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Briefing
April 2020

Investment management: Why active managers can outperform and how to select them

For
Your family ✓
Your firm
Your society

Reading time
12 minutes

Enodo can help
Select the right fund managers for your portfolio that suits your individual investment profile

Oversee the manager's performance over time and provide customised and comprehensive reporting for decision making purposes

Function as your family's investment committee to take investment decisions in a sustainable and long-term focused fashion

Executive summary

In our discussions with clients, we regularly find ourselves in a debate about the merits of active fund managers. Why not simply use passive funds that replicate a stock market index, cost a lot less, and seem to be doing the job similarly well? Clearly, there are good arguments that speak in favour of these trackers. However, they only work well in upward trending markets. In a downturn scenario, an index fund will perform poorly, because that is what it is supposed to do, whereas an actively managed fund can and typically will take measures to counter the blow of a crash.

To make this point clearer, we first compare performance figures of actively managed funds with the index. However, this is merely the starting point of this report. What we want to actually demonstrate is that, the selection of the *right* active manager is crucial in order to enjoy healthy, long-term returns. We look at how managers across different asset classes have fared over time and conclude that only a small fraction stands the test of time.

We then use the data available to test which factors actually drive fund performance. One finding is that the level of fees that managers charge is unlikely to be a major performance driver. Interestingly, the opposite is true for hedge funds where more expensive funds have performed better in the past. Another finding is that experienced fund managers don't necessarily outperform more junior colleagues in terms of performance. Lastly, managers that get the risk-return dosage right, i.e. those who achieve higher returns per unit of risk taken, have unsurprisingly outperformed other funds.

Ultimately, however, there are also softer, qualitative factors at play that require a thorough analysis when selecting an investment manager. The quality of the key decision makers in a fund, the manager's investment philosophy, but also the investment firm's procedures and risk control framework play a crucial role in our selection process.

The longest bull run in history came to a painful halt in the first quarter of 2020. The value being wiped off investors' portfolios was truly staggering. Most portfolios will take some time to reach the value prior to the meltdown again and many investors - burned by the huge losses - may decide to stay away from the markets for the foreseeable future. Even before this crash, in our discussions with business owners, we often heard the argument that keeping money in cash is simpler and safer. This mindset has gained traction more recently, as it has clearly produced superior returns – there have been no losses, unlike riskier asset classes. The other view regularly shared with us, from people willing to invest in markets, was scepticism of actively managed fund providers. A common, and growing, perception has been that low-cost index tracking funds produce better results after management fees.

Are cash deposits and index tracking funds really all you need?

We suggest two challenges to these viewpoints.

First, we are going to be living in a zero – or even negative – interest rate environment for the foreseeable future. For those depositing cash, this means a loss in the real value of your deposit, after accounting for inflation. Over time, the compounding effect will seriously harm any depositor's wealth position.

Second, the use of low-cost index tracking funds works well when there is an upward trend in markets. However, their *passive* nature means that they expose the investor fully – and indiscriminately – to a market downturn. In contrast, a well-run, actively managed funds will be able to avoid the market's worst excesses. Although, inevitably, this will still mean that the portfolio incurs a loss, the smaller size of that loss will prove vital when markets turn positive again. Elementary mathematics tells us that (say) a 25% loss in a portfolio just requires a 33% positive performance to recoup that loss. Whereas, a loss that is 10% greater (so 35%) requires a 54% return to reach its former level. So, protecting your portfolio from such excess falls is critical.

Just how exactly active fund managers have performed, and what to consider when selecting the most successful ones, is the subject of the remainder of this note. Using data available on Morningstar – a respected funds information provider – we employed a number of quantitative analyses on a panel of over 2,700 funds from across the global equities, bonds, hedge funds and property sectors.

Active fund managers can protect your portfolio, especially when markets turn negative

Let's, first, take a look at how equity fund managers that invest in blue chip stocks worldwide fared in the past, and compare their performance to an index that holds assets from the same investment universe, but is by nature *passive*.

Starting with the index – using the average of the *MSCI all-country* index and the *MSCI developed markets only* version – the ten-year annualised return, between March 2010 and March 2020, has been up +3.1% per annum. For shorter periods, the index has actually returned a loss on an annualised basis, of between -1% per annum over the last five-years and -21% over the last year. Most dramatically, the performance since the start of the year 2020 until 20 March has been a dismal -29% (the year-to-date, or YTD, number).

