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AUSTRALIAN EQUITY MANAGERS: SEPARATING LUCK FROM SKILL

Rick Di Mascio

Inalytics Research Paper 4 quantifies how misleading track records are as an indicator of skill. We provide evidence that even fund managers with no skill in stock picking have still been able to have positive track records against the standard Australian equity benchmark.

The starting point for the research was the conviction of the industry that Australian managers' track records, and consequently their levels of skill, was superior to their peers around the globe. However, based on the Inalytics' measures of skill, Hit Rates and Win Loss Ratios, we found that Australian managers' levels of skill are in fact very similar to those for the rest of the global industry.

The research reveals that:

- a significant proportion of the outperformance came from the underweights, which is highly unusual and is normally associated with luck (see Inalytics Research Paper 1 for details);
- of the 42 managers that had outperformed, they all had a significant contribution from the underweights;
- 30% of these managers got more of a benefit from the underweights than their actual stock picking;
- 18% of managers outperformed even though they show no skill in stock picking, in fact, they may have been given a performance bonus for "winning the lottery".

What makes these results interesting is that many of these fund managers are charging performance fees for beating the index; yet the positive results for some of the Managers are not based on good stock selection, but a structural issue with the benchmark or whether the Managers are given the right targets.

This paper examines the factors behind these highly unusual results and draws some conclusions on benchmarking and the need to assess skill when monitoring and selecting managers.

No getting away from the fact that the track records look exceptionally good

An industry in very good health

Whenever we have undertaken search exercises on domestic Australian Equity Managers, or monitored an Australian client's Domestic Managers, we regularly found that the vast majority have outperformed. Needless to say this has made us curious to see if they really are as good as they appear, if there are lessons we could learn about how clients select managers in Australia, and finally whether this really is the Holy Grail and the vindication of investment boutiques' approach that the rest of the world is seeking.

In order to address these questions a cross section of the industry volunteered data on 62 portfolios which, we believe, represents just over half the industry. Before presenting the findings we wish to thank those Super Funds and Fund Managers who provided data for their generosity and co-operation with this exercise.

The most striking feature from an international perspective is the extraordinary number of Managers that outperformed compared to elsewhere in the world. In fact we found that, out of the sample 62 managers in the database, no fewer than 42 outperformed the S&P ASX300 during the period being measured. Two thirds of managers outperforming their benchmark is a remarkable result by any standard, and one that sets the Australian industry apart from its peers around the world.

Identifying investment skill

But is it the same thing as skill?

History shows us time and time again that there is a world of difference between short term track records and investment skill. We hope that they are one and the same thing, but experience tells us differently. Therefore it is interesting to see how these bedfellows sit with each other with respect to the Australian Fund Management industry.

A manager with investment skill typically has one or both of the following attributes:

- gets more than half their decisions to own a stock right;
- is able to run their winners and cut their losers.

These skills are captured in our two key metrics of the Hit Rate, which is the percentage of decisions the manager gets right, and the Win Loss Ratio, which shows whether the good decisions generate enough return to offset the poor ones.

Average measures of skill, Benchmark: S&P ASX 300

Hit Rate	Win Loss Ratio
49.9%	104.9%

Looking at the same values for Inalytics' peer group average:

Average measures of skill, Global peer group

Hit Rate	Win Loss Ratio
49.5%	109.6%

The main observation is that although the performance track records are clearly superior to elsewhere in the world, the levels of skill appear to be broadly in line with their international peers.

Getting behind the track records to see what's driving them

What is behind this apparent contradiction?

The starting point for any of our analysis on skill is to separate the positive decisions, to hold or overweight a stock, from the decisions to underweight a stock. Almost always, managers add value from their positive decisions but either do not add any value from the negative or underweight positions, or more likely destroy value from the "negative bets".

The first thing that struck us about the results is that, almost uniquely from a global perspective, both the positive decisions, ie. overweights, and the underweights added value.

Average contributions in basis points Domestic Australian Managers

Underweights	Overweights	Total Contributions
289 bps	471 bps	760 bps

From a global perspective

This is highly unusual as managers typically only add value from the overweight decisions and the comparison with international managers could not have been more striking. The following is based on a sample of over 700 funds, across the Inalytics client base:

Average contributions in basis points Inalytics' global peer group

Underweights	Overweights	Total Contributions
-59 bps	615 bps	556 bps

Separating luck from skill among the outperforming managers

Taking the 42 Australian managers that outperformed, we noticed that:

- 39 had positive contributions from the underweights;
- 11 portfolios, the contributions from the underweights exceeded the overweights;
- 7 portfolios, the contributions from the overweights were negative.

All of these observations are highly unusual and made us wonder whether there is a structural bias within the benchmark as the chances of 39 out of a sample of 42 managers displaying this level of skill would be highly unusual.

Once we started to look into the results we noticed that instead of the usual normal distribution of over and underweights at the sector level, there was an extraordinary coincidence of view in one sector, that of Real Estate Investment Trusts (REITs). In fact, out of our sample of 62 managers, all except two were underweight in the REITs sector throughout the period under review.

REITs bet paid off

This decision paid off in spectacular fashion adding some 261 bps on average to the performance of the Funds in the sample.

Average contributions in basis points

Contribution from underweighting REITs	Contribution from all underweights
261 bps	289 bps

It is not the purpose of this paper to speculate on whether this was luck or judgement, but it is clear that a sizeable proportion of the alpha came from this single decision to underweight REITs. In fact, this decision makes up virtually all the contribution from the underweights.

The quote

The main observation is that although the performance track records are clearly superior to elsewhere in the world, the levels of skill appear to be broadly in line with their international peers.

The issue for us is whether there is skill beyond this decision and whether there is what the academics call breadth; the ability to apply skill across a wider range of decisions that mark out a sustainably skilful process (in our terms, a decent Hit Rate).

In order to double check that we are on the right lines we re-ran all the portfolios against the S&P ASX300 ex REITs benchmark, because if there is genuine breadth, it will be revealed. Taking the same measures as before, the results are as follows:

Average contributions in basis points Benchmark: S&P ASX300 ex REITs

Underweights	Overweights	Total Contributions
-237 bps	592 bps	355 bps

This now looks like the rest of the world and suggests that the normal pattern we see everywhere else, managers adding value from the overweights and losing it from the underweight decisions, also holds for Australia. Experience has taught us that if the return is focused on a single outcome, in this case the poor performance of REITs, then if it turns the other way the outperformance usually reverses as quickly. Time will tell if this follows this time honoured pattern.

Conclusion

We believe that this analysis provides a valuable insight into the reason behind the recent success of some of the Australian equity managers. The conclusion from this research is that there is skill, but not necessarily as unique or strong as the track records would suggest. Also track records serve to flatter some managers, while others display the same characteristics of skill that we find elsewhere.

Once the systematic underweighting of REITs has been allowed for, the Australian Fund Management Industry looks pretty similar to its peers around the world, in terms of the key measures of skill.

Looking forward, it will be interesting to see what happens when REITs turn, as they inevitably will at some point, and what this means for asset owners when setting benchmarks and targets. **FS**