Challenges faced when selecting investment managers

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ON MANAGER SELECTION

A sign on the freeway promoting the state lottery will only display the possible amount you could win; it will not reveal the low probability of actually taking home the jackpot. Most investment opportunities are sold the same way. Wall Street promotes the possibility of earning superior returns—not the probability.

The US mutual fund industry comprises a vast universe of investment strategies that reflect a diverse range of philosophies and approaches. In pursuit of superior performance, some managers forecast macroeconomic trends in an attempt to identify which sectors are likely to outperform in the prevailing stage of the business cycle, while others attempt to identify individual companies that are perceived to be undervalued.

So-called "top down" strategies, or those focused on macroeconomic forecasting, attempt to overweight defensive sectors (e.g. utilities, healthcare, and staples) ahead of economic contractions and cyclical sectors (e.g. financials, materials, and industrials) ahead of economic expansions. In order to gain insight into broad economic forces, managers study monetary and fiscal policies, economic indicators, and political developments in major economies.

So-called "bottom up" strategies, or those focused on individual security selection, attempt to identify companies with strong growth potential whose current market prices are trading below their perceived intrinsic values. These managers attend shareholder meetings, speak with industry experts, sift through regulatory filings, and analyze reports produced by large brokerage firms.

The irony is that for most investors, professional or individual, most of this activity will not yield returns superior to that of an index. Professional investors are often quoted as being "tactically overweighted" in one market segment or another, but this does not mean they are, on average, successful. The data shows that few active investment managers have consistently delivered benchmark-beating returns over time. And, although it is easy to find managers with impressive track records, past outperformance is rarely a reliable indicator of future success.

Let's consider some of the challenges involved in the selection of investment managers in greater detail:

INVISIBLE DATA

Most individual investors are surprised to learn just how many mutual funds become obsolete over time. Investment strategies that experience sustained poor performance, fail to gather assets, or a combination of both are often closed by their provider.

Traditionally, such funds are eliminated from performance databases such as Morningstar's. Accordingly, the track records of closed funds cease to exist for the purpose of calculating category average returns and assigning peer group rankings to surviving funds. What's the big deal?

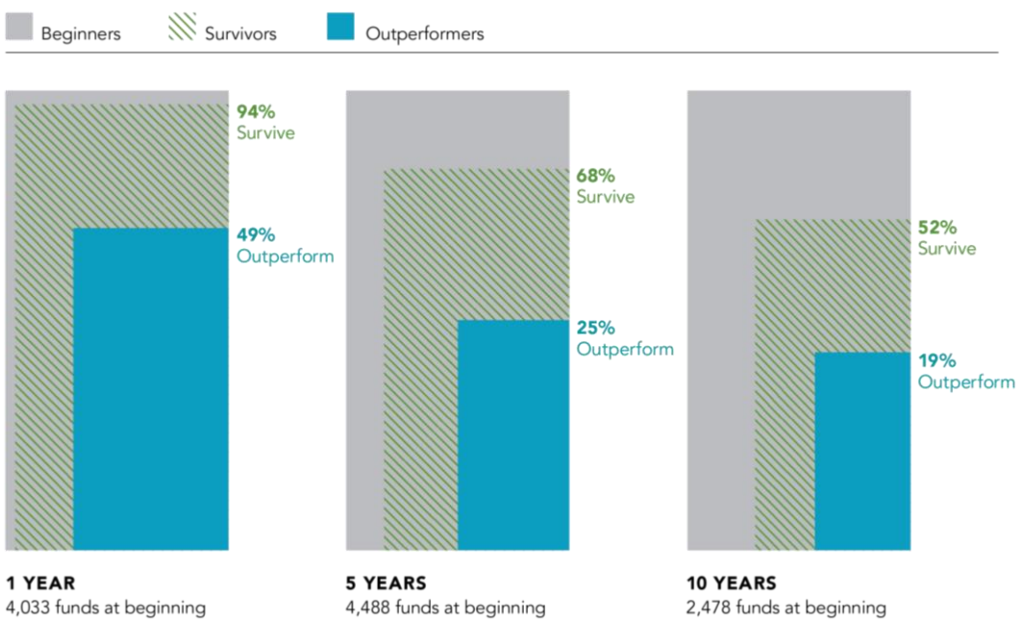
The treatment of this data biases category average returns in favor of active management (since the worst actively managed performers are not included in the calculation), and the failure to account for closed funds when assigning category rankings gives investors a false perception of the probability of picking a winning manager (since a higher percentage of funds will be shown to outperform indexes).

