

MORE ON INVESTOR PERFORMANCE: CONTINUITY & CONSISTENCY

Winners and Losers!

PERFORMANCE CONTINUITY

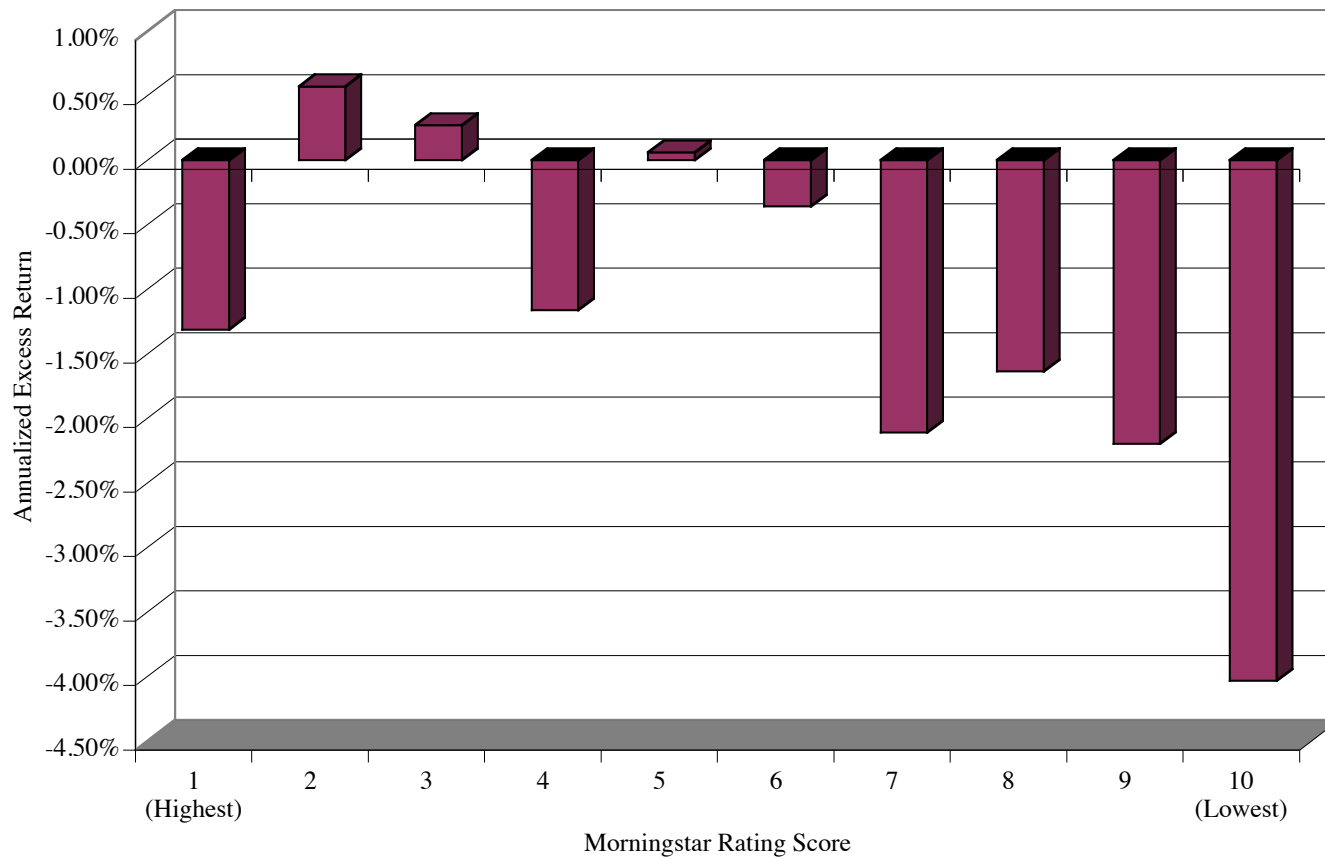
- Fund managers argue that **the average is brought down by poor money managers**. They argue that good managers continue to be good managers whereas bad managers drag the average down year after year.
- The evidence indicates otherwise. While there is **some evidence of a hot hand phenomenon with mutual fund managers**, the **overwhelming evidence is that there is no continuity in performance**.