Table 1: Average annualised returns for global large equities (active vs. passive approach)

Passive indices	YTD	1Y	3Y	5Y	10Y
MSCI Developed Markets	-29.0%	-20.6%	-3.2%	-1.0%	3.4%
MSCI Developed and Emerging Markets	-28.7%	-20.9%	-3.5%	-1.2%	2.8%
Average of two indices	-28.9%	-20.7%	-3.3%	-1.1%	3.1%
Active managers by performance quartile rank					
Top quartile fund performance (top 25%)	-21.1%	-11.7%	0.8%	4.2%	7.8%
2nd quartile fund performance	-26.2%	-17.4%	-2.3%	1.1%	6.1%
3rd quartile fund performance	-30.1%	-22.3%	-4.9%	-1.1%	4.5%

Notes:
Sourced from Morningstar for fund information based on 1154 global equities funds. MSCI data for index information.
Both data valid as of 20.3.2020

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In stark contrast, the top 25% of actively managed funds have produced between -21% (YTD) and +7.8% (10Y), comfortably outperforming the index by four to nine percent, each year.

It is worth noting that even the second quartile of managers – so, all fund managers that ranked in the top 50%, have produced better results than the index. Given the extreme drop in markets we have witnessed in the first quarter of 2020, it is not entirely surprising that even the third quartile of fund managers achieved a respectable performance, as even rather mediocre managers tried to do *something* to avoid bigger losses in this market turmoil.

Whilst the recent market environment clearly favoured active managers, we are not advocating a complete avoidance of index trackers. On the contrary, we believe that *both* have their place in your asset allocation. However, where active managers are deemed more suitable, we cannot emphasise enough that careful selection is vital. Choosing a top quartile fund manager that has consistently produced strong results, from a vast universe of managers, will have a transformative impact on your performance, especially in the long run.

What you need to know when selecting a fund manager

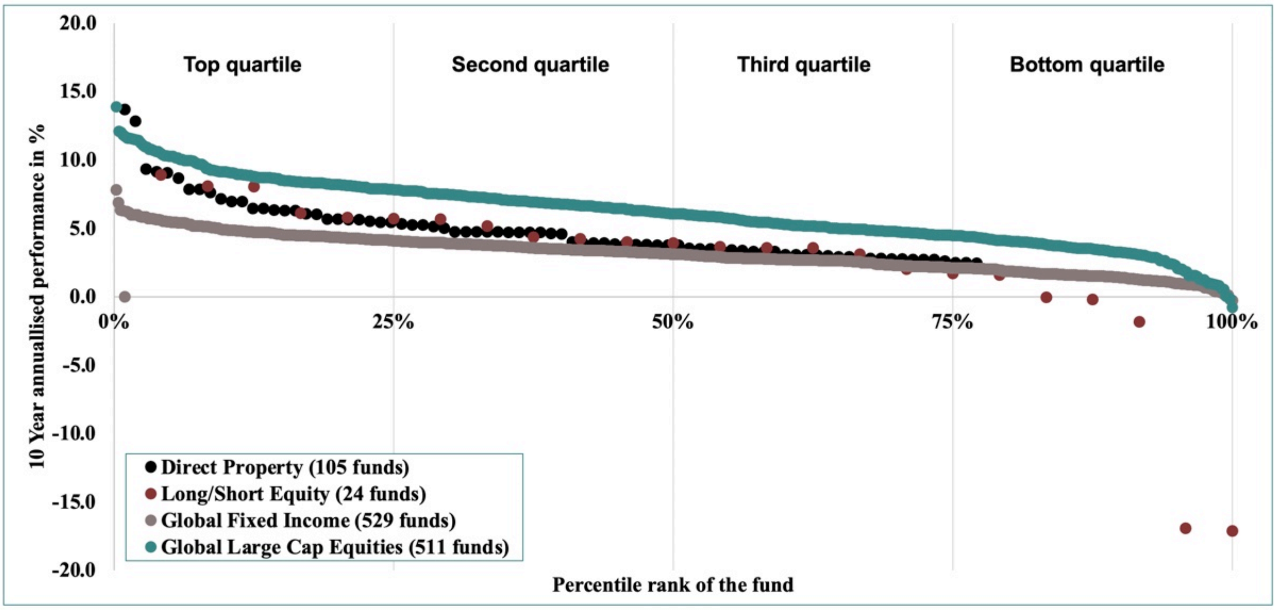
The obvious challenge for any advisor is demonstrating their value by picking suitable, top-performing managers. Failing to do so will likely lead to worse results than just merely investing in a low-cost index tracking instrument. The importance of the advisor's choices become evident when looking at chart 1 below. It displays all managers with a ten-year track record in our database and plots their annualised returns in ranked order.

