FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

14 October 2022
Volume 1157

Talking tracking

Author: Casparus Treurnicht, Portfolio Manager, and Megan Fraser, Head of Business Development & Marketing at Gryphon Asset Management

William Sharpe is credited as being the architect behind the first index fund established over 50 years ago. He is also known for developing the Capital Asset Pricing Model (CAPM), one of the first theories that explains why the prices of securities behave the way that they do and why their expected returns differ from one another on a relative basis. If the average person wonders why butter got so much more expensive while the price of milk moved only slightly, you could tell them, tongue in cheek, that it's dependent on the market price of fish. Sharpe's research contributed to the widely held view that systemic risk* is the single biggest remaining risk to consider when combining securities in a portfolio and that market performance determines the eventual outcome. In 1961, this was groundbreaking research that contributed to the analysis of financial markets and was the reason the Nobel Committee called his work "the backbone of financial economics".

*[*Systemic risk, in this instance, is financial market risk that cannot be diversified away and is always present, whereas company-specific, non-systemic risk is the additional risk assumed when investing in only one stock/counter. When one stock is held, an investor faces systemic and non-systemic risk. By combining several stocks in a portfolio, one decreases the total amount of non-systemic risk leaving mostly systematic risk. This way the potential risk-reward ratio improves.]*

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

“Don't look for the needle in the haystack. Just buy the haystack!”

— John C. Bogle

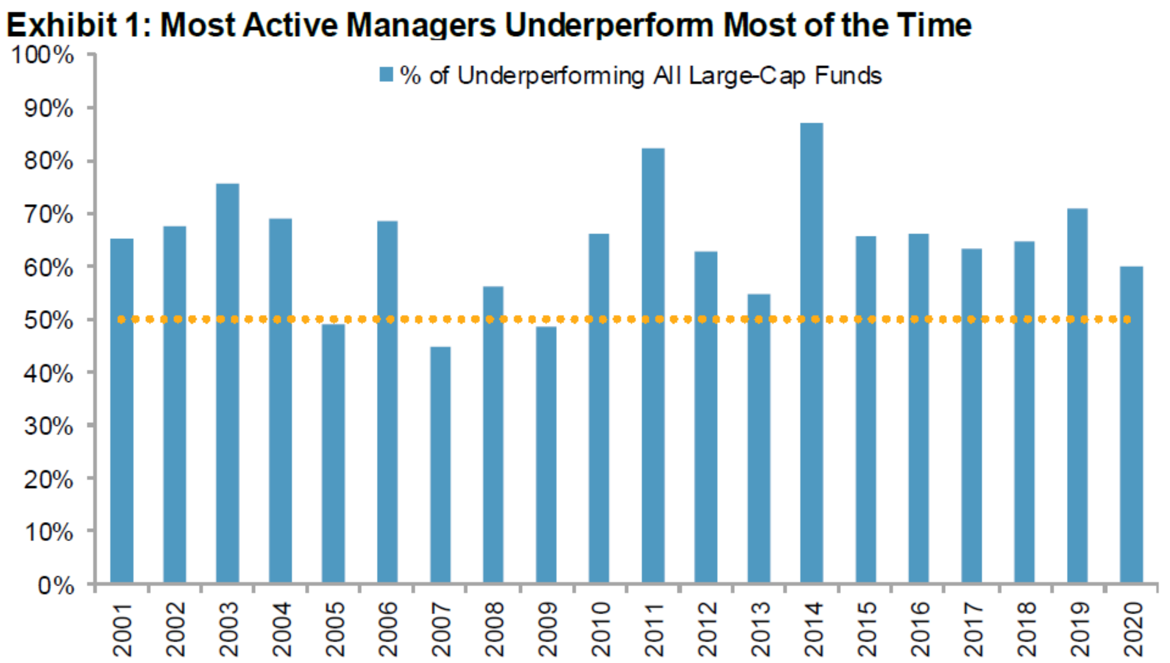
As we described in a previous article, when investing via pooled investment vehicles, issues such as fees, portfolio turnover, market impact and emotions are some of the factors that can diminish investment performance – we'll collectively refer to these as “frictions”. Ideally, one would like to eliminate as many ‘frictions’ as possible in order to enhance returns, or at the very least, minimise the drag on performance. With some investment products, in particular stock portfolios, active investment funds, hedge funds, and fund of funds, these embedded frictions can become so burdensome that they wipe out all gains. So, how do you eliminate these frictions? Realistically, they can never be fully eliminated, but they can be significantly reduced and effectively controlled through the practice of indexation; sometimes called passive investing.