1. TRANSITION PROBABILITIES: MUTUAL FUNDS FROM 2022-2024

	Quartile 1	Quartile 2	Quartile 3	Quartile 4	Merged/Liquidated
Quartile 1	25.5%	15.6%	12.0%	25.7%	15.2%
Quartile 2	24.3%	16.9%	14.1%	6.1%	16.9%
Quartile 3	15.2%	17.7%	25.7%	16.9%	18.8%
Quartile 4	12.5%	26.6%	23.6%	10.6%	15.4%

2. THE VALUE OF RANKINGS

Figure 13.12: Annualized Return based on Morningstar Ratings- 1994-1997



BUT RATINGS HAVE BECOME MORE INFORMATIVE..

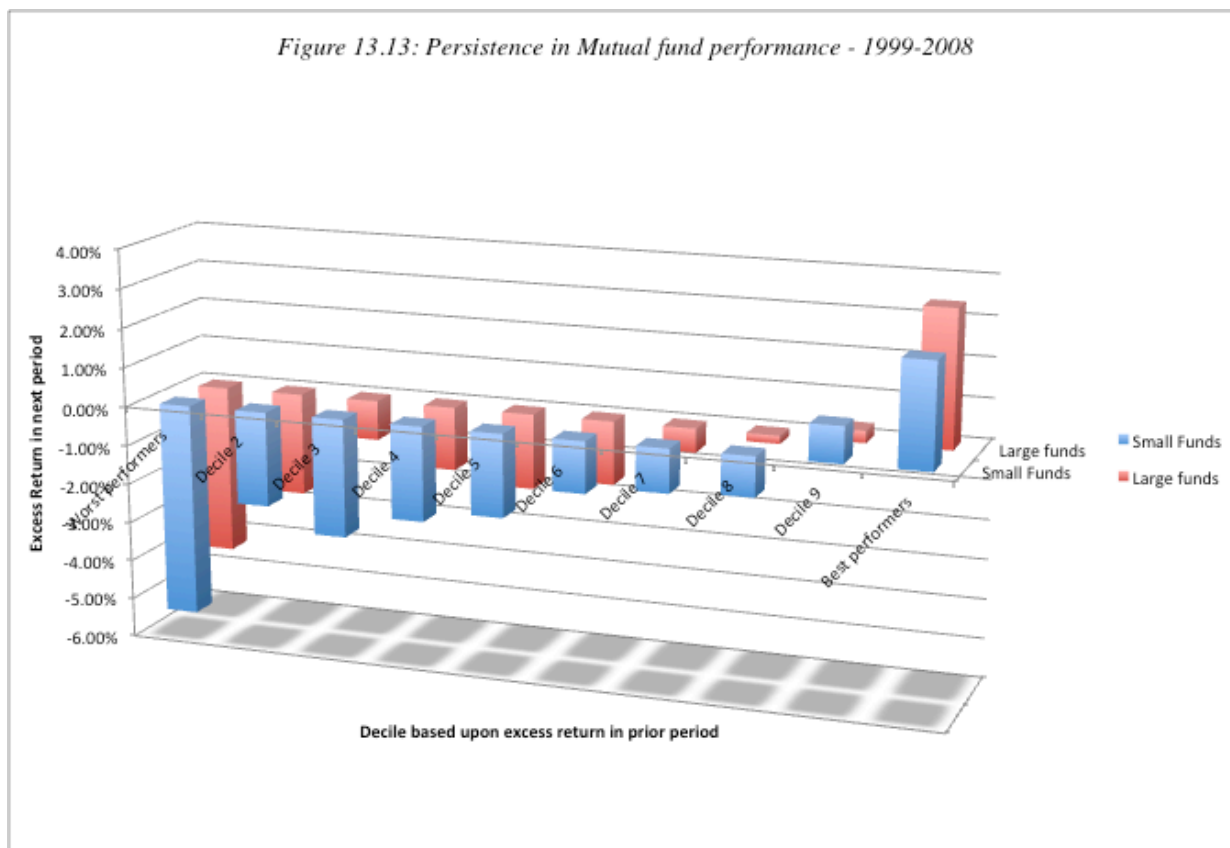
- Morningstar did revamp its rating system in 2002, making three changes.
 - They **broke funds down into 48 smaller subgroups rather than four large groups**, as was the convention prior to 2002.
 - They **adjusted their risk measures to more completely capture downside risk**; prior to 2002, a fund was considered risky only if its returns fell below the treasury bill rate, even if the returns were extremely volatile.
 - Funds with **multiple share classes were consolidated into one fund** rather than treated as separate funds.
- A study that classified mutual funds into classes based upon these new ratings in June 2002 and looked at returns over the following three years (July 2002-June 2005) finds that **they do have predictive power now, with the higher rated funds delivering significantly higher returns than the lower rated funds.**