Each green dot, for example, represents the performance of one of 511 global large cap equities managers included in the sample. As can be inferred from the graph, the best performing fund achieved a return of around +14% per annum (the dot at the top left corner at 1st percentile), whereas the worst performing manager achieved a dreadful -1% per annum during the same period (the dot on the right bottom corner at the 100th percentile).

The grey dots signify a similar representation for global fixed income fund managers. As you would expect from bonds, the variation is somewhat less than for equities, with the top performing fund achieving around +8% per annum and the bottom performing at -1% per annum, which is still a significant difference.

Property investing fund managers (black dots) had a range of performance between +14% per annum and +2.5% per annum, whilst long/short equity managers (red dots) achieved anything between -17% and +9% per annum.

Chart 1: 10 Year annualised performance of managers by asset class and percentile distribution



Notes:
Data sourced from Morningstar. Data valid as of 20.3.2020

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You may be surprised to see relatively few managers delivering below 0% per annum returns. This can be explained by the reality that consistently negative performing funds end up being closed and won't report their poor results as a consequence. This survivorship bias actually skews the performance data to appear even more favourable than it actually is. It also strongly reinforces your need to identify the very best fund managers to deliver credible performance for your portfolio.

The differences between fund managers are real and significant. Consistently choosing top-quartile managers would have delivered at least 4.1% per annum more in fixed income, 5.4% in real estate, 5.7% in long/short strategies and 7.8% in large cap equities. In a balanced portfolio of USD50m, that could equate to an additional return of USD30m, over the ten-year period!

Focus on active managers who have consistently delivered superior returns

The results shown in chart 1 were a snapshot taken at a certain point in time (March 2020). It is therefore fair to assume that a different time period may have yielded varying results, with other fund managers being at the top. In order to identify those managers that deliver superior returns consistently, the analysis needs to be extended to include different time periods.

What constitutes a superior return is, however, subject to much debate in the industry and depends on a number of considerations. For the purposes of this note, we define superior returns as the manager's ability to achieve returns that only the top 25% of all funds have achieved for the period under consideration. In other words, we focus on *relative returns*, i.e. on how the returns of a fund manager compares to those of her peer group of fellow fund managers. We then declare those as superior that are amongst the best 25%.

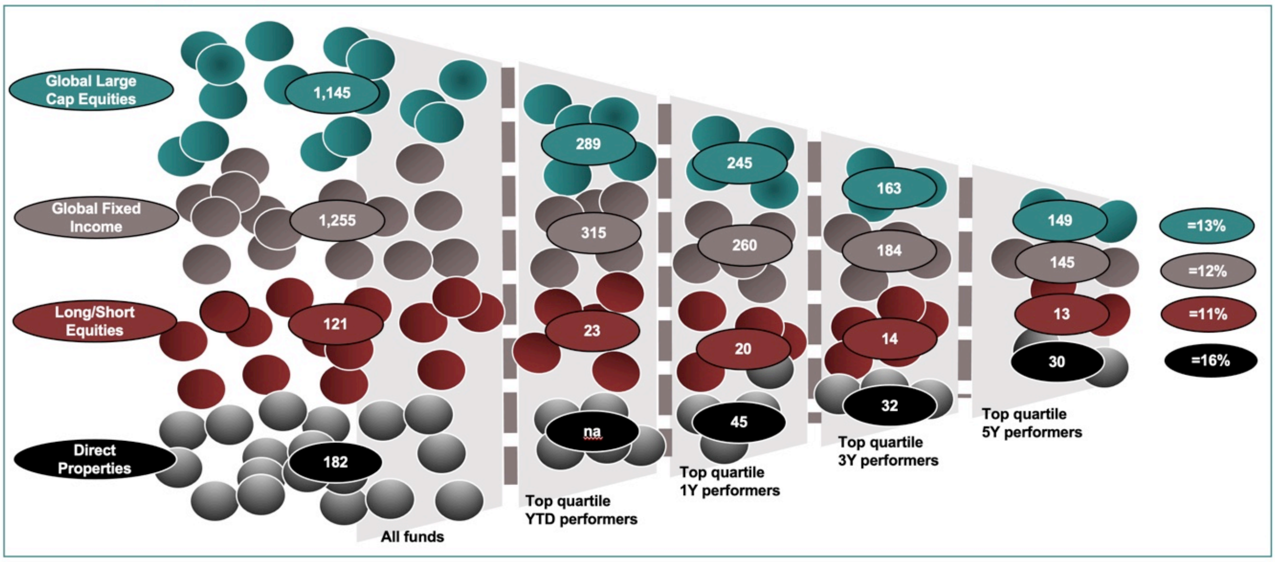
However, for hedge fund managers deploying a long/short equity strategy, we also require the fund to achieve a positive return, so in addition to a relative comparison of manager, we select only those with positive *absolute returns*. The reason for this distinction is that hedge fund managers are far less constrained in their strategy and aim to achieve a positive return in any market environment – and their fees reflect this. To achieve this, they employ strategies not open to conventional managers, such as leverage and shorting.

