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Is your fund manager taking enough risk?

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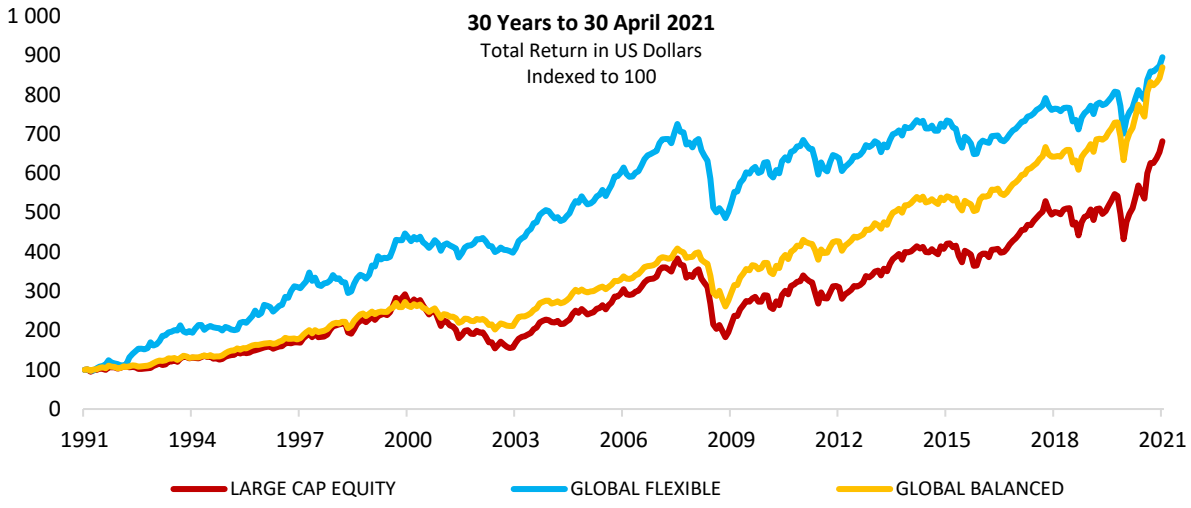
We tend to think about risk in a negative sense, focusing on capital loss, drawdown or downside risk. While this is extremely important and entirely correct, less attention is paid to opportunity cost or upside risk. We are cognitively hardwired to avoid losses and the behavioural finance literature covers the topic of loss aversion – a tendency to prefer avoiding losses to acquiring equivalent gains – quite extensively.

Risk aversion is also distinguishable from loss aversion; we tend to prefer outcomes with higher certainty, while our experience of loss tends to inform our approach to risk. This relationship also highlights the difficulty investors have with probability and the trade-off between highly probable, low returns versus lower probability, high returns, even if the average pay-off profile of the lower probability-high return scenario is the same or significantly better.

While one would expect dispassionate, professional fund managers to be immune to these mere human frailties, it turns out that (on average) this may not be the case. One area where this risk or loss aversion might be most evident is in the Multi-Asset Global Flexible fund category, although we acknowledge that the analysis is complicated by the disparate nature of the strategies in this category.

Flexible funds – a full expression of active management



Source: Morningstar and Northstar Asset Management

Multi-asset flexible funds have a broad range of asset classes and return streams at their disposal from which to offer their investors a suitable risk-adjusted return proposition. Therefore, the full benefit of active management should, arguably, be brought to bear in this fund category.