The evidence of a number of scientific studies reveals that active investing (investors selecting *a combination of single stocks* with the goal of outperforming the market) will, in the majority of cases, result in underperformance versus the market on a consistent basis. In other words, investors trying to cherry-pick winning stocks often end up with the result that their portfolios produce lower returns than the market, *and thus their passive peers,* by some margin. Furthermore, the longer the history, the greater this difference in performance.

	3 years	5 years	10 years
US: % of funds underperformed the S&P 500®	68	74	83
Europe: % of funds underperformed the S&P Europe 350	62	72	83
SA: % of funds underperformed the S&P South Africa 50	81	95	95
SA: % of funds underperformed the S&P South Africa DSW Capped	44	56	73

Source: S&P Dow Jones Indices/SPIVA
Data as of Dec 31, 2021

In January *2022, S&P Dow Jones Indices* released a paper (hereafter, referred to as the study) asking investors what proportion of active managers they expected would underperform the market based on performance in the previous year, 2021. The S&P Dow Jones indices researchers contended that *most* active managers would continue to underperform *most* of the time; but conceded that *most* of the time is not *all* the time, and that *most* active managers is not *all* active managers. The corollary to this then, is that *some* active managers would outperform, some maybe even consistently.

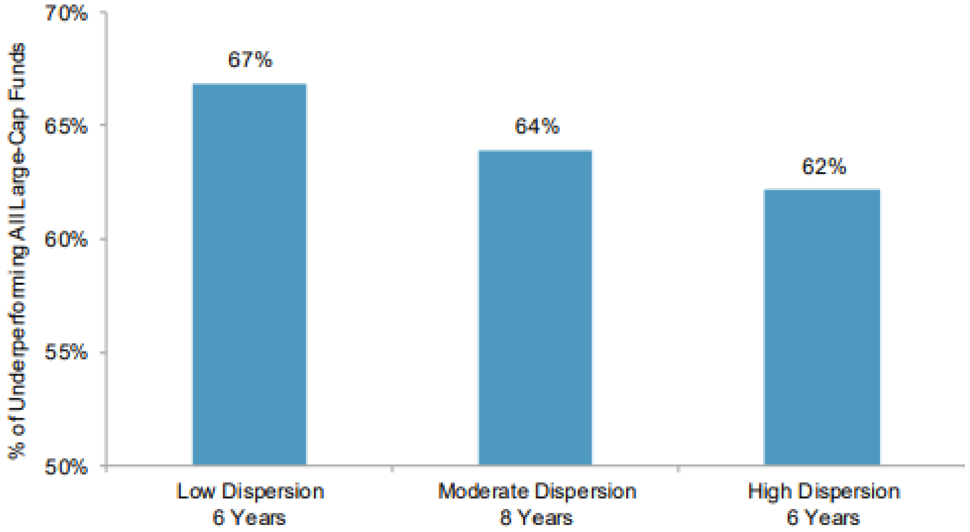


Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2020. Chart is provided for illustrative purposes.

In theory, if 50% of managers underperform a broad market index *before* fees, the magnitude of fees charged (one of the frictions most easily quantified) will shift this percentage north to some degree. The study revealed that 64% of US large-cap fund managers underperformed the S&P 500 over a 20-year period, and they tried to establish the market conditions that cause this underperformance, taking factors other than fees into account. If one is able to recognise the factors that result in under-performance, one has to wonder whether, given certain circumstances, there in fact could be a situation in which active managers *do* outperform the market, maybe even over multiple periods. The factors identified include:

- **Dispersion** (defined as the spread between highest-performing stock and lowest-performing stock within the market benchmark): When the spread of returns within index constituents is high, the opportunity for managers to outperform an index increases. Low dispersion among index constituents works against active fund managers.