To identify those managers in our panel that stood the test of time – those that consistently outperformed their peers over multiple periods – we employ a funnel that essentially filters out managers that didn't achieve a top quartile performance result in *each* of the considered time frames.

Let's look at an example: We start off with 1,145 fund managers with a mandate for global large cap equities for four different time periods (YTD, 1 year, 3 year, 5 year). We then identify the top 25% of performers, for each of the respective periods. The first filter eliminates 75% of managers that do not belong to the top quartile performance in the period between the start of 2020 and March 2020 (the YTD performance). Left with 289 managers, we eliminate those that have not been top 25% in the '1 year' category, reducing the sample further to 245.

Applying the same approach for '3 years' and '5 years' leaves us with a short list of 149 managers (or 13% of the total), that have consistently managed to be in the top quartile population.

Chart 2: The top quartile performance funnel over time



Notes:
Data sourced from Morningstar database. Data as of 23.3.2020
Clean asset share class only, except for property funds where all available funds were used. Only funds with at least 5 year track record were selected

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Using the same approach for the other asset classes yields similar results: for global fixed income managers, a list of 145 managers (12% of the initial list), 30 direct property fund managers (16%) and 13 long/short equities managers (11%).

While the commonly known disclaimer 'past performance is no guarantee for future performance' should not be forgotten, a selection on the basis of past performance certainly gives a good first cut of suitable funds, eliminating those managers that have not delivered in the past. By using multiple filters, we can minimise the risk of selecting a manager who has had a lucky one-off performance period, identifying those that have delivered solid and consistent returns.

But performance data alone doesn't tell us the whole story

Are there other relevant criteria we should focus on in addition? To answer this, we employed a regression analysis to test a number of potentials factors that might drive fund returns:

Fees
Fees are an intuitive place to start. In the relatively low yielding environment we are in, you may believe that dollars saved in fees would translate into better performance. However, surprisingly, we have found little evidence that relative fee levels matter much – in particular in the equities and fixed income asset classes. We found some evidence for direct property, but this effect fades over time. Rather surprisingly, we found clear evidence that those hedge funds in the long/short equities sector that charged higher fees than the average, actually performed better. This effect is quite pronounced across multiple time periods and might indicate that it costs money to access the best hedge fund talent?

Tenure of fund manager
It is often assumed that industry experience of the fund manager is an important determinant of success. After all, first-hand experience of the full market cycle would surely help them make better decisions? However, our analysis of the data offered the opposite picture. Shorter tenured managers consistently achieved better returns than managers with a longer industry experience, especially in the equities and fixed income asset classes, whereas tenure played no role for property funds and hedge funds. This could indicate that more experienced managers may become complacent over time compared to their more junior, hungrier (?) colleagues.

The size of the fund
The size of the fund may also impact a fund's performance, however, there are valid reasons that size could both influence the performance in both helpful and counterproductive ways. In our sample, it appears that smaller fixed income managers have a clear advantage over larger competitors. One possible explanation for this could be that a manager at smaller fund is less constrained and nimbler in her investment approach. This may come particularly handy in this highly competitive market with very small return differentials amongst bonds. On the other hand, we can see a positive relationship between the fund's size in the direct properties space. Here, we speculate that the set-up costs of running a property fund are sizeable and that larger funds benefits from significant economies of scale which ultimately translate into better returns for investors.

The size of the companies in the portfolio
The market capitalisation of the companies in the portfolio might influence results. The benefit of larger companies is higher liquidity, whilst smaller, under-researched companies offer more opportunities to identify a potential mispricing in the stock price. Our analysis shows little support for this phenomenon, with the exception of the longer-term performance of long/short equities funds where larger company exposure has tended to product superior returns. An explanation here could be that more liquid stocks provide better opportunities for shorting.

