

# The Elusiveness of Market-beating Fund Performances

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How difficult is it to identify *ex ante* the fund manager that will yield market-beating returns over long-term investment holding periods?

Unfortunately, it seems it is much more difficult than merely looking at past-performance records and hoping that a manager's historical outperformance records will repeat itself going forward. In fact, it seems that outperformance *per se* is a much more random event than most of us would expect, given that the fund managers entrusted with our hard-earned savings are well-educated, good investment processes are typically in place and they have built some reputation over the years of managing monies fairly well.

To illustrate my argument, I have analysed fund managers' equity fund performances over the past ten years (June 2006 to June 2016) and compared that with an appropriate equity market benchmark (I used the Shareholders' Weighted All Share Index or better known as SWIX) over this period. In total, I identified 35 equity funds, all relatively large (more than R500 million under management as at the end of June 2016) and thus significant from an asset management perspective, and managed by well-known fund managers/investment institutions in South Africa.

How did the fund managers fare over this ten-year period? In the table below, I show a fund's annualised relative performance to the market benchmark (SWIX) over this period. A positive relative performance number indicates the extent of market-beating returns over the ten-year period.

In total, 11 out of the 35 funds managed this feat, and in order of outperformance: FM7, FM5, FM6, FM28, FM29, FM25, FM24, FM11, FM22, FM2 and FM21.<sup>1</sup>

Fund manager	Relative performance p.a.	Rank	AUM (June 2016)
FM1	- 0.50	16	3,225,992,443
FM2	0.30	10	39,292,349,624
FM3	- 0.06	12	506,212,553
FM4	- 1.95	28	495,522,670
FM5	1.56	2	6,931,441,975
FM6	1.27	3	17,660,433,252
FM7	1.74	1	12,345,190,909
FM8	- 0.17	14	1,080,333,268
FM9	- 0.09	13	8,174,334,392
FM10	- 1.82	27	5,404,763,640
FM11	0.46	8	4,685,971,238
FM12	- 1.13	19	595,792,108
FM13	- 1.57	25	1,255,498,188
FM14	- 0.72	17	15,317,610,273
FM15	- 0.48	15	2,671,123,122
FM16	- 2.78	30	6,545,935,768
FM17	- 1.40	24	545,494,500
FM18	- 3.42	33	2,150,476,896
FM19	- 1.35	23	1,591,596,398
FM20	- 4.30	34	2,375,613,925
FM21	0.18	11	13,555,989,189
FM22	0.41	9	470,147,542
FM23	- 1.66	26	1,452,327,911
FM24	0.46	7	4,892,592,330
FM25	0.83	6	2,680,478,202
FM26	- 1.19	21	2,177,000,544
FM27	- 2.91	31	513,270,169
FM28	1.08	4	641,059,349
FM29	1.03	5	7,576,654,309
FM30	- 0.73	18	2,883,323,329
FM31	- 4.51	35	723,969,790
FM32	- 1.32	22	3,872,826,959
FM33	- 3.00	32	11,184,493,745
FM34	- 2.74	29	2,281,851,260
FM35	- 1.14	20	1,165,201,848

<sup>1</sup> See Appendix at the end of document for a complete list of fund managers evaluated.