Nevertheless, an accurate depiction of the manager selection challenge requires performance data from both surviving and non-surviving funds. Without information on the qualitative characteristics of the failed group, selection criterion may appear to be more effective than it actually is. That is, to understand success and analyze what caused it, we need to study the traits present in failures. In randomness-laden professions, where individuals can succeed largely by luck (i.e. investment management), it remains the case that disconfirming evidence is far more powerful in establishing truth—we can know what is wrong with a lot more confidence than we can know what is right.

Certainly, investors would like to identify obsolete funds in advance and avoid them. But the reality is everyone must choose from a universe that includes funds that will not survive. Let's explore the so-called survivorship bias in more detail (explanation follows):

Survivorship and Outperformance—Equity Funds

Performance periods ending December 31, 2013



US-domiciled mutual fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago. Funds are identified using Lipper fund classification codes and are matched to their respective benchmarks at the beginning of the sample periods. Sector funds and funds with a narrow investment focus, such as gold, were excluded.

In the chart above, the large gray boxes visually represent the number of US-domiciled equity funds in operation during the past one, five, and ten years. These funds compose the beginning universe of each period. For example, an investor trying to select a mutual fund at the start of 2013 could have chosen from more than 4,000 unique strategies.

How many of the funds that began each period still existed at the end of 2013? The striped areas show the proportions that survived. During the one-year period, 6% of equity funds ceased to operate and 94% survived. Over time, fund survival rates dropped sharply—the five and ten-year survival rates were just 68% and 52%, respectively.

But investors likely have a more ambitious goal than to just pick a fund that survives. What were the chances of picking an outperforming fund? The blue shaded areas show the proportion of equity funds that outperformed their respective benchmarks.

In 2013, 49% of equity funds survived and outperformed their benchmarks for the one-year period. But the odds of success turned decidedly lower over time. Only about one in four equity funds survived to provide benchmark-beating performance over the five years through 2013. Over ten years, the ratio dropped to about one in five.

Now, if we did not account for the non-survivors, it would appear as though nearly two in five managers outperformed (i.e. 19 out of 52 instead of 19 out of 100). As such, by not accounting for the so-called survivorship bias, many investors believe they are twice as likely to succeed as they are in reality, imparting a mistaken perception of the probability of success.

Each year, the Brighton Jones investment team is approached by hundreds of investment managers. Before considering an investment with any particular fund family, we require that they provide a timeline of strategies that were either merged or liquidated. A mutual fund family with a laundry list of fund closures indicates a tendency to chase fads, whereas a mutual fund family with relatively few closed strategies indicates their adherence to a well-articulated investment philosophy.

Understanding why certain strategies were closed in the context of the prevailing market environment is also important. For example, the closing of a "conservative allocation" strategy following a prolonged down market could be an indication that the manager took more risk than he should have for that type of strategy. However, if the same strategy were closed following a prolonged run up, it could just indicate a lack of demand by investors.

Ultimately, the key to long-term success lies not in the past few years' performance numbers, but in the professional culture of the organization. Some mutual fund companies are skilled at the business of "asset gathering" but are not focused on the professional discipline of successful investing—like politicians who know how to get elected but not how to govern. It is important to identify and avoid these types, for they represent the slimy underbelly of the investment world.

PAST PERFORMANCE

The investment management industry is unique in that success in this business is harder and harder to replicate going forward–hence the industry's well-known disclaimer, "past performance is no guarantee of future results." There are many different explanations as to why managers might have a difficult time repeating past success.

