The Absolute Return Letter
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The Facts They Don't Want You to Know

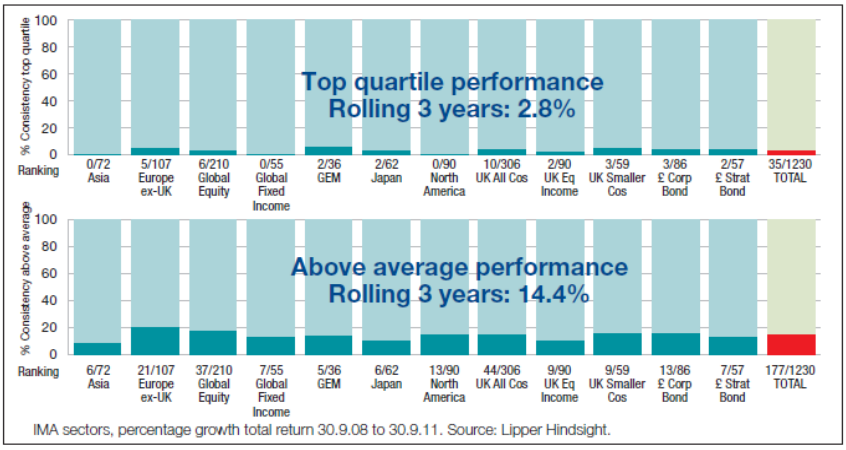
What have Bill Gross, John Paulson, Anthony Bolton and Bill Miller all got in common? They are all 'rock star' fund managers who have fallen on hard times more recently. Life in the fund management industry is not what it used to be like. Life is tough even for the supremely skilled. Markets are changing, fund managers are struggling to adapt and clients are growing restless as a result.

If I told you that the composition of an average UK equity fund changes by 90% a year, would that startle you? How would you feel if I added that the 20 funds with the highest turnover returned just 4.7% to investors in the 3 years to the end of March 2011 whereas the 20 funds with the lowest turnover returned 16.8% over the same period?[1]

From the same source: Out of 1,230 funds across 12 different strategies, only 35 fund managers produced a performance consistent enough to earn their fund a place in the top quartile in each of the last three years (upper half of chart 1). In a universe of 1,230 funds, over a three year period and completely disregarding skill, the expected number of funds consistently ranked in the top quartile is $1{,}230*0.25^3=19.22$.

In other words, more than half the 35 managers were there not because of skill but because, statistically, someone was always likely to 'over-achieve'. This leaves about 15 fund managers out of a universe of 1,230 – ca. 1% - who could with some right claim that they have consistently been in the top quartile.

Chart 1: The TRMC Consistency Ratio (through September 2011)



Source: Thames River Multi Capital Quarterly Survey

The problem is we don't know who they are. All we know is that none of them are managing Asian equities, North American equities or Global fixed income funds as those three strategies didn't produce a single top quartile performer between them. And when you look at the second, and

[1] *Study conducted by Thames River Multiple Capital (3 years through March 2011) and based on the IMA's All Companies Sector.*

slightly less demanding, part of the study – those who have been in the top half in each of the past 3 years – the picture is broadly the same (lower half of chart 1). 177 fund managers achieved the required consistency but 154 of the 177 are likely to have done so because of luck, not skill.

I have never come across a fund manager who openly admits that his (or her) outperformance is down to luck. On the other hand, I often come across fund managers who suggest their underperformance is down to *bad luck*. I suppose no manager ever skilfully underperforms, but to put it down to bad luck is an insult when we all know that human error is the most common cause of underperformance.

If a fund manager's outperformance is based on skill rather than luck, wouldn't one expect the majority of the outperformance to come from those stocks with the highest weights in the portfolio? This seems a reasonable assumption given that one would expect any rational fund manager to allocate the most capital to his/her highest conviction ideas.

However, in a study conducted by UK consulting firm Inalytics (see here), 39 of 42 Australian funds managers who outperformed their benchmark owed their outperformance to the 'underweights' in the portfolios - suggesting that human error is not only the source of underperformance but perhaps also of some of the outperformance.