Source: Morningstar

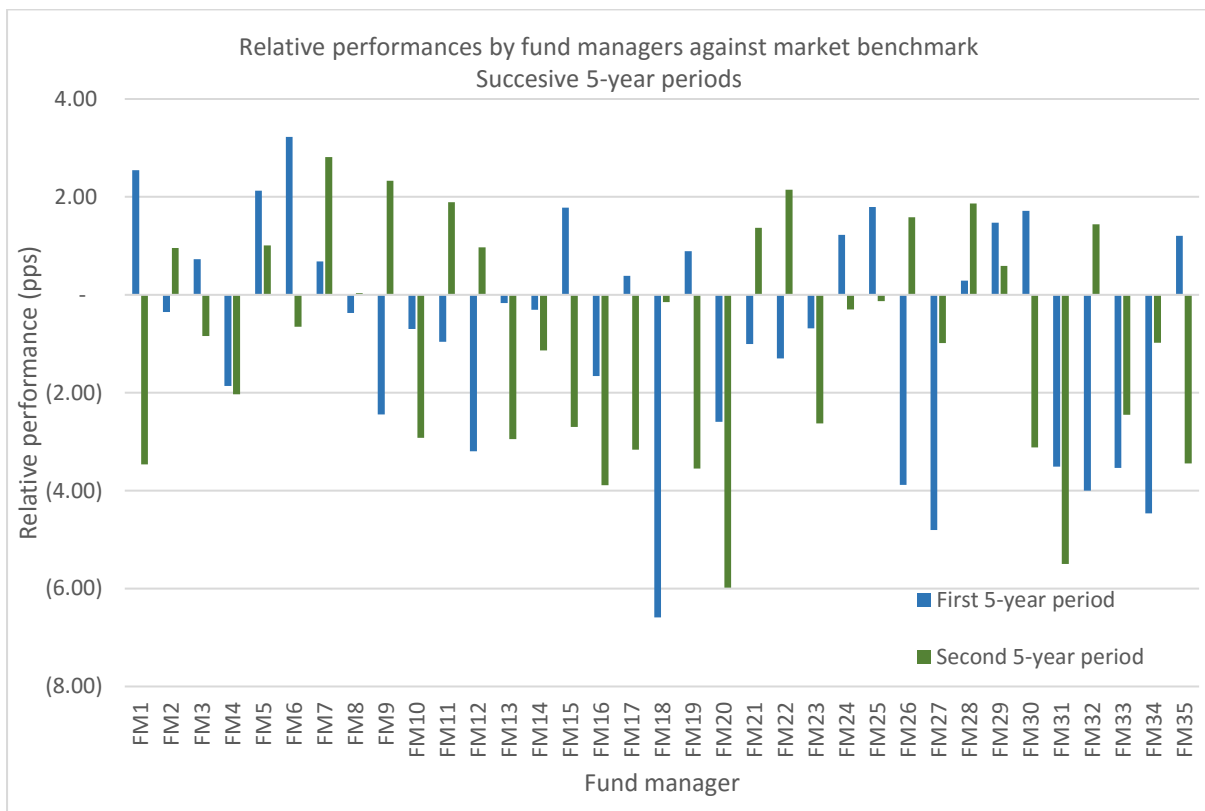
Note, however, that the ten-year outperformance record by no means indicate that these “winning” funds persistently outperformed during this period, i.e. a market-beating fund today might have had a mediocre performance initially, and *vice versa*.

Next, I dissected the ten-year period into two five-year holding periods, which incidentally is a “long enough” period to judge the added-value qualities of a fund manager. I did this because investors often are “jumping the ship” after experiencing relative under-performance for a prolong period and often migrate to performing funds at the time. These withdrawals are often done at exactly the wrong time because the following period might have yielded excellent performances by the same funds.