Some point to the competitive landscape of the investment management industry in general. Because institutional investors are so large, so well-informed, and so active, it becomes extremely difficult for any one of them to gain and sustain a repetitive and useful advantage over all others. In this sense, the problem isn't that investment research isn't done well; the problem is that the research is done very well by many.

But, this is good news for long-term investors. Each day, the global financial markets process millions of trades worth hundreds of billions of dollars. This trading aggregates vast amounts of dispersed information into prices, driving them towards fair value. As we learn in game theory, the optimal strategy will incorporate an understanding and anticipation of the strategies and behaviors of others. Ironically, it is the efforts of the many determined competitors in the market place that leaves us with reasonably efficient markets and limits their own ability to yield superior results.

Others will point to the observation that success generally leads to more assets under management, and as assets under management grow, a portfolio has reduced liquidity and flexibility because it owns a greater proportion of an underlying security's float. Also, as size precludes taking positions in smaller or less liquid issues, the opportunity set of investments is diminished. Thus, substantive changes in the asset base over time relative to the capacity of a particular asset class can make a manager's past track record less meaningful.

Whatever the reason, nobody can deny that the search for future winners is a formidable challenge. Confronted with so many fund choices—and lacking an investment philosophy to inform their search—many investors will resort to using track records as a guide to selecting investment managers.

Let's take a look at how this approach has paid off (explanation follows):

Do Winners Keep Winning—Equity Funds

Past Performance vs. Subsequent Performance

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The chart above illustrates the lack of persistence in outperformance. Three-, five-, and seven-year equity mutual fund track records are evaluated as of December 2010, and funds that beat their respective benchmarks are re-evaluated in the subsequent three-year period ending December 2013.

Less than a third of the beginning funds outperformed in the initial periods—and subsequent performance was not much better. For example, only 39% of the equity funds with past outperformance during the initial three-year period (2008–2010) continued to beat their benchmarks in the subsequent three-year period (2011–2013).

Longer track records do little to help investors identify future outperforming funds. The results for funds with good five- and seven-year track records were similar—only about a third beat their benchmarks in the subsequent period.

It is natural for the best performing investment strategies at any particular time to be the most visible. Most mutual fund companies are not going advertise or otherwise pitch investment strategies that have recently underperformed when vying for new business.

Of course, any mutual fund company will "explain" the success of their outperforming strategies in terms of superior tactical skills, the right education, a balanced breakfast to start the day, or some other reason seen in hindsight. The imperative question to ask is whether such characteristics are also apparent in those who failed. After all, risk taking is necessary for large success—but it is also necessary for large failures.

To overcome the natural tendency to be drawn towards the most visible investment strategies, we determine the critical attributes for each of the market segments in which we invest, and our manager search and selection process is designed to identify managers whose portfolio attributes meet our criteria.

For example, the mandate for our capital preservation portfolio is to protect cash needs and reduce volatility. Our preferred managers will be those with limited duration and high average credit quality. However, the conservative nature of what we deem "capital preservation" means that other strategies that take on greater risk are likely to steal the headlines and top category rankings.

When considering past performance, it is important not to confuse the order of horses and carts. It is a mistake to use statistics without logic, but the reverse does not hold. That is, past performance should not be used to *identify* a sound investment philosophy. As is standard in the scientific community, a hypothesis must be formed first and tested with data second.

IMPACT OF COSTS

If intense competition drives stock prices to fair value, as previously suggested, one might wonder why underperformance is so common. It's simple: before a fund can outperform, it must first add enough value to cover its costs.

All mutual funds incur costs. Some costs, such as expense ratios, are easily observed, while others, including trading costs, are more difficult to measure. The question is not whether investors must bear some costs, but whether the costs are reasonable and indicative of the value added by a fund manager's decisions.

