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Evaluating Money Manager Skill –

A Matter of Persistence

By Ian A. Post, CFA

In a competitive world we often look to track records as a measure of skill. For example, doctors with better previous patient outcomes are expected to perform better with future patients than doctors with worse previous outcomes. The same holds true of attorneys and their clients.

The best example of this concept is with athletes. Superior athletic performance tends to persist into future periods. For example, Derek Jeter was a model of consistency. He hit .314 in his first full major league season and hit .310 for his career. At the beginning of each season, you could write in something around .300 based on his previous performances and you wouldn't be far off from his actual results.

Why?

Because what separated Jeter from everybody else was true skill. He really was a better hitter and that elite skill manifested in a high batting average almost every season.

Investors often mistakenly apply the same reasoning to 'active'[1] money managers. Whether they are well-known staid mutual fund managers or high flying, headline seeking hedge fund managers, investors often assume that money managers with great[2] track records are skillful and so can continuously outperform the market.

We can test the idea that money managers possess market-beating skill by using empirical evidence in a two-part test. First, we can look at what percentage of funds outperform their benchmark[3] over a specific time period. Those who outperform are placed in the Possibly Skillful Manager "PSM" group. Second, we look at how the PSM group does in the next time period. If they are truly skillful, à la Jeter, we should be able to find skillful managers by reviewing their record of past outperformance.

A recent report from Dimensional Fund Advisors, "The U.S. Mutual Fund Landscape – 2016" presents the data we need to test this idea.

First, we look at how all equity mutual funds performed relative to their benchmarks from 2001-2010. During that ten-year period, 541 out of 2,758 funds, or 20%, outperformed their benchmark (80% underperformed). These outperformers will form the PSM group for our test. The second part of the test is where we would expect to see the cream rise. If we look at a group composed 100% of managers who outperformed over the previous ten years, we would expect the vast majority of that group to outperform in the next period ***if they are truly skillful***.

So how did the PSM group do? In the five-year period from 2011-2015, 63% underperformed their benchmarks.

So what is the take away for investors? First, and most importantly, money managers are not future Hall of Famers. Second, money managers don't possess special skills that persist into future time periods. Without skill, money managers can't add enough value to overcome the high fees levied by their funds. The high expense levels of actively managed mutual and hedge funds is what drives their underperformance. The alternative for investors seeking high quality portfolios is to use low-cost index and asset class funds, designed to deliver the benchmark return.

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[1] 'Active' here refers to money managers that utilize strategies such as stock selection and/or market timing in an attempt to outperform the market or a benchmark. [2] For purposes of this article, we'll assume we know a manager actually has a great track record. In fact, because of erroneous benchmarking, it is difficult to say even in hindsight if a manager has a good track record or not. [3] Benchmarks are generally used as a way to measure the success or failure of active money managers.