The performance of active equity fund managers

It's easy to make money when market conditions are highly favourable. **PHIL DOLAN, PATRICK HODGENS** and **GEOFF WELLS** illustrate that active equity fund managers are feeling the strain of recent less favourable timeframes.

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Our previous paper (Dolan, Hodgens and Wells, 2001) looked at the performance of wholesale active Australian equity managers as reported in one of the more widely used surveys. The survey showed that the median manger was adding significant value above the benchmark index. In our earlier paper, we examined the impact on reported manager performance of a number of factors, and concluded (pg 1):

> "The net effect of each of the factors is to call in question the extent to which, if at all, the median active manager has consistently added value above index. The outperformance is seen to be largely due to idiosyncrasies in the construction of the surveys, or one-off factors that cannot be relied upon to recur. Thus, the view that simply selecting an active manager at random will, on average, result in outperformance of the index is likely to lead to disappointment."

The factors in question, and our conclusions regarding them in 2001, included:

- size-weighting each fund's returns. An equally weighted median tends to overestimate the industry-wide level of outperformance, as, on average, larger funds have performed less strongly than smaller ones;
- allowance for survivorship bias in the construction of the surveys. Over the five-year period to June 2001, approximately 25% of the funds in the survey five years before exited, and, on average, such funds underperformed prior to their disappearance. Adding back such funds to the surveys for periods prior to their departure tends to lower cross-sectional summary statistics such as the median;
- the impact of stock selection within the small stock sector. Typically, managers within this sector have outperformed strongly (by 20% pa on average) in recent years. Given this sector is about 10% of the overall market, it is possible that a significant fraction of the reported overall outperformance has come from a relatively narrow subset of the market;
- avoiding the stocks that were the main contributors in the Australian market to the so-called technology bubble. Many mainstream fund managers were underweight in the more speculative technology stocks which were sold off heavily when the bubble burst in April 2000. Since many of these stocks were only included in the index after their strong run-ups in 1999 and early 2000, managers were not penalised compared to the index by not holding them in this period, but subsequently benefited from not holding them when prices fell;
- underweighting the so-called entrepreneurs, especially in the early 1990s. This underweighting would have significantly improved manager performance. As with the technology bubble, the companies in question

generally failed to attract widespread institutional support, and while avoiding them in the period prior to the 1987 crash would have pulled down median manager returns, doing so would also have boosted performance thereafter.

Updating the findings

This article updates these findings, via an examination of the latest available returns from the corresponding survey for the year ended December 2002. It is shown that the data bears out our prediction that, as the influence of the factors above has disappeared from, or at least been less prevalent on, managers' returns, the positive excess performance of the median manager would also disappear. This is in fact seen to be the case.

Examining the Mercers Australian Shares Specialist and Diversified surveys for periods ending June 2001 and December 2002, we find the following median manager and index returns (Tables 1 and 2.)

It can be seen that the outperformance that was evident over prior periods has begun to decline. While the influence of the factors listed above is still impacting on the longer-term (3 and 5 year) returns to the median manager, over shorter, more recent periods, the outperformance has disappeared.

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In contrast to the periods examined by Dolan et. al. (2001) ending in June 2001, over which the median manager appeared to be outperforming by 3% p.a. or more, updating the analysis shows that these positive excess returns are 'working their way out' of the data.

Given that several of the factors identified were of an episodic, or even one-off, nature, this is not surprising. For example, the impact of the tech bubble, which burst in April 2000, will not affect the one-year numbers to December 2002, but will continue to have some influence on the three-year ones until April 2003.

Similarly, it was noted in 2001 that very strong small cap outperformance (on the order of 10–15% pa by the median small cap manager) was contributing to the overall returns of managers benchmarked to the S&P/ASX 200 or 300.

Since small caps are approximately 10% of the overall market, the previous strong outperformance within this sector would have boosted returns to the median manager by 1–1.5% pa. Over periods ending December 2002, these small cap excess returns have been much less pronounced.

For the quarter, the median manager added 0.6% above index; for the year it was 0.9%. These much lower levels would have had a commensurately smaller (less than 0.1%) impact on overall fund outperformance above benchmark.