THERE IS SOME EVIDENCE OF HOT HANDS..

<i>Year</i>	<i>Percent of repeat winners</i>	<i>Year</i>	<i>Percent of repeat winners</i>
1971	64.80%	1980	36.50%
1972	50.00%	1081	62.30%
1973	62.60%	1982	56.60%
1974	52.10%	1983	56.10%
1975	74.40%	1984	53.90%
1976	68.40%	1985	59.50%
1977	70.80%	1986	60.40%
1978	69.70%	1987	39.30%
1979	71.80%	1988	41.00%
1971-79	65.10%	1989	59.60%
		1990	49.40%
		1980-90	51.70%

AND THE PERSISTENCE CONTINUES.. AT BOTH SMALL & LARGE FUNDS

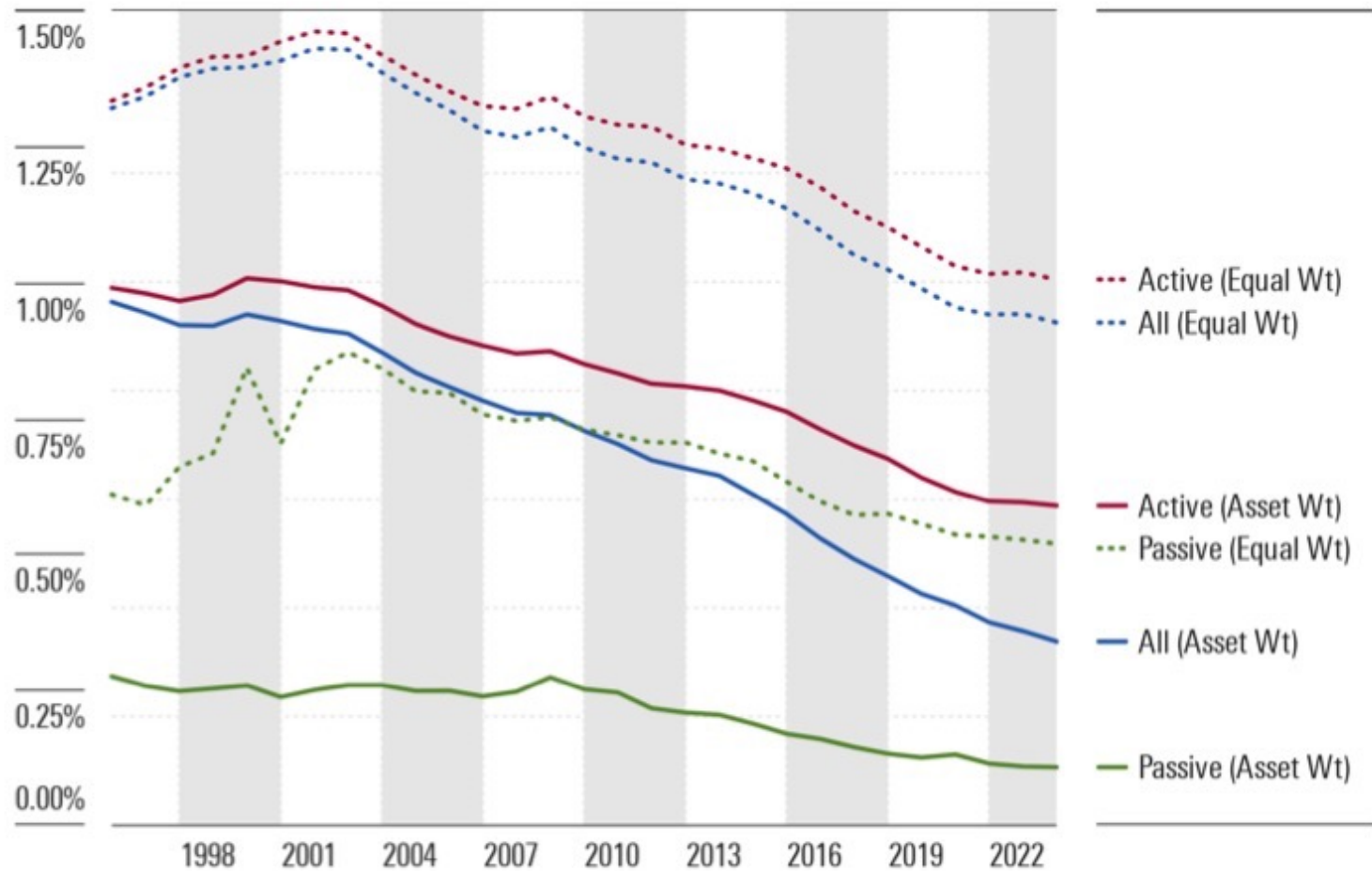
Figure 13.13: Persistence in Mutual fund performance - 1999-2008



