SKAGEN Funds
How to find good active managers?

- *There are large differences in the performance between the average and best active equity managers*
- *What are the characteristics of a good (and bad) active equity fund manager?*
- *The outlook for stock-pickers is favourable with significant upside potential and downside protection*

With many things in life there is often a sizeable difference between the average and the best. Whether it is in respect of business, sport, politics etc. the average is never the best.

The same holds true in asset management where an examination of the performance of global equity funds over the last five years shows a large difference between the returns of the best fund managers - those in the top quartile (+73.0%) and the average managers - those in the middle (+63.1%)[1].

Picking winners

So how should you select the funds most likely to be in the top quartile rather than in the middle, or even worse, those in the bottom quartile? According to recent research[2,] the most active fund managers i.e. those whose portfolios differ most from an index or benchmark, are the best performers over the long run. To have the best chance of beating an index you need to invest differently from it. This 'difference' between a portfolio and an index can be measured by **active share** and an active share of over 80% is a good place for institutions to start looking for potential winning fund managers.

There are a variety of factors, as detailed below, both qualitative and quantitative, to assess whether an investment manager's investment philosophy and its implementation will result in superior returns over a market cycle.

What to look for?

- **A long-term approach**

A long-term and stable approach characterised by low portfolio turnover (i.e. the extent to which the companies within a fund are bought and sold) should be a key feature of a successful active equity fund. Trading costs will be lower than the median fund and this is due to the fact that many triggers for share price appreciation occur over time and patience is therefore integral to achieving substantial returns. Research[3] on US funds over the 19 year period from 1995 to 2013 shows that the most patient portfolios outperformed by an average 2.3% per year, net of fees.

- **Alignment of interest**

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[1] *Source: Trustnet (IA Unit Trusts & OEICs - Global Equity Income) as at 23 February 2015 (GBP)*
[2] *Active Share and Mutual Fund Performance - Petajisto (2013)*
[3] *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently - Cremers (2014)*

Good active investment managers can also be identified through an alignment of interests with their clients. This is evidenced by substantial investments in their own funds by portfolio managers and the majority of their remuneration coming as a result of the performance of their fund and that these rewards are paid out over a period of three years or more.

Performance-related fees are another strong signal of interest alignment as the active manager only does well if the client does well and their rewards are directly proportionate to the excess returns generated for clients.

Capacity awareness and demonstrating a controlled approach to new assets for the benefit of existing investors is also important to ensure that the fund's opportunity range is not compromised and to allow the manager to concentrate on the portfolio rather than day-to-day administration. This is reflected in research[4] which shows that performance tends to deteriorate as portfolios grow too large.

There are many examples of this throughout fund management history. A well-known one is the Fidelity Magellan fund which grew to be the largest in the world when its assets exceeded $100bn in 1999, thanks to the fame of its manager Peter Lynch who successfully invested in smaller companies throughout the 1980s. Its performance for much of the past two decades has been distinctly average and it now has only $17bn of assets under management.

For UK pension funds this was seen when a few fund managers in the 1990s and 2000s dominated the accumulation of equity assets only to subsequently produce lackluster performance for their clients.

- **Business independence**

A successful investment strategy requires a solid business strategy behind it and investors should look for independence, where decisions are made for the benefit of the organisation and its clients rather than a parent company or external shareholder(s). Stock market-listed asset managers face the tyranny of quarterly reporting which not only provides a distraction but can also engender a short-term focus.

Asset managers owned by banks or insurance companies are arguably further restricted given the competing objectives and pressures of their parent companies, who rarely understand investment management. An independent ownership structure, on the other hand, purely focused on asset management, should provide the financial freedom to select the best long-term opportunities and prioritize fund performance over asset gathering.

Reasons for optimism

Many commentators expect 2015 to be a strong year for active managers with market conditions favourable for stock-pickers to generate index-beating returns as the headwinds of 2014 dissipate or reverse.

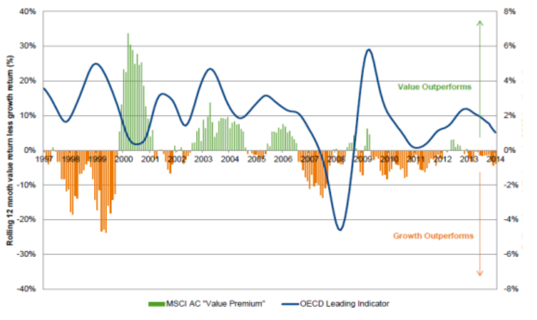
Last year was one of the worst years on record for active managers, with four in five stock-pickers failing to beat their benchmarks. There were several additional factors that made the going tough for the more genuine stock pickers in 2014.

[4] *Does fund size erode mutual fund performance? The role of liquidity and organization - Chen, Hong, Huan and Kubik (2004)*

Firstly, lower volatility in a rising equity market meant investors profited less from selecting the best companies. Secondly, small and mid-cap companies – generally favoured by active managers – underperformed large and mega-cap ones, which inevitably represent a bigger chunk of the index.

So far 2015 looks more encouraging. Volatility of the US blue-chip index in January was nearly 10 percent higher than its 50-year average, fuelled by renewed uncertainty over economic growth prospects, particularly in the eurozone and Japan, and heightened geopolitical tensions in Russia, Africa and the Middle East. Similarly, last year's small and mid-cap underperformance is likely to be reversed with companies expected to increase cash returns to shareholders and benefit from greater M&A activity.

Value out of favour over five years



A further headwind in 2014 was that value underperformed growth, a phenomenon that has now occurred for the past five years. As economic expansion has slowed post the financial crisis, investors have placed a higher premium on stocks offering growth, driving up valuations relative to value stocks. Given the length of the current period of underperformance, it is reasonable to expect a reversal and a sustained period of value outperformance given previous cycles and the fact that over the long-term, as demonstrated by the graph, value has beaten growth.

Downside risk

As well as upside potential, investors should not underestimate the downside protection that active management can provide. The outlook for US equities, in particular, has been deteriorating due to the global economic slowdown and a stronger dollar – January saw the biggest fall in estimates for corporate profitability since 2009's recession. The US stock market has increased by over 200% since its post financial crisis trough in March of the same year, not only making the companies more expensive, but also increasing the risks of a significant downwards correction, see chart. This threat is largest for passive investors, with those tracking the MSCI All Country World Index having over half of their portfolio exposed to US equities at present.

US equities due for a correction?

Source: Bloomberg

2015 opportunities

Despite the collective underperformance of active managers in 2014 it is important not to see them as homogeneous and it is even more important to pick the right fund manager as the outlook for stock-picking improves. There are plenty of opportunities for those who think differently and make high conviction investments in strong but unpopular and undervalued companies to generate superior long-term returns.

At present emerging markets are a particularly good hunting ground given their superior long-term growth potential, attractive demographics with increasing numbers of affluent consumers and valuations at a steep discount to developed markets. Small and mid-cap companies similarly look appealing on valuation grounds, particularly given the increasing valuation bubble around many large-caps.

By being aware of what to look for, pension schemes should be able to assess whether a manager is picking the best stocks for their portfolio rather than surrendering to the index and is therefore best placed to deliver these optimal risk-adjusted rewards for their members.

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