The much lower levels of outperformance being achieved by the median small cap manager are probably attributable to the following:

- a reduction in the number, and quality, of initial public offerings. Subdued market conditions have resulted in far fewer IPOs relative to the situation in recent years, and the 'stag' profits that have been able to be realised from them have been much smaller as well;
- "quality" small cap stocks, of the kind more likely to be bought by the larger, mainstream fund managers have underperformed relative to more speculative issues over the last 12 months. Rather than reward stocks with sustainable above average earnings growth and strong market positions, the market has tended to focus more on those stocks that were perceived to have been "oversold". There is a pronounced value/growth cycle at work in the small cap sector, and it has recently favoured value stocks (especially "deep value" stocks) very strongly;
- some of the larger (in terms of funds under management) small cap managers have suffered significant outflows, in some cases due to

TABLE 1 SURVEY MEDIAN RETURNS TO DECEMBER 2002 (%PA)

Performance Period	Diversified Survey	Specialist Survey	S&P/ASX 300
1 year	–9.8	–9.0	–8.6
3 years	3.0	3.2	1.9
5 years	7.1	8.2	6.5

Source: WM Mercer

TABLE 2 SURVEY MEDIAN EXCESS RETURNS TO DECEMBER 2002 (%PA)

Performance Period	Diversified Survey	Specialist Survey
1 year	–1.16	–0.36
3 years	1.11	1.31
5 years	0.59	1.69

Source: WM Mercer

These values compare with those from our 2001 paper, which found excess returns of:

TABLE 3 SURVEY MEDIAN EXCESS RETURNS TO JUNE 2001 (%PA)

Performance Period	Diversified Survey	Specialist Survey
1 year	2.8	4.2
3 years	2.6	3.2
5 years	1.9	3.3

Source: WM Mercer

personnel changes. To the extent they have been forced sellers, this tended to depress prices for those stocks in which these managers had large overweight positions. In some cases, these stocks were widely held across a number of managers, and the subsequent downward pressure on prices has affected those managers' performance.

Another factor identified as a potential source of upward bias in the reported returns to the median active manager was survivorship bias. This occurs in any sample when certain members of the sample are systematically excluded from the data. In the case of performance measurement studies, it can occur when managers with below average returns are more likely to exit the data over time than are managers with better returns.

Our earlier paper found significant evidence of survivorship bias over the period examined, with up to 25% of the managers in one survey disappearing over a five-year period.

The possibility that a manager's performance is sufficiently poor that he/she either (i) decides to withdraw from the survey, or (ii) loses enough funds under management to be no longer eligible for inclusion, means that the average and median returns across the remaining managers will be biased upwards.

Our earlier paper found significant evidence of survivorship bias over the period examined, with up to 25% of the managers in one survey disappearing over a five-year period. There is less evidence of survivorship bias over the more recent periods examined here.

For example, in the specialist survey for periods ending December 2002, 9% of managers exited over the prior three year period, and 17% did so over the preceding five years.

For the diversified survey, the corresponding values were 5% and 19%. Thus, while there is still some evidence of manager "turnover", it is less pronounced than was the case for periods ending June 2001. Over the latest year and quarter (to December 2002), there were no exits from either the Specialist or Diversified surveys.

One-off performance

Until recently, it appeared that the median active equity manager in the Australian market was significantly outperforming the benchmark. This apparent outperformance was shown to be largely the result of a number of factors, either 'one-offs', or to do with the ways in which managers' performance was measured and the benchmark constructed.

The influence of these factors has become much less pronounced in recent periods, especially over the last 12 months. As a result, the performance of the median active equity manager has declined to the point where it is now below the return to the benchmark index on a pre-fees basis (and hence ever further behind, post-fees). Our 2001 paper concluded (pg 19):

> "The selection of an active Australian equity manager is not a 'riskless' decision, in terms of longer–term outperformance potential. In particular, while the recent performance of the median manager in the published surveys suggests that outperformance has been large and seemingly sustainable, this is not clear. Selection of a genuinely skilled active manager is likely to require significant effort, beyond simply selecting a manager at random from the published surveys."

Recent active manager returns make it even more likely that this remains the case.

REFERENCES

Dolan, P., Hodgens, P., and Wells, G., 2001, "Recent Performance of Active Australian Share Managers", *JASSA,* Issue 4, Summer 2001.

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