WHY ACTIVE MONEY MANAGERS FAIL...

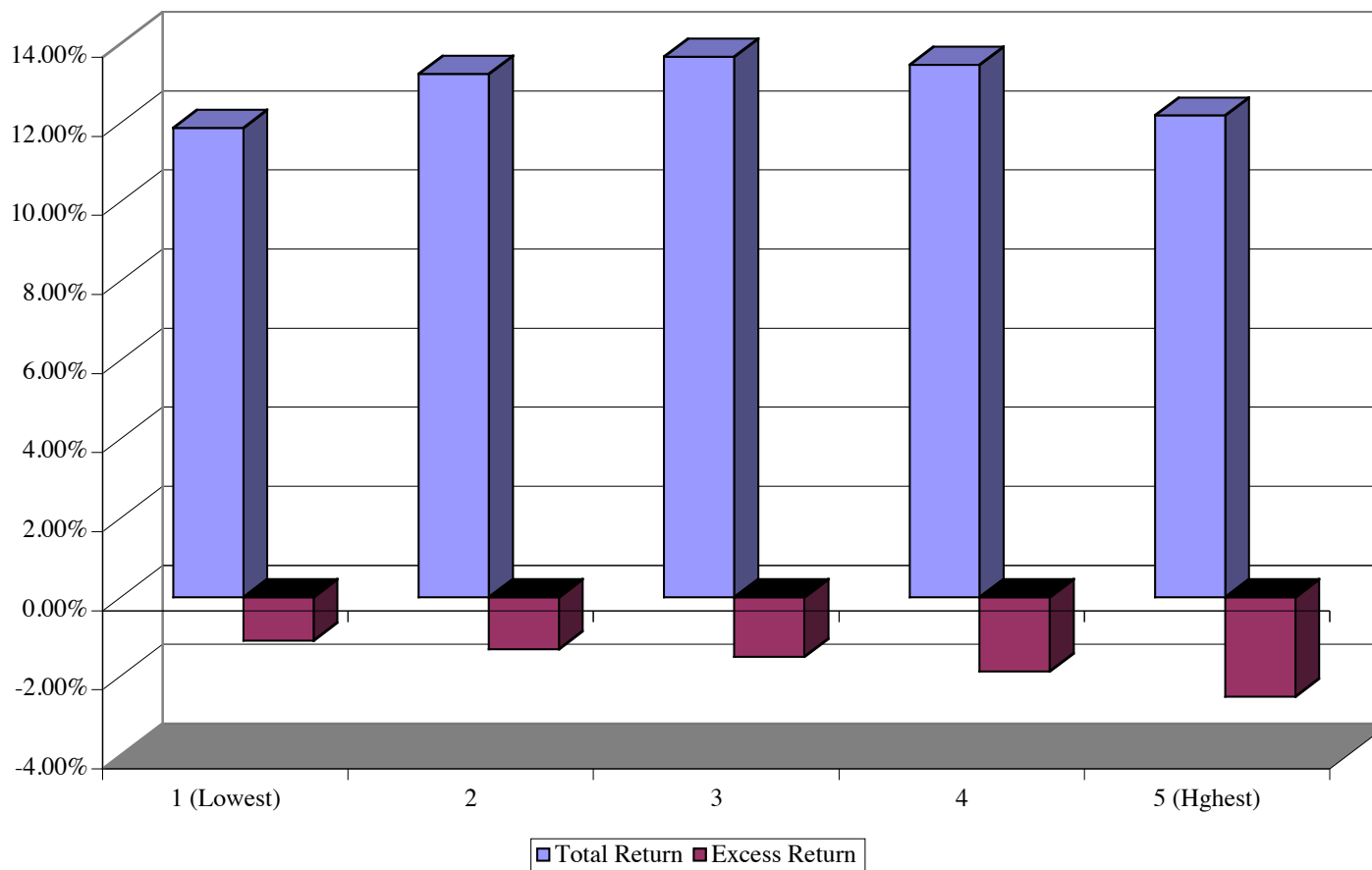
- **High Transactions Costs:** The costs of collecting and processing information and trading on stocks is larger than the benefits from the same.
- **No core philosophy:** Lacking a rudder, money managers shift styles constantly, leading to high turnover, transactions costs and tax bills.
- **Too much activity:** Activity, by itself, can be damaging as investors often sell when they should not and buy when they should not.
- **Failure to stay fully invested in equities:** Since mutual fund managers are not great market timers, failing to stay fully invested hurts more than it helps.
- **Behavioral factors:** All of the behavioral problems that we see with individual investors apply in spades with institutional investors.