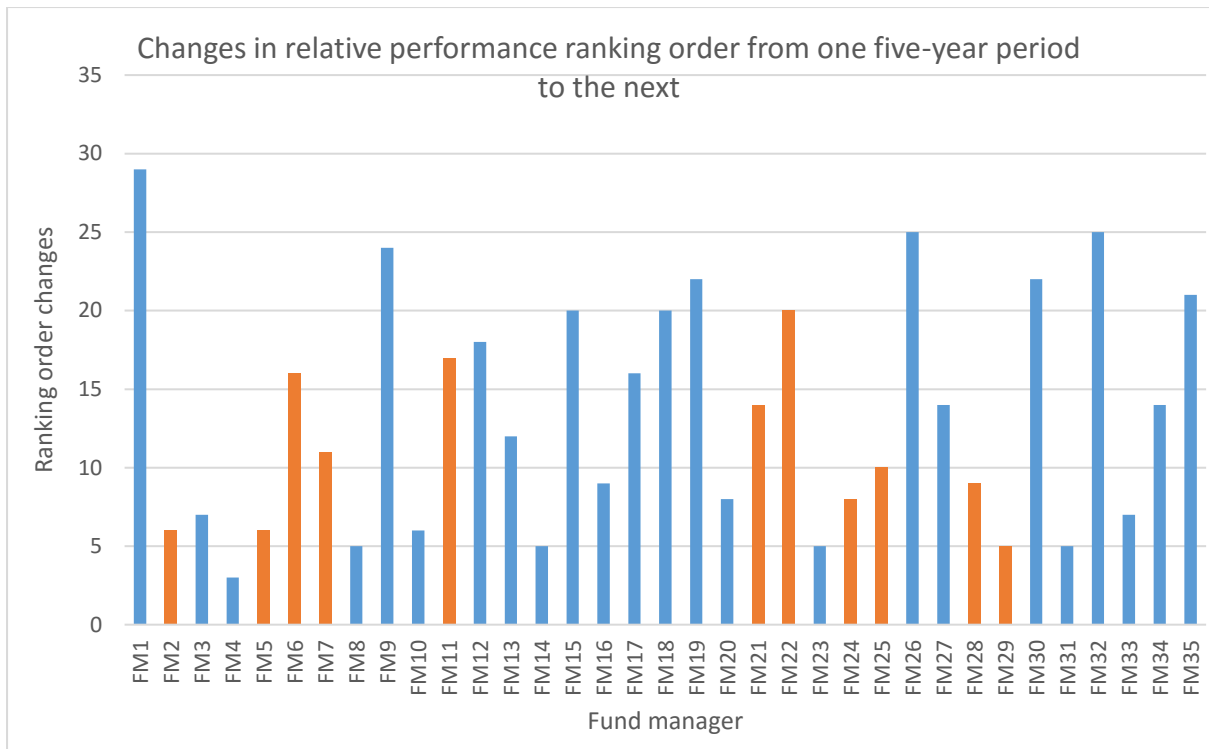
Fund manager	Relative performance (Jun 2011-Jun 2016)	Rank	Relative performance (Jun 2006-Jun 2011)	Rank
FM1	- 3.46	31	2.55	2
FM2	0.96	11	- 0.35	17
FM3	- 0.84	18	0.73	11
FM4	- 2.03	22	- 1.86	25
FM5	1.01	9	2.12	3
FM6	- 0.65	17	3.23	1
FM7	2.82	1	0.68	12
FM8	0.03	13	- 0.37	18
FM9	2.33	2	- 2.44	26
FM10	- 2.92	26	- 0.70	20
FM11	1.89	4	- 0.96	21
FM12	0.97	10	- 3.19	28
FM13	- 2.95	27	- 0.17	15
FM14	- 1.14	21	- 0.31	16
FM15	- 2.70	25	1.78	5
FM16	- 3.89	33	- 1.66	24
FM17	- 3.16	29	0.39	13
FM18	- 0.15	15	- 6.59	35
FM19	- 3.55	32	0.89	10
FM20	- 5.98	35	- 2.60	27
FM21	1.37	8	- 1.00	22
FM22	2.14	3	- 1.30	23
FM23	- 2.63	24	- 0.68	19
FM24	- 0.30	16	1.22	8
FM25	- 0.13	14	1.79	4
FM26	1.58	6	- 3.88	31
FM27	- 0.98	20	- 4.81	34
FM28	1.87	5	0.29	14

Fund manager	Relative performance (Jun 2011-Jun 2016)	Rank	Relative performance (Jun 2006-Jun 2011)	Rank
FM29	0.59	12	1.47	7
FM30	- 3.11	28	1.72	6
FM31	- 5.50	34	- 3.51	29
FM32	1.44	7	- 4.00	32
FM33	- 2.45	23	- 3.54	30
FM34	- 0.98	19	- 4.47	33
FM35	- 3.44	30	1.21	9

