LEARNING FROM THE PAST

Can the industry learn from the past to improve their performance? asks **Tim Giles**, **Tim Wilsdon** and **Darren Butterworth**, of Charles River Associates

THE REGULATORY DEBATE ON past performance appears to be drawing to its conclusion. From the Financial Services Authority's perspective the use of past performance information has been diminished through its exclusion from comparative tables although there is no restriction on magazines such as *Money Management* publishing tables of past performance.

The use in advertising of past performance is also under increased scrutiny. From the industry's perspective, the value of past performance has been justified by its inclusion in disclosure documents and the continuing importance placed on it by consumers and their advisers.

Through work on behalf of the Investment Management Association (IMA) we were able to establish that persistence is evident in the performance of UK managed equity funds. This work has given us a unique perspective on this debate and a unique database of historical unit trust returns.

From this work it has become clear to us that insights derived from the analysis of performance persistence are applicable to the management and strategy of fund houses. In particular, the same tools used in the regulatory environment can be important when thinking strategically. Understanding past performance remains the key to the short term competitive success of a fund and to identifying sustainable competitive advantages of a fund house. In this short article, we explain how the application of new techniques can help to understand:

- the value of information to consumers and advisers; and
- where the sources of competitive advantage reside.

To do this we look at an example of how persistence in performance can, in principle, be tied back to fund houses.

TABLE 1: Illustrative examples of fund houses that demonstrate a persistent house effect funds

1981	1991	2001
Allied Dunbar	Friends Provident	HSBC
Barclay's	Invesco	Threadneedle
Henderson	M&G	Jupiter
M&G	Lloyds Bank	Schroder's

Value of information

Past performance is one of the key characteristics used to get funds on IFA panels and in the selection of funds for particular investors. But it is usually used in conjunction with other pieces of information, including risk, charges, the fund house's brand and its financial strength.

However, such additional information can only ever be useful in as much as there is some element of persistence in returns. That is, its value can only ever be confirmed by testing whether it can assist in identifying future performance and this is only possible if returns are themselves persistent to some degree.

Accordingly, the value of this additional information and the value of past performance is inter-linked. When we consider the value of additional information it is, therefore, important to consider whether it is independent of past performance. That is, the fund house effect that we examine below may just be a proxy for, and add nothing to, past performance. Alternatively, knowing the risk of a fund may be sufficient information and past performance and other observable characteristics of a fund may simply be proxies for fund risk.

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The important issue is to identify where information is additional to past performance and risk and where it is simply a proxy for these.

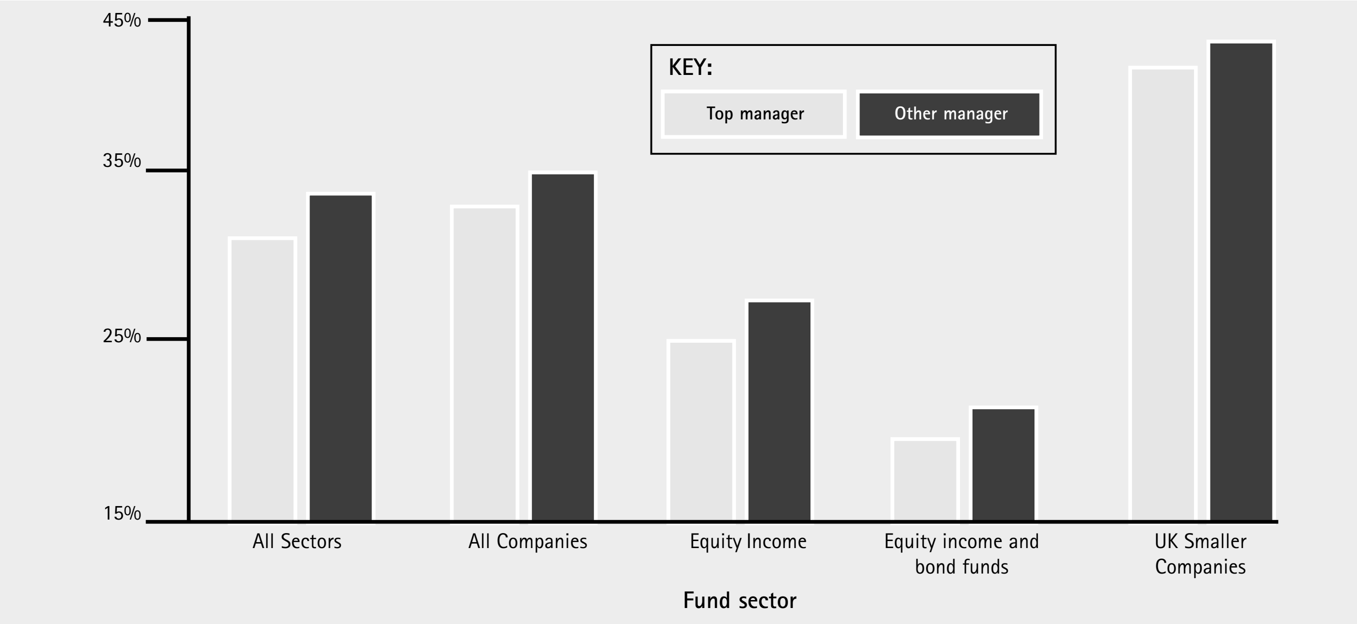
Understanding the sources of competitive advantage