1. HIGH TRANSACTIONS COSTS



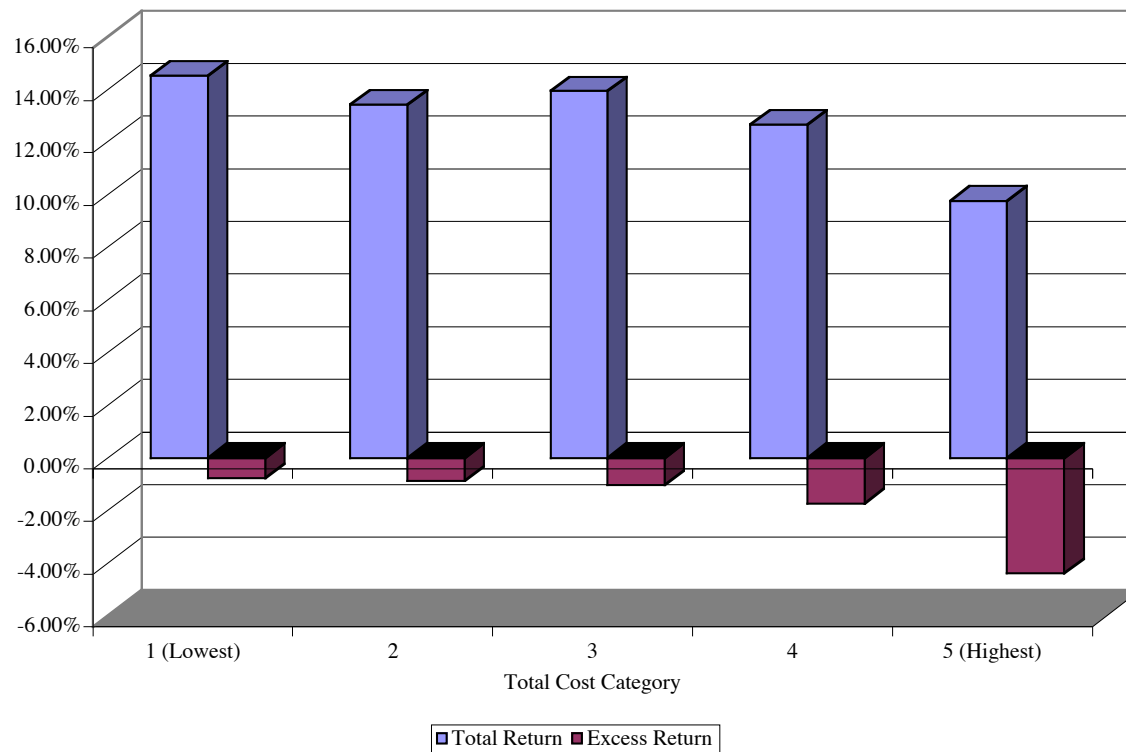
TURNOVER RATIOS AND RETURNS

Figure 13.15: Turnover Ratios and Returns: Mutual Funds



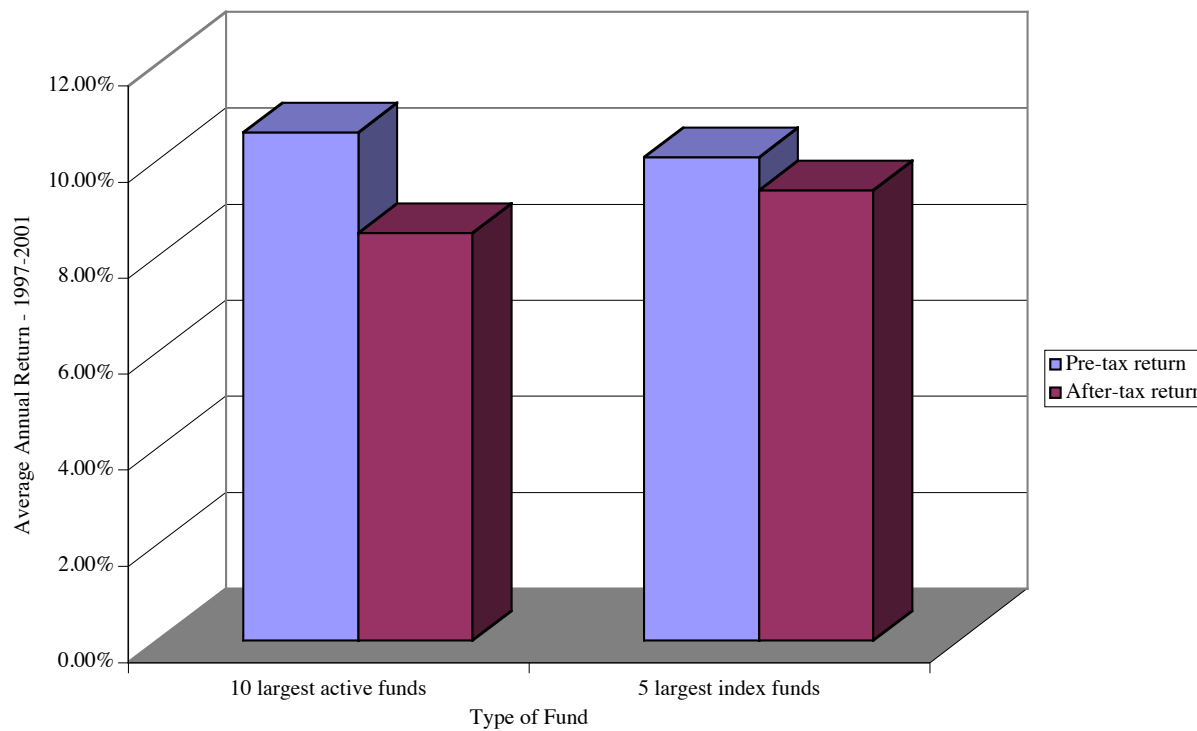