Proper reward for risks taken
Across the board, we found very strong evidence that achieving a higher return for every unit of risk taken, leads to superior returns. Funds managers that do this well and consistently achieve better returns, versus peers. But how about the absolute levels of risk? Does taking more risk lead to higher returns? In general, this has proven to be the case. Having said that, with more recent downturns in the market, this has led to some underperformance. These findings are perhaps not surprising, as higher risks should be rewarded with higher returns over the long-term.

Table 2 summarises our findings. It shows the level of significance for various multi-variate regressions that were run to test the above hypotheses.[1]

Table 2: Regression results of influence factors on manager performance - by level of significance

		Asset class															
		Global Large Cap Equities				Global Fixed Income				Long Short Equities				Direct Properties			
		YTD	1y	3y	5y	YTD	1y	3y	5y	YTD	1y	3y	5y	YTD	1y	3y	5y
Factor	Fee	/	/	/	/	/	/	/	/	dir**	dir***	dir***	/	n/a	inv*	inv**	/
	Tenure	inv**	inv**	/	inv*	inv***	inv***	inv***	/	/	/	/	/	n/a	/	/	/
	Fund size	/	/	/	/	inv***	inv***	inv***	inv**	/	/	/	/	n/a	/	dir***	dir*
	Market cap	/	/	/	/	/	/	/	/	dir*	dir*	dir*	dir***	n/a	/	/	/
	Risk -StD	inv***	inv**	dir**	dir*	dir***	dir***	dir***	dir***	inv***	inv*	/	/	n/a	dir***	dir***	dir***
	Risk - Sharp	dir***	dir***	dir***	dir***	dir***	dir***	dir***	dir***	dir*	dir***	dir***	dir***	n/a	dir***	dir***	dir***
	R-squared	31%	44%	81%	49%	15%	22%	39%	27%	27%	24%	58%	64%	n/a	84%	61%	62%

Notes:
inv: inverse relationship with performance
dir: direct relationship with performance
*** 1% significance level (very high level of confidence)
** 5% significance level (high level of confidence)
* 10% significance level (moderate level of confidence)
/ No significance found

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Beyond numbers – effective manager selection also requires qualitative judgement

Our regression analysis identifies a set of factors that explain the performance of actively managed funds, which supports us in selecting the managers with positive characteristics. However, it remains a quantitative approach, which, by itself, is insufficient. As with every regression analysis, ours can also only explain a portion of the variation in performance outcomes. Depending on the asset class and timeframe, we see that between 16% and 85% of the variation in performance remains unexplained (the ‘R-squared’ in the table which displays the percentage that is explained)

To fill this gap, additional assessments of more qualitative nature are carried out to reach a well-founded conclusion. A core aspect of our qualitative analysis is an assessment of the quality of the key decision makers in the fund – based on their qualifications, track record and general conduct during our conversations.

[1] For each asset class, the YTD, 1 year, 3 year, and 5 year performance was regressed against a set of variables, ranging from fees, tenure, size, market capitalisation, fund performance standard deviation, and fund Sharp ratio. The body of the table then shows the direction and significance level for each of these factors. The bottom line shows the R^2 for each of the regressions.

Further critical points we consider are – the manager's investment philosophy and realism of the investment returns that the manager hopes to achieve. The investment firm's procedures, risk control framework and clarity with which results are reported are equally assessed, as is the firm's resourcing of its research and back office functions.

Last but not least, we take a closer look at the manager's fee structure to ensure they are fair and aligned with the client's interest. By applying a balanced scorecard, these less tangible but critical elements of fund manager selection feed into our overall assessment.

How we can help you in making the right choices

Selecting a manager that will provide satisfactory, long term results that are suitable for your risk appetite is clearly the holy grail that everyone aspires to achieve. To a certain extent it is as much an art as it is a science given that nobody can predict the future. We want to make our expertise in this field available to you and offer you a complimentary and comprehensive health check for your portfolio. Our assessment would also include an in-depth review of your attitude to risk, which will ultimately determine your ability and willingness to expose yourself to different asset classes. To get a glimpse of our approach, we have developed an online, fully customisable version – the Enodo **G**oal-based **A**sset and **L**iabilities **A**llocation (GALA) Modeller™ – which can be accessed here.