The data show that many mutual funds are expensive to own and do not offer higher value for the higher costs incurred. Let's consider how one type of explicit cost—expense ratios—can impact the probability of success (explanation follows):

High Costs Make Outperformance Difficult—Equity Funds

Winners and Losers Based on Expense Ratios (%)

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In the preceding chart, equity funds in existence at the beginning of the one-, five-, and 10-year periods are ranked by quartiles based on their average expense ratio. Fund expense ratios range broadly. For the one-year period ending in 2013, the average expense ratio was 1.1% for equities. In 2013, funds in the lowest quartile cost equity investors an average of 0.47%. The most expensive quartile, at 1.66%, had an average cost that was more than three times higher.

Are investors receiving a better experience from higher-cost funds? The chart suggests otherwise. Especially for longer horizons, the cost hurdle becomes too high for most funds to overcome. Over 10 years, 25% of the lower-cost equity funds outperformed, vs. only 9% of the higher-cost equity funds.

Note: the weighted-average expense ratio for a typical Brighton Jones portfolio ranges between 0.20% and 0.30%, depending on the allocation.

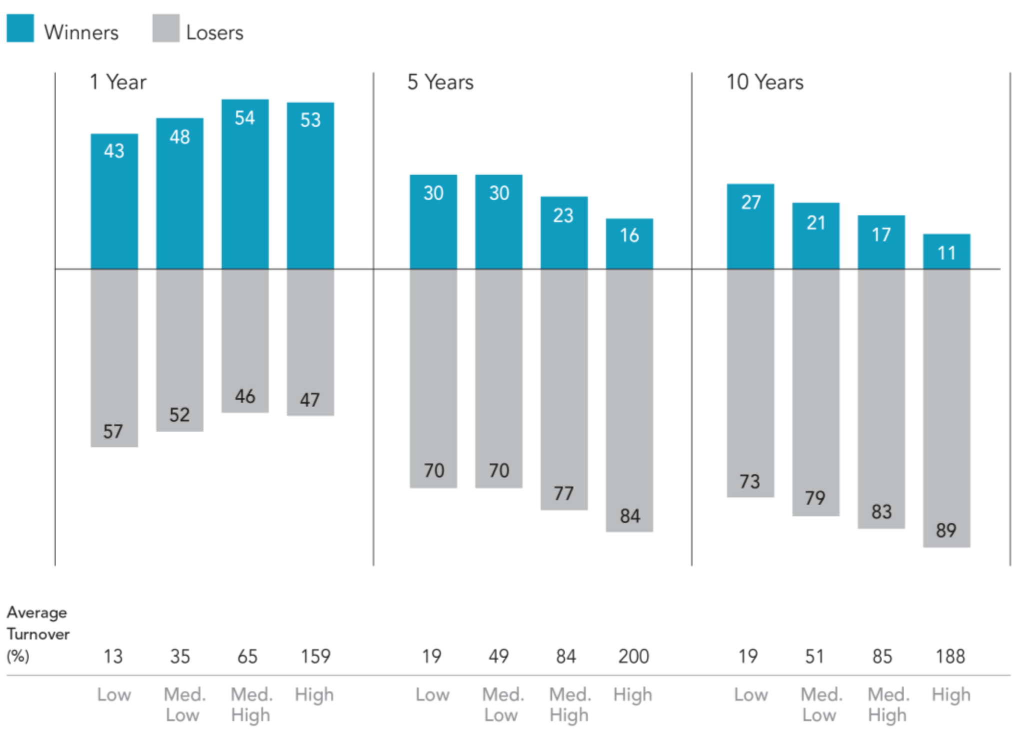
IMPACT OF TURNOVER

Other activities can also add substantially to a mutual fund's overall cost burden. Equity trading costs, such as brokerage fees, bid-ask spreads, and price impact, can be just as large as a fund's expense ratio. Trading costs are difficult to observe and measure, but they impact a fund's return nonetheless—and the higher these costs, the higher the outperformance hurdle.

