Better Odds Playing Powerball Than Picking Best Mutual Fund

Research Affiliates argues that the few investors who manage to select superstars will likely dump them before their worth is proven

NOVEMBER 25, 2014

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The odds of selecting the sort of benchmark-beating mutual funds investors dream of are a slim 1 out of 119, yet investors would not likely stick with them even if they did pick these superstars.

Research Affiliates' managing director John West and researcher Amie Ko take readers of their November newsletter deep into the institutional manager selection process to show how even the most disciplined professionals, let alone inexperienced consumers, find it difficult to consistently beat the market through active management.
"With these odds, you actually have a slightly better chance of collecting a cash prize on the multi-state Powerball lottery," West and Ko write.

One might think that the modern age's wide availability of data would improve our ability to monitor and evaluate manager performance.

For example, "popular software programs can run attributions over custom periods to tell us that our manager added *x* basis points of stock selection effect in the technology sector," West and Ko write.

Yet today's obsession with performance measurement tends rather to undermine investment performance.

That is because the standard three-year windows and quarterly updates that institutional managers conventionally employ do not correspond to the reality that "even the most sterling of long-term track records is pockmarked with performance potholes" of long duration.

Using Burton Malkiel's definition of a stock mutual fund that genuinely adds value as one that has exceeded the market return by more than 2 percentage points for more than a 40-year period, West and Ko show how unlikely it is to select such a fund in advance.

Of the 358 U.S. equity funds available in 1970, just 30% have survived these past 45 years. Of the survivors, only 45 have outperformed the S&P 500 index.

Of those long-term performers, just three have added valued of 2% or greater excess return, indicating a mere 0.8% chance (1 out of 119) of selecting a superstar manager.

Since even investors satisfied with a star manager (those 45 out of 358 actively managed funds) rather than a superstar have a better than 8 in 10 chance of picking a loser, "it makes considerable sense," the authors write to monitor their managers' performance.

But herein lie the pitfalls of contemporary "watch list" policies.

West and Ko show that even superstar mutual funds would wither under the glare of watch lists using the conventional rolling three-year evaluation window with quarterly reporting.

Under this measurement framework, the three superstar funds (Franklin Templeton Mutual Shares, Fidelity Magellan and Fidelity Contrafund) would have spent more than a third of the 1970 to 2014 period under the special scrutiny of the watch list.

"This actually translates to *61 quarters or over 15 years* in totality," West and Ko calculate, adding that even Warren Buffett's Berkshire Hathaway wouldn't be exempt from such scrutiny, despite delivering an extraordinary excess return of 5.5% since December 1990. ("Buffet would have been flagged for scrutiny for *longer than four years*," write West and Ko.)

But the Research Affiliates duo take readers inside the pressure-filled world of investment fiduciaries who have the responsibility to report and act on manager underperformance on a quarterly basis.

So, beyond the global observation of a period stretching close to 45 years, they look at the three superstar funds' record on the basis of continuous stretches of underperformance and calculate "17 spells of continuous underperformance, with the median duration of each consecutive stretch being nine quarters."

"Would an investor be committed to retaining any manager, even a top-notch one, who is targeted for scrutiny quarter after quarter after quarter after quarter (repeat that another five times)?"

But it gets worse, West and Ko explain. Nine rough quarters is, after all, a median figure. They examine the record of the three superstar funds and show that their worst stretches of underperformance ranged from 18 quarters (for Mutual Shares) to 23 quarters (for the Magellan Fund). They argue it is unlikely in actual practice that investors would stick with the Magellan fund during a period of underperformance lasting over five straight years.

(And as a side note, they add that watch lists may have the effect of incentivizing excessive risk taking on the part of managers who fear being fired and who are thus desperate to beat their benchmark.)

The Research Affiliates duo conclude that the plethora of available data is misused when evaluating managers over a period of years and quarters when investors' time horizons are measured in decades.

"Even the most extraordinary long-term performers will spend a significant time trailing benchmarks (and, often, enough time to look downright incompetent)," they write. Recognition of the difficulty of finding and the fortitude required to keep top managers is a factor fueling the rise of passive management and smart beta strategies, they say.