Source: Morningstar, DRW Investment Research



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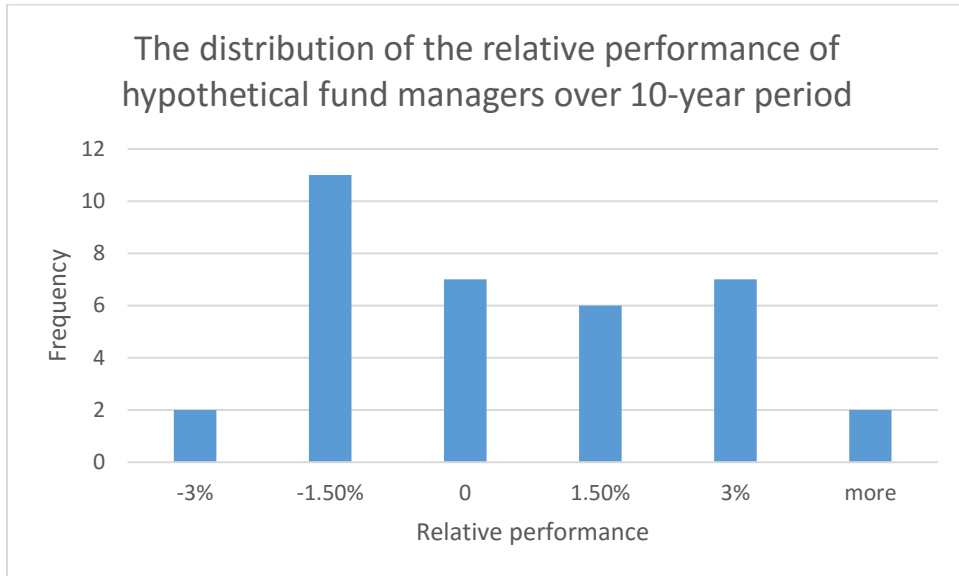
Clearly, it can be seen from the above that relative performances across the funds tend not to be persistent from one longer-term period to the next. Even the 10-year market-beating funds, depicted by orange bars in the graph above, show in some cases relative large rank movements in relative performance from one five-year period to the next. In total, only 4 fund managers achieve outperformance in both 5-year periods, 12 had underperformance in both, and the rest of the funds had mixed results.

The question arises then whether outperformance is in fact a random occurrence and is it worthwhile pursuing, i.e. keep on switching from one top-performing manager to the next? I will argue, yes, it is to a large extent (but not completely) random and, no, I do not believe in chasing performances, switching from one fund to another based purely on recent past performances.

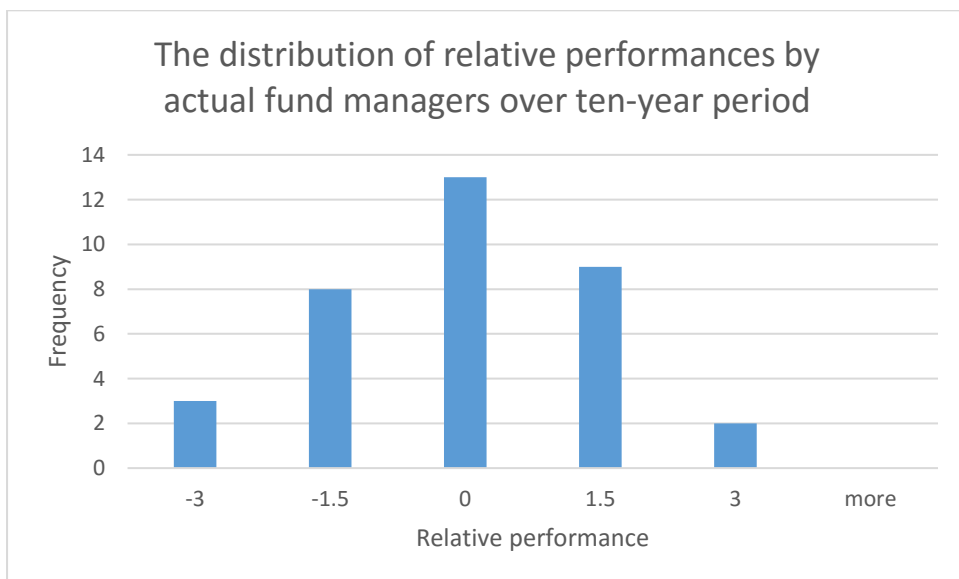
To elaborate on the above, I constructed a hypothetical situation where there are 35 fund managers with an expected excess return of 0% (thus outperformance is purely random) and a tracking error (expected deviation from the performance of the index benchmark) of 7.5%.