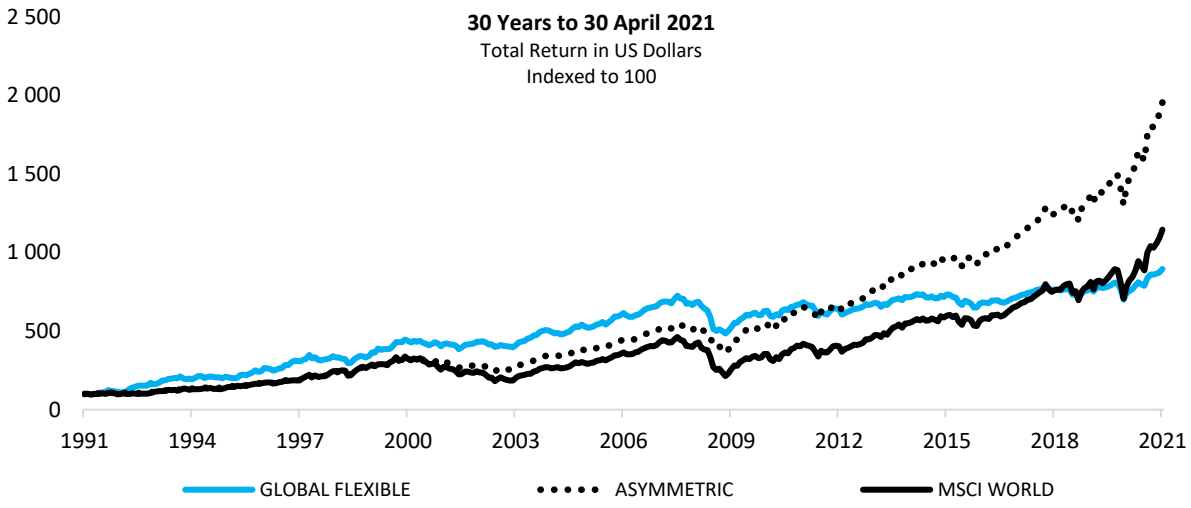
From the chart above, it is apparent that this was very much the case in the 20 years leading up to the Global Financial Crisis. In fact, the average Global Flexible Fund outperformed the MSCI World Index in the 10 years to April 2001 (annualised total return in US dollars of 15.4% vs 10.6%) as well as the 10 years to April 2011 (5.1% vs 4.4%). Importantly, this was also achieved with less risk, as reflected in the volatility of the respective returns.

The full benefit from diversification and active management is also evident in the higher returns relative to the average Large Cap Global Equity fund and a passive 60:40 balanced portfolio of global equities and bonds.

Post-GFC malaise

While the average large cap equity fund has perennially underperformed the MSCI World Index, the underperformance from multi-asset flexible funds over the past 10 years (2.7% p.a. vs 10.5% for the MSCI) stands in stark contrast to the strong outperformance in the preceding 20 years.

This phenomenon is no doubt a result of a multitude of factors, but the experience of loss through the GFC has clearly played an important role in establishing risk appetite, resulting in significant upside risk or opportunity foregone over the subsequent 10 years.



Source: Morningstar and Northstar Asset Management

If the objective of active management is to skew the likely outcome in the investors favour by balancing risk and return, then an asymmetry in returns is required for superior risk-adjusted performance.

For a typically equity-centric flexible fund, such as the Northstar Global Flexible Fund, participating in most of the market's upside, whilst avoiding large drawdowns is evident in an upside/downside capture profile of 78% vs 58% since inception 1. Modelling the target 80% vs 60% asymmetric return profile against the MSCI World over the past 30 years highlights the compounding effect of this simple rules-based asymmetry and puts into context the difficulty the average Global Flexible fund manager has faced in keeping pace with the equity benchmark.

Sources of asymmetry

The desired return profile is a function rather than an objective of our fundamental process. An insistence on only investing in the relatively small group of companies, able to demonstrate the benefit of their inherent competitive advantage, evident in sustainably high returns on invested capital (ROIC) and free cash flow (FCF) growth, is the primary source of asymmetry. Avoiding companies which employ excessive leverage and / or display a high degree of cyclicality is a source of asymmetry.

Maintaining a disciplined, probability weighted scenario approach to valuation and integrating fundamental risk limits and valuation into position-sizing is an equally important source of asymmetry. Pre-investment, proprietary Bull, Base and Bear case scenarios, with probabilities ascribed to each, ensures appropriate levels of risk-taking and results in longer holding periods of companies with positive fundamental momentum and quicker corrective action where the Bear case scenario plays out.

Not having to be fully invested and the flexibility to diversify across asset classes is a valuable source of asymmetry, if informed by valuation.

Conclusion

Active managers have experienced a poor decade post the GFC. Global flexible funds, on average, have been too conservatively positioned, ex-post, squandering much of the strong record of superior risk-adjusted returns established in the 20 years prior.

The rise of a cohort of disruptive, internet-enabled growth companies, meaningful structural shifts in market cap weighted benchmarks, the shift into passive investing and the enduring deflationary pressures arising from slack in the labour market as well as technology and automation, have all played their part, along with unorthodox monetary policy, in complicating the investment landscape and valuation of asset classes.

With signs of rising inflation and higher interest rates on the horizon, active managers have the prospect of greater dispersion in returns to look forward to. Only those able to synthesise all the inevitably conflicting sources of information and opinion into a sensible and robust risk management framework, are likely to achieve the appropriate level of risk tolerance for whatever the next decade may hold.

[1] Average rolling 3-year equity capture ratio vs MSCI World Index since inception 11th January 2016 – 30th April 2021

Glacier Research would like to thank Rory Spangenberg for his contribution to this week's Funds on Friday.

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