There is still considerable debate within the industry regarding the long term source of competitive advantage in fund management. In particular, the relative importance of luck and marketing opportunism, the talents of extraordinary fund managers and characteristics of the fund house. The relative and distinct merits of these is important to the ultimate consumers (or their advisers) as well as fund houses themselves.

For example, if luck and opportunism are really the only drivers of long term performance beyond risk, then running multiple funds is a key strategy as it gives fund houses a higher chance of having a leading fund to market at any given time. Alternatively, if individual fund managers are the only source of competitive advantage, fund houses will need to spot them early and lock them in if possible – much in the way that football managers and record companies compete for young talent and tie them in to long term contracts.

However, if the characteristics of the fund house itself is the key, eg, through training, processes of risk control and culture, then a fund house must seek to identify these in order to develop a sustainable competitive advantage. Understanding which of these hypotheses might be correct is therefore the key to developing a sustainable competitive advantage in the future.

GRAPH 1 : Impact of the fund manager effect on the worse performing quartile four funds



Testing for the fund manager effect

To illustrate we examine one characteristic of fund houses – the number of funds that they market – to determine whether this characteristic adds information in addition to past performance as to whether a particular fund will perform well in the future.

We constructed an extensive dataset for UK equity unit trust funds that were marketed at any stage between 1981 and 2001 – the study excluded all other non-equity based funds such as international, sector specialist, balanced and fixed income unit trust. Return data was collected at monthly intervals for all the 942 funds that existed at any time in that period from the following IMA sectors:

- UK All Companies funds;
- UK Equity Income funds;
- UK Equity and Bond Income funds; and
- UK Smaller Company funds.

From this returns database we identified the top 10 fund managers, in terms of the number of funds that they were currently marketing (we refer to these as the largest or established fund managers). We then tested whether the past performance of funds managed by these fund managers were more persistent than those run by other managers.

In investigating the issue of persistence in fund returns and whether there is a significant established fund manager effect, we seek to predict the future performance of a individual fund based on its existing performance, where returns are categorised into quartiles on the basis of relative returns – if performance was purely random we would expect each fund to have a 25% chance of being in each quartile. So for all the funds that are top quartile in the current period, we would expect only 25% of them to be top quartile next period, and 25% of them to be in each of the other three quartiles. If there was no effect of established fund managers, we would expect these numbers to be the same for both established fund managers and others.

Our results show that the larger fund manager effect is statistically significant (ie a result that is unlikely to have occurred through chance) for all quartiles. However, this effect is strongest for the worst performing, fourth quartile, funds (see GRAPH 1). That is, a fourth quartile fund that is associated with a larger fund house has a lower likelihood of continued poor performance than funds from smaller houses. For example, across all four sectors, a fund currently performing poorly has a 31% probability of it performing badly in the subsequent period if it is owned by a larger fund house, compared to a 33% probability of future poor performance otherwise. This effect is also found to be pervasive across each sector in isolation.

Graph 1 shows the impact of the fund manager effect on the worst performing quartile four funds.

Conclusion

We have presented a very simple analysis for testing whether basic information on the provider of a fund represents valuable additional information when selecting funds. This suggests that this information is valuable when selecting a fund.

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Equally, this suggests that larger fund managers are better able to sustain their performance compared to lesser fund houses. To many this will be a completely unsurprising result. However, in our experience fund houses are openly sceptical that this effect can be identified and the size of this effect quantified. The existence of this result should be a source of confidence to successful fund houses about their long term sustainability and a source of information for aspiring fund managers.

This effect could be subject to further investigation. For instance, is it as strong in a bear market as in a bull market? Do particular fund managers have identifiable effects in particular sectors? Are fund manager effects consistent over time, ie how long do fund manager effects persist for?

The same approach can be used to test which fund managers have the strongest ability to sustain performance and based on the characteristics of these fund managers we can understand from where these advantages are derived. With our comprehensive database we believe that it is possible to make these distinctions and are progressing in this direction.