As expected, about half of the fund managers underperformed the index benchmark over a 10-year period. The real-life statistics, however, show that the minority of fund managers (typically twenty to thirty percent) achieve outperformance status. That in itself, is not too

surprising because the simple law of averages will dictate that after costs most fund managers will underperform the appropriate market benchmark. Effectively, market-beating performances are actually more difficult to attain and sustain than purely by chance alone.

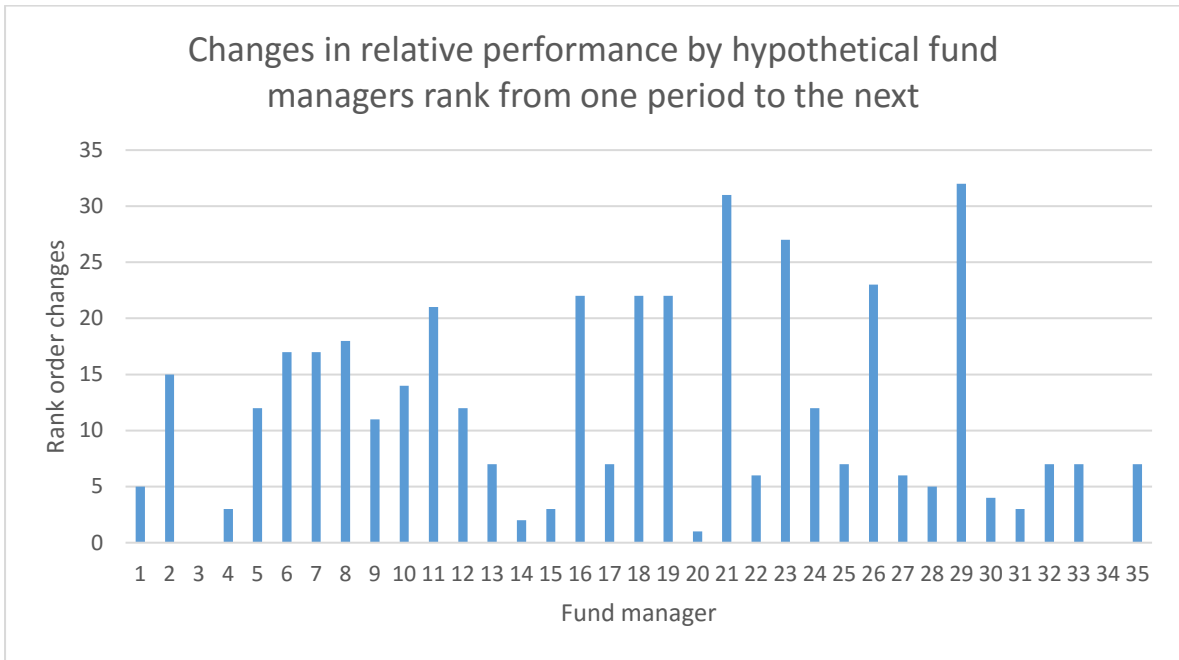


Source: Morningstar, DRW Investment Research

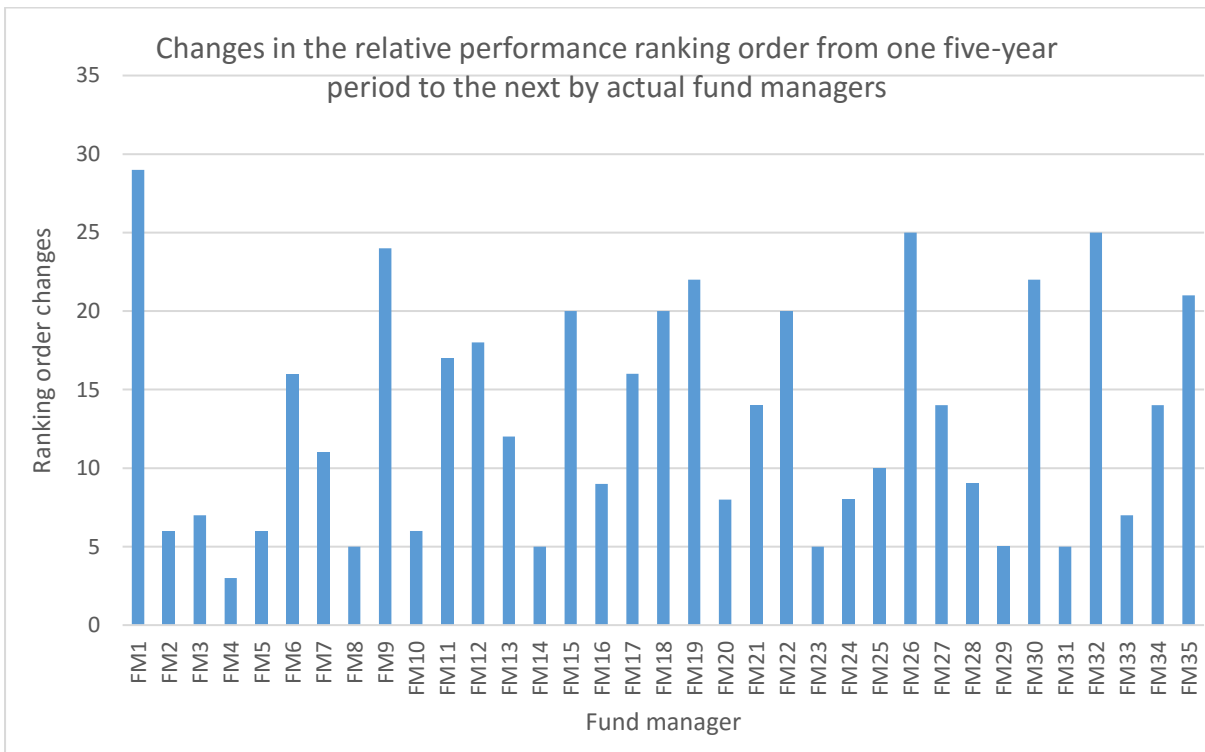


Source: Morningstar, DRW Investment Research

In the hypothetical example, I also separated the ten-year period into two five-year periods and observed, as expected, the same large changes, as with real-life managers, in the rank orders of relative performances by the hypothetical fund managers between the two five-year periods.

