be able to assimilate them, and are overpaying for the companies they buy, ones with weak balance sheets, and those where the managers appear inexperienced, are pursuing a growth strategy that doesn't make sense, or seem to be interested in maximising their personal earnings at the expense of their companies' shareholders. Do all the above, and you will surely live happily ever after, and possibly become very rich.

Unfortunately, the real world doesn't reward us fund managers quite as easily as that. In a technology bubble, any active manager who avoids technology shares will underperform horribly, and will probably lose most of his or her investors long before the strategy has started to bear fruit. These periods of mis-pricing can continue for long periods - as Keynes once said 'The market can remain irrational for longer than you can remain solvent'.

Why performance doesn't matter any more

A manager who avoided companies with the unattractive characteristics listed above would be aiming to maximise fund performance by filtering out those companies which might impede it. Why would any fund manager not run their fund in such a way as to maximise performance? It seems that there are many reasons. Here are some of them.

A small fund needs to attract new money in order to grow to a viable size, and has the flexibility to adapt quickly to changing market conditions. Many small funds are run for performance, investing in the best assets the manager can find, and many produce excellent returns. Some very good funds remain small, (I will give an example of one such fund later on), but some grow large, and some grow large very quickly.

What happens when a fund grows large? Sometimes a fund can grow too large for the market it invests in. This happens in markets, such as UK smaller companies, where the pool of available assets of sufficient quality is limited. Above a certain size, a fund can become hemmed in, like a large animal in a small cage.

Success brings with it a larger number of investors, all of whom want access to the fund manager, who may end up with less time to run the fund. Complacency is another hazard. After a few years of index and peer-beating performance, it is easy for managers to believe they have a special knack, other than endless hard work and vigilance, and there are plenty of people who will encourage them in this belief.

Another pressure is institutional. Once a fund grows large, its fee income becomes an important element of its parent company's revenues. Salaries and other overheads come to depend on it. Gradually, the fee income becomes institutionalised. Soon it can be more important for the fund not to shrink than to grow. The unspoken mandate is no longer to perform better than others, but not to perform worse than others, so as not to lose investors and their fees. Once a fund is big and famous, backed by a large institution with plenty of marketing spend, the mandate may slip further, to 'not to underperform by too much, and not for too long'. Not all large funds succumb to this change of emphasis as they grow larger.

The world's most striking example is Berkshire Hathaway, managed by Warren Buffett and Charlie Munger, which continues to produce eye-watering performance, despite being over £200bn (\$255bn) in size. But there is a tendency for institutionalisation to creep in. It is perhaps true that active fund management and large institutions are fundamentally incompatible. Institutions want predictability and certainty, while life and the financial markets are essentially unpredictable. Active fund management is by nature entrepreneurial, taking advantage of opportunities as they appear, just as a trout hovers in quiet water, patiently waiting for the tit-bits that pass by on the current. As a fund grows in size and importance to its institutional parent, the institution wants to impose institutional constraints, which involve becoming more predictable and measurable. A fund is then under pressure to become a **closet tracker**, which purports to be an actively managed fund, but in practice holds all the constituents of the index, in more or less the same proportions, so that by definition it can't under-perform the index by very much.

Why don't investors transfer out of these large, stodgy funds into smaller ones which perform better? In practice, it's hard to do so. The large fund is familiar, and has the kudos of a high media profile, a well-known host company, and probably a star fund manager. How much underperformance should investors tolerate? A few months? A few years? Or longer? An alternative smaller fund will be less well-known, and research is needed to confirm that its managers have sufficient experience, and that their success is repeatable, and not just the result of one or two lucky stock-picks. With a smaller fund, you don't have the comfort of knowing that everyone else owns it.

In our experience, investors still haven't forgotten the trauma of the 2007-9 crisis, and are less willing to back their own judgement and be experimental today than they were a decade ago. The funds that have really taken money since 2008 are ones which are believed to be defensive in adverse market conditions, so, should we return to the conditions of 2008, their losses would be limited. Investors prefer these perceived defensive funds even though their potential returns are often minimal.