TRADING COSTS AND RETURNS

Figure 13.16: Trading Costs and Returns: Mutual Funds



HIGH TAX BURDENS

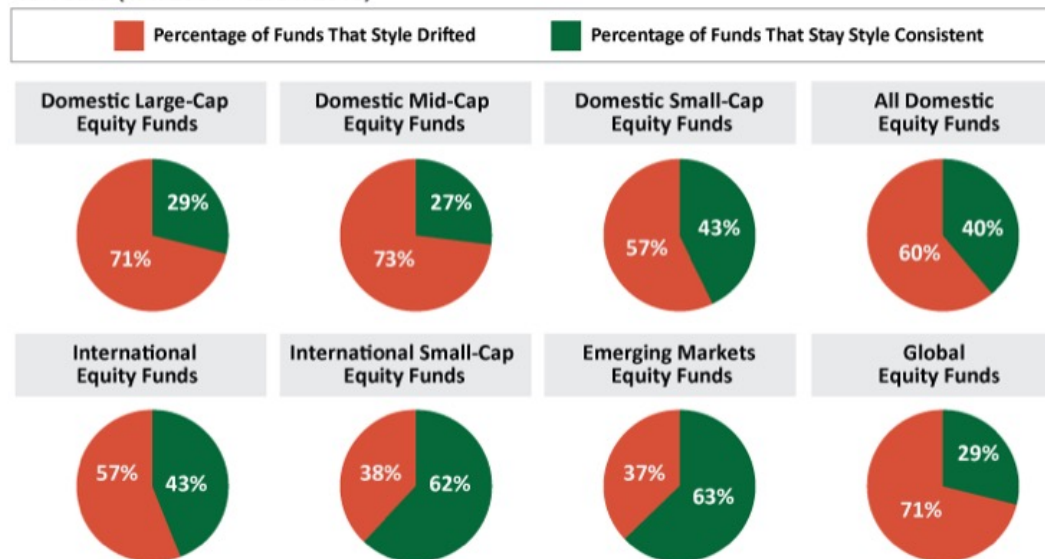
Figure 13.17: Tax Effects at Index and Actively Managed Funds