About the authors

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Nick has over 20 years of experience in wealth management, predominantly spent at UBS where he was a Managing Director. He held a number of senior leadership roles, including Head of Wealth Management for Global Emerging Markets in London, where he led a sizable business advising wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

For six years, Nick was Head of Investment Products and Services where he led the investment management, capital markets, alternative investments, lending and wealth planning functions, responsible for over USD50 billion of client assets, and a sizable lending book. He also founded the client philanthropy unit in the UK, which supported clients in maximising the strategic impact of their giving. He has been a regular media commentator. Over the years, he has also maintained a strong academic interest in business psychology.

He has served on numerous non-profit boards and is currently Vice Chairman of the governing body of Royal Holloway, University of London, amongst the top 25 in the UK and 250 globally. He also chairs the committee overseeing the university's USD100 million endowment.

He holds MSc in Organizational Psychology and MBA in Finance degrees from the University of London, is a Chartered Wealth Manager, Chartered Fellow of the Chartered Institute for Securities & Investment and Member of the British Psychological Society. He was elected Fellow of the Royal Society of Arts for his work in philanthropy. He is also a part-time Doctoral researcher in organizational psychology and family-owned business at Durham University.

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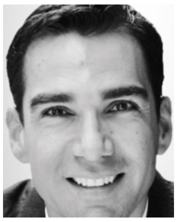

Baris has over 15 years of experience in wealth management and investment banking in London, Zurich and Frankfurt. Between 2006 and 2020, he worked for UBS, where he was a Managing Director.

He served as Head of the Global Family Office, Ultra High Net Worth Emerging Markets and Financial Intermediaries units for UK and Jersey, offering wealth management, structuring, lending and investment banking solutions to the largest clients of the firm. His team was entrusted with over USD12 billion of client assets.

Prior to this, he was responsible for various significant teams serving wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

Before joining UBS, Baris was a research assistant to the Chair of International Banking and Finance at the Goethe University Frankfurt and a visiting scholar in Finance at the Wharton School, University of Pennsylvania.

He published papers on global stock exchanges in peer-reviewed academic journals, including the prestigious Journal of Banking & Finance, and was a regular commentator in the media.

Baris holds a Doctoral degree in Finance from Goethe University Frankfurt and the Diplom Kaufmann degree from the University of Regensburg, as well as an MBA degree. He has completed the Chartered Financial Analyst and Financial Risk Manager programmes.

The story of Enodo

Enodo is the Latin word to explain, literally to *unknot* or *untangle*. This encapsulates our vision – to bring clarity to the complexity of being wealthy.

Our founders have had the privilege of advising some of the world's wealthiest families. They've observed first-hand the liberation and opportunity that wealth can bring – unifying families around a common purpose, creating real economic impact via a family business, or contributing to wider society through audacious philanthropy.

At times, they've also seen the stress and confusion that can result. They've witnessed family disharmony, miscalculations in family business or investment strategy, and the hugely detrimental impact of working with advisors who put their own interests first.

Our founders have engaged in the discipline of advanced academic research. Their own analysis of peer-reviewed academic literature across the disciplines of finance, economics and business psychology, combined with their deep professional experiences, have allowed them to arrive at new perspectives on how *to be wealthy* and how *to manage wealth*.

The result of their thinking is the Enodo Leadership in Wealth™ advisory framework which supports wealthy families in using their wealth to lead across all the dimensions of their life – *family, firm* and *society*. Amongst other things, their framework includes:

For your family

- Family governance and family office set-up
- Investment risk and asset allocation – including family business assets and debt
- Chairing a family investment committee
- Selecting the best investment managers
- Analysing investment opportunities, including alternative investments and recent innovations (e.g. cryptocurrencies)
- Understanding the impact of investing in your passions, such as art and collectibles
- Monitoring of performance and risk
- Guiding and analysing where you are in dispute with your investment advisor

For your firm

- Organizational culture and performance
- CEO / founder succession and role of family members
- Financial optimisation – including debt, hedging and foreign exchange
- Reviewing your equity and debt capital market opportunities
- Corporate and social responsibility

For your society

- Philanthropy and impact investing
- Establishing a family foundation

The Enodo Goal-based Asset and Liability Allocation (GALA) Modeller™ offers ground-breaking insights into optimal strategic asset allocation – examining the risk characteristics of a family business shareholding and analysing tolerance for risk from psychological personality profiling. You can experience a shortened version of this powerful tool here.

At Enodo, we offer rigorous, independent and intelligent advice to wealthy families around the world. We aspire to be your trusted partner, wherever life leads you.

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