For example, one might compare two funds which are both managed in Edinburgh. One, the Standard Life Global Absolute Return Fund (GARS) aims to make cash-plus returns by using a large number of hedge-fund strategies. It is in consequence opaque and difficult to understand. In the eight years since the beginning of 2009, the fund has made a return of 62.8%*, at an annual compound rate of 6.4% per annum. The fund is popular with investors, and has grown to £ 26.3bn* in size. The GARS is managed from Standard Life's offices in George Street. At the other end of George St., in Charlotte Square, Paul Jourdan and his team manage the TB Amati UK Smaller Companies fund. This fund is an excellent example of one which, despite stellar performance, has remained small, currently £38m*. In the eight years since the beginning of 2009, the Amati fund has made a return of 395%*, or 22% per annum. In eight years, the GARS would have turned £100 into £162.80. TB Amati UK Smaller Companies would have turned £100 into £495. However, because of its perceived defensiveness, the GARS fund is roughly 700 times the size of the Amati one. This comparison tells us much about the attitudes and preferences of investors in the post-crisis world. The fact that of £500bn which is held in ISAs in the UK, £300bn is held in cash ISAs, paying next to nothing, tells a similar story. Maybe it goes some way towards explaining why investors remain in the large, under-performing 'dogs', rather than transferring to smaller, more nimble alternatives.

*All figures taken from Financial Express on December 20th

What to look for in an actively-managed fund

Managers

What did they set out to do, and have they succeeded?

The record of the managers matters more than the history of the fund they manage. We know more about a new fund with an experienced manager than we do about an old fund with a brand-new manager. We tend to avoid managers until we have seen how they perform over time, in both benign and challenging conditions. We also like one-to-one interviews with managers, to understand in more depth how their processes work day-to-day. Every fund adopts the style and personality of its managers, and all funds perform better in certain conditions than others. We need to understand this dynamic in order to work against the market cycle, increasing holdings when funds are out of favour, and reducing them after periods of particularly strong performance. Many investors do the opposite – they buy after performance has been strong, and sell after a period of weakness. This behaviour leads with great certainty to poor returns. Also it makes a fund harder to manage, by providing the manager with cash at the top of the market when there is nothing much to do with it, and taking it away at the bottom, when there are plenty of assets at bargain prices, and a great need for cash.

For us, an investable fund must have a credible investment process, and must adhere to it consistently, avoiding ‘style-drift’.

Company

As mentioned earlier, there is a potential conflict between the aims of the managers of a fund and those of their employers. Fund managers need to be left alone to concentrate on their research, rather than distracted by numerous other responsibilities. We tend to be suspicious of managers who are involved in more than two funds, knowing from experience that there tends to be a ‘favourite’ fund, with others getting attention only in the odd moments. Good fund management companies are financially sound, long-term in their approach to the business, and properly supportive of their fund managers.

Knowledgeable, well-supported, motivated, experienced managers who have the freedom to concentrate on the job of fund management, tend to add value over the long term.

What keeps us investing in the ‘dogs’?

Investors don’t always help themselves, being too cautious to move away from the security of the familiar dinosaurs.

Many **advisers** these days outsource their investment decision-making. Allocation decisions are made by committees, often with influence over very large sums of money, making allocation to smaller funds impractical for them.

Advisers like to use funds which have been scored highly by the **rating agencies**, but some of the agencies charge substantial fees for their ratings, which the smaller funds can’t afford.

These days the bulk of retail investors' money is held on **platforms**, sometimes known as 'fund supermarkets' – Cofunds, Fidelity Funds Network, Hargreaves Lansdown and others. With over 3,000 retail funds to choose from, you might expect the supermarkets to take pride in their ranges, competing with each other to offer the widest selection. In practice, small funds are unprofitable for the supermarkets, who tend to promote a relatively short list of preferred funds, all large – and thereby tending to grow larger. Investors who search for a smaller fund, such as TB Wise Income, on the Hargreaves Lansdown platform, will be told that the fund isn't one of their 'Wealth 150', and as such isn't one they recommend. Investors are advised to look instead at the Wealth 150 list, which is on another page. TB Wise Income is available on the HL platform, but the company's practice is to guide investors away from it. They are not alone in this.