2. THEY SEEM TO HAVE NO CORE PHILOSOPHY..

Style Drifts: Major Equity Asset Classes

15 Years (1/1/2004 - 12/31/2018)



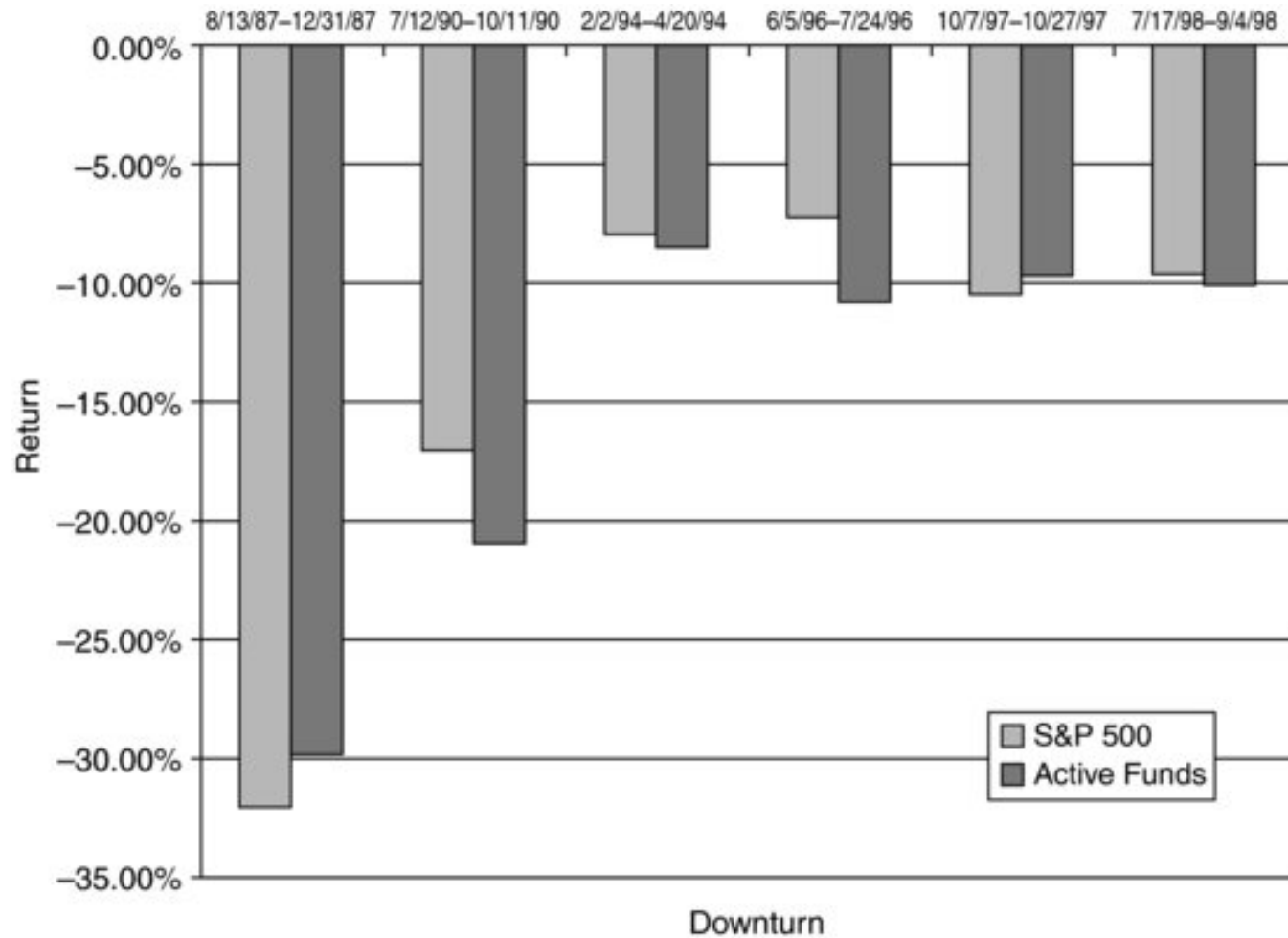
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Source: SPIVA Year End 2018 Scorecard - Created: 3/13/19

3. TOO MUCH ACTIVITY

- In an interesting study, researchers have looked at the **value added by activity by comparing the returns generated by funds over a year** with the returns that they would have earned over the same year, if they had left their portfolios untouched over the year.
- These studies generally find that **activity generates negative returns: the returns from the frozen portfolios exceed the actual returns, with the magnitude a function of how much activity the fund is involved in.**

4. FAILURE TO STAY FULLY INVESTED



5. BEHAVIORAL FACTORS

- **Lack of consistency:** Brown and Van Harlow examined several thousand mutual funds from 1991 to 2000 and categorized them based upon style consistency. They noted that **funds that switch styles had much higher expense ratios and much lower returns than funds that maintain more consistent styles.**
- **Herd Behavior:** One of the striking aspects of institutional investing is the **degree to which institutions tend to buy or sell the same investments at the same time.**
- **Window Dressing:** It is a well documented fact that portfolio managers try to **rearrange their portfolios just prior to reporting dates**, selling their losers and buying winners (after the fact).

CONCLUSION

- There is **substantial evidence of irregularities in market behavior**, related to systematic factors such as size, price-earnings ratios and price book value ratios.
- While these irregularities may be inefficiencies, there is also the **sobering evidence that professional money managers, who are in a position to exploit these inefficiencies, have a very difficult time consistently beating financial markets.**
- Read together, the persistence of the irregularities and the inability of money managers to beat the market is testimony to the **gap between empirical tests on paper and real world money management in some cases, and the failure of the models of risk and return in others.**
- The performance of active money managers provides the best evidence yet that **indexing may be the best strategy for many investors.**