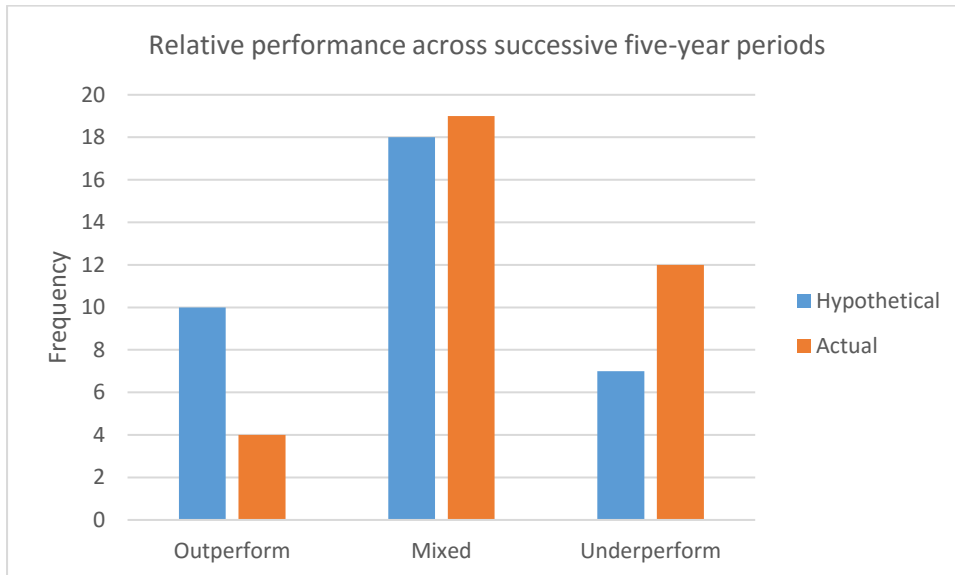


Source: Morningstar, DRW Investment Research



Source: Morningstar, DRW Investment Research

In the hypothetical example 8 fund managers achieved outperformance in both periods, and 14 underperformed both. The rest of the hypothetical managers had mixed results. In the real-life example only 4 fund managers attained excess returns in both periods, and 12 fund managers underperformed in both periods.



Thus, in all probability, it could be argued that outperformance by fund managers over a period is to a large extent a random event. Alternatively stated, a fund manager claiming outperformance over a long-term period will undoubtedly experience a period(s) of underperformance relative to its peers and the market benchmark. The real test for investors then is whether they can stomach such periods. I will argue most investors are not really hard-wired to endure such underperformance periods and are probably inclined to make switches to alternative performing managers at the time.

I will argue, furthermore, that to invest in a particular fund manager in the hope of achieving the same outperformance results as maybe in the past, is perhaps the wrong focus all together. I would rather invest in a fund manager because I trust their investment process and philosophies, I am happy and understand how much they are charging for their professional fund management services, and I believe they are acting as real custodians of my savings; i.e. not allocating irresponsible, concentrated bets on certain segments of the market. Yet, it is far more popular to “go with the flow”, to invest with the reigning performers, and with little regard for an appreciation of the ebb and flow of relative performances and intrinsic understanding of the investment philosophies of the fund manager concerned. To my mind, it is the sure path to investment disappointment down the road.



## APPENDIX

ABSA Select Equity A	FM1
Allan Gray Equity A	FM2
Aylett Equity Prescient A1	FM3
Community Growth Equity	FM4
Coronation Equity R	FM5
Coronation Top 20 A	FM6
Foord Equity R	FM7
Investec Active Quants A	FM8
Investec Equity R	FM9
Investec Value R	FM10
Marriott Dividend Growth R	FM11
MET General Equity A	FM12
Nedgroup Inv Growth R	FM13
Nedgroup Inv Rainmaker A	FM14
Nedgroup Inv Value R	FM15
Oasis Crescent Equity D	FM16
Oasis General Equity D	FM17
Old Mutual Albaraka Equity A	FM18
Old Mutual Growth R	FM19
Old Mutual High Yield Opp A	FM20
Old Mutual Investors R	FM21
Old Mutual Managed Alpha Equity A	FM22
Old Mutual Top Companies R	FM23
Prudential Dividend Maximiser A	FM24
Prudential Equity A	FM25
PSG Equity A	FM26
PSG MM Equity FoF A	FM27
Sasfin MET Equity A	FM28
SIM General Equity R	FM29
SIM Value	FM30
STANLIB Capital Growth R	FM31
STANLIB Equity R	FM32
STANLIB MM Equity B1	FM33
STANLIB SA Equity R	FM34
STANLIB Value B1	FM35



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