Bestinvest produces an annual survey called *Spot the Dog* (see here for the latest survey) which has gained considerable attention in the UK fund management industry, although it is not a league table you will be proud to be mentioned in. According to the 2011 survey published back in August, over £23 billion is currently managed in so-called dog funds[2], an increase of no less than 74% since the previous report.

You don't become a dog just because you have a bad quarter or two. The members of that exclusive club have a history of serial underperformance, yet they will generate in the region of £350 million of fees to their firms this year despite the obvious value destruction.

And the story gets worse - much worse in fact. According to an unpublished report conducted by IBM, our industry destroys $1,300 billion of value *annually* – a staggering 2% of global GDP (see here for details). This includes about $300 billion in fees on actively managed long-only funds which fail to outperform their benchmarks, $250 billion spent on wealth management fees for services which do not meet their benchmarks and $50 billion in fees on hedge funds which underperform. Do I need to say any more?

Why are fund managers finding it harder than ever to outperform and what are the long term implications of those miserable performance statistics? Let's deal with the 'why' first. There is no question that managing money – in particular equity mandates – has been a delicate affair over the past decade.

Through the 1980s and 1990s global equity markets benefitted from a strong undercurrent of bullishness. As a result, fund managers went into the bear market of 2000-01 on a wave of optimism (who doesn't recall the repeated calls in the late 1990s of a new investment paradigm?) epitomised by the record high P/E levels in 1998-1999 just before it all went pear shaped in 2000.

Since then investors have been punished for their optimism. As you can see from chart 2, those who bought UK equities in 1998, 1999 and 2000 and held on to them for 10 years have suffered the indignity of negative inflation-adjusted returns.

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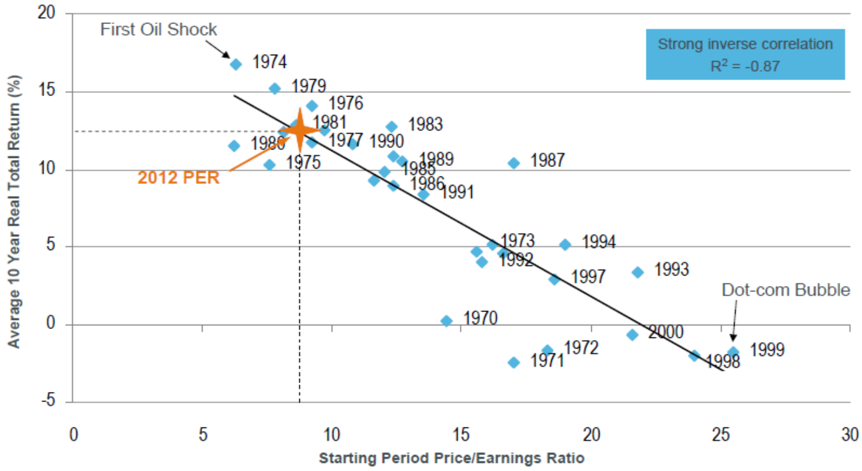
[2] *Bestinvest defines a dog fund as a fund that (a) has underperformed in each of the last 3 years, and (b) underperformed their benchmark by at least 10% over the last 3 years.*

Chart 2: The Link between Long-Term Returns and Starting Point P/E Ratios



Source: Blackrock, Oriel Securities.
Based on FTSE All Share Index as at 7 September, 2011. 2012 P/E = 8.9.

I believe much of the underperformance of recent years is a bi-product of the excessive optimism of the late 1990s. An entire generation of investors grew up believing equities would always go up in the long run. Since 2000 the investment environment has changed for the worse but the faith in equities has only gradually been undermined, causing fund managers to only slowly adapting to a more challenging environment.

Another factor making life difficult for active managers in more recent times is the rising dominance of the '*risk on*' versus '*risk off*' mentality. Not that it represents a new paradigm. Investors have always been either pro risk (*risk on*) or against risk (*risk off*). What is new is how those cycles appear to become more and more compressed and how investors increasingly demonstrate herd-like behaviour (i.e. most of us are either *risk on* or *risk off* at the same time).