Among equity funds, portfolio turnover can offer a rough proxy for trading costs. Managers who trade frequently in their attempts to add value typically incur greater turnover and higher trading costs. Although turnover is just one way to approximate trading costs, the data shows that funds with higher turnover are more likely to underperform their benchmarks (explanation follows):

High Trading Costs Make Outperformance Difficult—Equity Funds

Winners and Losers Based on Turnover (%)



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In the chart above, equity funds existing at the beginning of the one-, five-, and 10-year periods are placed in quartiles based on their average turnover. Turnover varies dramatically across equity funds, reflecting many different management styles. For the most recent one-year period (2013), funds in the lowest quartile averaged 13% turnover. The average turnover for the highest quartile was 159%, more than 12 times higher.

The data shows that higher turnover is a drag on performance: funds with high turnover have much lower rates of outperformance over longer investment horizons. For the lowest- turnover group, 27% of funds managed to beat their benchmarks over the ten-year period. This fraction dropped to just 11% for the funds with the highest turnover.

Note: Because our strategy seeks broad market exposure and emphasizes efficiency, our underlying equity managers have very low turnover—generally under 5%.

CONCLUSION

This analysis of US mutual fund performance illustrates the obstacles confronting investors seeking outperforming funds.

Intense market competition drives securities prices to fair value, making it difficult to persistently add value by identifying mispriced securities. Despite the best efforts of many professionals working in the industry, the vast majority of funds fail to outperform their benchmarks.

Although the odds are stacked against them, many investors continue searching for winning mutual funds and look to past performance as the main criterion for evaluating a manager's future potential. In their pursuit of returns, many investors surrender performance to high fees, high turnover, and other costs of owning the mutual funds.

The underperformance of most US mutual funds highlights an important investment principle: capital markets do a good job of pricing securities, which makes beating benchmarks (and other investors) quite difficult. Moreover, when fund managers charge high fees and trade frequently, they must overcome high cost barriers as they try to outperform the market.

Choosing a long-term winner involves more than seeking out funds with a successful track record, as past performance offers no guarantee of a successful investment outcome in the future.

Investors should consider other variables, including a mutual fund's underlying market philosophy, investment objectives, and strategy. They should also consider a mutual fund's total costs, including trading costs, which may be affected by the manager's approach.

THERE'S MORE…

To this point, we've only addressed the likelihood of a single manager outperforming her benchmark. But investors typically don't own just one mutual fund; they own a portfolio of them. A portfolio of actively managed funds has a lower probability of outperforming a portfolio of index funds than a single manager has of outperforming a single index fund. As the number of actively managed funds increases, the odds that a portfolio will outperform decrease. The reasons for this are twofold.

First, when investors allocate capital to multiple active managers it is often the case that one manager's active bets offset another's. For example, you might have one manager who is overweight Microsoft and another manager who is underweight Microsoft. The more managers held in a portfolio, the more likely it becomes that the underlying holdings, in aggregate, look very similar to a broad market index. The only difference is that a broad market index will cost 10 basis points, but a portfolio of active managers might cost in excess of 100 basis points.

The second reason stems from the dissymmetry between probability and payout for active management. Since the odds are against active management, it follows that the payouts for the winning active funds should make up for the losses derived from selecting losing active funds. But they don't. It's rare for managers to outperform their benchmarks by more than 75 basis points over a long time horizon, but it's quite common to see performance deficits in excess of 2-3%--sometimes more. The excess return for picking a winning active manager is far below fair payout given the high probability of selecting a losing fund and the average shortfall from losing funds. It's like betting $1 on a coin flip and only getting $1.30 when you win when you should be getting $2.

The nature of the unfair payout becomes an exponentially greater problem as more managers are added to a portfolio. Because the magnitude of underperformance is so much greater than that of outperformance, even if an investor defies the odds by selecting six managers who outperform in a portfolio of ten managers (three times the expected number), he is still likely to only break even relative to a portfolio of indexes.

Finding just one active manager who delivers benchmark-beating performance is a challenge for any investor. Selecting a portfolio of active managers that outperforms a portfolio of index funds is another matter entirely.

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