Finally, **product providers** don't always help. Manufacturers of new funds have always taken the view that the investing public should be offered what it wants. That's why, over the last 20 years or so, we have seen a host of funds launched at inappropriate times. Providers issued a raft of Emerging Markets funds into the EM boom of 1993-4, a slew of TMT funds into the 1997-2000 technology bubble, and a tranche of commodity funds at the height of the 'super-cycle' enthusiasm of 2008-10. In the years before the Crisis, a few funds even appeared giving retail access to Credit Default Swaps, once memorably described by Warren Buffett as 'weapons of financial mass destruction'. Nearly all these funds, helpfully introduced to cater to the current trend, failed and were subsequently either merged into others, or disappeared altogether.

More recently, the fashion has been for high-income (various forms of packaged debt, peer-to-peer lending, aircraft leasing, infrastructure etc) and risk-graded funds. During the crisis, investors discovered that their appetites for risk were not equal to the market movements that were happening around them. Lowering risk is a fundamental part of asset management in any form, but at a time when the least risky asset class, government bonds, has become so expensive as to be extremely risky, the more so if a modicum of inflation returns, the construction of low-risk portfolios is more demanding than might appear. We are no more able to foretell the future than anyone else, but I wouldn't be surprised if the returns from these low risk funds turn out to be as disappointing over the next few years as all the other demand-led funds turned out to be.

FEES

Active funds charge fees, whereas an index doesn't. If you invest in an index-tracking fund, the fees are usually, though by no means always, modest. For an actively-managed fund to beat an index, it needs to produce a return that's greater than the index return, plus its own charges. If a fund charges 1.0% per annum, in a year where the index makes a return of 5.0%, the fund must return at least 6.0% in order to out-perform.

The financial press often quotes fund charges in its campaign to promote index-trackers and ETFs against actively managed funds. However, what matters isn't so much charges as performance net of charges. Charges have come down and are still falling. Taking TB Wise Income for example, at launch our main share class was the A share with a 4% initial charge and an annual charge of 1.65%. Today, the A share is a legacy class which no one uses, and our main share is the B class, with no initial charge and an annual charge of 0.9%. In other words, the annual fee on our main share class has almost halved in a decade.

Besides, in comparing an index tracker with an active fund, you aren't comparing like with like. A tracker is a commodity, whereas an active fund is a service. It has a manager, who issues progress reports, and a style, which you get to know. In difficult times, you can't turn to a tracker fund for guidance or advice.

The higher the manager's fee is, the lower the investor's returns will be, so it is the duty of responsible fund managers to keep our fees as low as is practically possible. We believe that performance fees, which are a way of being paid twice for the same job, are never justified.

SUMMARY

Investing through index-trackers is advocated as an objective system that avoids human bias. In fact, the composition of an index reflects the investment fashions of the day, and hence is vulnerable to changes in investment fashion, as we have seen several times in the last couple of decades.

It follows that rational fund managers can be more unbiased than the index, and can beat it, and many good managers consistently do beat their index benchmarks, net of all fees. We look for certain characteristics. These include experience, dedication, the ability to admit mistakes, a long-term approach, a supportive parent company, and fees which reflect an honest concern for the investors' returns. We particularly like to invest after their investment styles have been out of fashion for a while.

That said, there is a vast sum of money in large, underperforming active funds, which appears to stay there as a result of caution, inertia, and structural factors within our industry.

My prediction for 2017 is that despite Brexit, President Trump, and everything else that's going on, the good, focussed, long-term managers will continue to do well. And one of my New Year's resolutions will be to continue giving them our support.

I would like to thank you for your continued support of the Wise funds, which is always greatly appreciated. Together with the small but growing Wise Funds team, I would like to wish you a very happy Christmas, and a joyous New Year.

Tony Yarrow

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Please note – this blog contains the personal views of Tony Yarrow and is not intended as financial or investment advice