Exhibit 2a: More Active Managers Underperformed in Low-Dispersion Environments



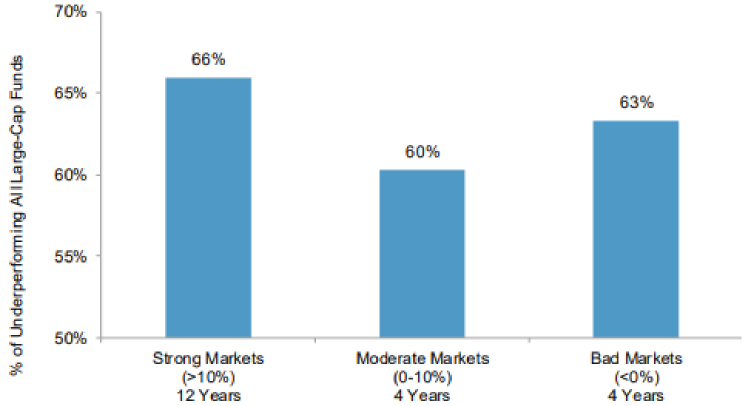
Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2020. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

- **Concentration:** Most capitalisation-weighted indices have a few large components that tend to be underweighted in active manager portfolios. When these larger constituents underperform, the active managers tend to perform better if they have tilts towards smaller capitalisation stocks.

- **Low volatility:** Some active managers also tend to have a tilt against low volatility, explaining the existence of the low volatility anomaly. They prefer to have exposures toward higher beta counters and shoot the lights out when this sub-segment of the market performs well.

What we found interesting in this paper was that contrary to our expectations, no relationship was found to the factors that we might have expected, namely:

Exhibit 4a: Fewer Active Managers Underperformed in Moderate and Bad Markets Compared with Good Markets



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2020. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

- **Market direction:** It is generally perceived that in a falling market, active managers will provide downside protection. The S&P indices versus Active (SPIVA) scorecards reveals that this outcome is not quite as expected and that active managers are not notably skillful at protecting investors' capital during falling markets.

- **Correlation:** Correlation does not play any meaningful role in explaining active managers' under- or over-performance. Some argue that when co-movement between stocks increases then stock selection becomes more challenging – the S&P paper posits that this relationship is inconclusive, and that dispersion plays the bigger role.

Our take is that some of these factors can indeed come together and produce the perfect environment for active managers to outperform, but the probability for all these circumstances to do so at the same time is low and, more importantly, largely out of anyone's direct control. Based on historical analysis the percentage of managers underperforming is generally too high for us to have much confidence in the successful outcome of stock picking.

The study ends with the following statement: "*Readers can form their own opinions about the balance of these observations; our estimate is that active underperformance is likely to persist when SPIVA results for 2021 become available*".

These results have since been published and the SPIVA numbers disclose that 85% of US active managers and 73% of South African active managers underperformed the broad market in 2021.

Our conclusion – some active fund managers can and do outperform the market. The challenge is in identifying *which fund* will*, when* and *for how long*. Based on our research and experience, we maintain the best approach to long-term equity investing remains indexation, the safest route with the least amount of friction.

"We should all work on the assumption that we do not know what will happen next." - John Authers

Glacier Research would like to thank Megan Fraser & Casparus Treurnicht for their contribution to this week's *Funds on Friday*

Megan Fraser,
Head of Business Development & Marketing
Gryphon Asset Management

Megan has been involved in establishing business development networks in financial services for nearly 40 years. Having worked for Norwich, Investec IMS, Coronation, Stanlib, Fraters, SI, and Aylett & Co, she has a acquired a breadth of experience as well as valuable insights in this time. Her current role with Gryphon provides the opportunity to create awareness and appreciation for the unique, innovative investment approach delivered by this well-established, rules-based investment house. Beyond the office, her passions include reading, travel, holistic health, and trying to get the whole world to embrace meditation.

Casparus Treurnicht,
Portfolio Manager & Research Analyst
Gryphon Asset Management

Cassie has been in the industry since January 2007 and joined Gryphon in 2011, bringing a strong quantitative background which made him a natural fit for maintaining and developing our proprietary valuation models and conducting equity research. He is an integral member of the Gryphon team fulfilling a number of roles but primarily responsible for managing the Gryphon ALSI Tracker Fund.

Cassie is considered a campsite connoisseur and applies the same passion and analytic skills to the campsite fire as he does to his funds.