It is not for me to speculate on why that is but the implications are there for everyone to see. As *risk on* switches to *risk off*, virtually all share classes sell off simultaneously, rendering simple portfolio techniques such as diversification largely useless. Until active fund managers embrace the new world and adjust their portfolio management techniques accordingly, they will likely continue to struggle.

Consulting firm FundQuest has analysed the performance of 32,730 US domiciled non-index mutual funds over a 30 year period (see chart 3). Managers were judged to have generated alpha if they beat their benchmark by more than 50 basis points.

Chart 3: Correlations Up, Alpha Down
% of Fund Managers Generating Alpha

Asset Class	High Correlation Periods	Low Correlation Periods
Municipal Bonds	8%	11%
Other Bonds	38%	39%
US Equity	44%	70%
Non-US Equity	41%	74%
Commodities	31%	57%
Alternatives	46%	50%
Multi Asset Class	15%	74%

Source: FundQuest, Funds Europe Magazine

Several conclusions stare the reader in the face:

1. Giving money to active bond managers is (statistically) a losing proposition in any environment. When well over 50% underperform their benchmarks even at the best of times, it is hard to see the justification for using active managers in this asset class.

2. Managers in charge of equity and commodity funds can only justify their existence in more benign market environments. When the going gets tough (risk off), less than half the managers deliver alpha.

3. Alternative managers have nothing to be proud of. With only about half the managers generating alpha regardless of environment, you might wonder whether you should resort to the art of throwing darts.

4. Multi asset class managers struggle badly (only 15% outperform) when correlations rise – not really surprising considering high correlations undermine the very idea of the multi asset class strategy (i.e. diversification across asset classes) but worth bearing in mind if the 'risk on/risk off' environment which has so dominated the investment landscape in recent years continues for a prolonged period of time.

So far my focus has been on actively managed long-only funds but that doesn't imply that hedge funds are covering themselves in glory - far from it. Hedge funds have enjoyed tremendous growth in recent years, spurred on by what looks to the untrained eye as vastly superior returns when compared to long-only funds. In a research paper published back in January (see here) this perception was challenged.

Using data from 1980 to 2008, the authors calculated the compound annual return for the average hedge fund to be 13.8%, easily outperforming more traditional asset classes over the period in question. This number makes hedge fund managers look like superstars when compared to traditional fund managers and is used by the hedge fund industry as one of the key reasons why everyone should invest in hedge funds.

Now to the naked reality. The best performance in the hedge fund industry came in the early years when assets under management were much smaller. The authors adjusted for this by calculating dollar-weighted returns instead; i.e. more recent returns when assets under management have been much bigger carry a higher weight than more distant returns when assets under management were negligible. The dollar-weighted number is thus a *much* better proxy for actual profits earned by investors in hedge funds. For the whole period 1980-2008 that number is 6.1% as opposed to the 13.8% headline number. Hardly blowing your socks off!

Now, if the hedge fund universe is difficult to navigate, can funds of hedge funds add any value? Regrettably the answer seems to be a resounding 'NO'. In the paper referred to above the buy-and-hold return on funds of hedge funds for the entire 1980-2008 period was 11.0% per annum whereas the dollar-weighted return was a much more modest 4.1% per annum.

In another study on the performance of funds of hedge funds (see here), the authors conclude that, during the period 1994-2009, only 21% of all funds of hedge funds generated pre-fee alpha and, once the extra layer of fees were taken into consideration, only 5-6% of all funds of hedge funds outperformed the hedge fund benchmark.

These results are obviously disappointing and explain why funds of hedge funds are struggling to keep up with the growth of the hedge fund industry. In 2007 funds of hedge funds accounted for about 43% of underlying hedge fund assets. Three years later, their share had dropped to 33%, suggesting that more and more hedge fund investors go directly rather than through funds of funds (see here for details).

As a footnote, and in the spirit of full disclosure, Absolute Return Partners' main line of business used to be funds of hedge funds and it is no secret that our funds of hedge funds have struggled and continue to suffer the consequences of decisions made back in 2005-07 when we all thought we could walk on water.

So, if the performance of the average long-only manager stinks, the typical hedge fund does not fare much better and the run of the mill fund of funds add little or no value, what should investors do? Well, to begin with we should clean up the way investment products are sold and that is precisely what the UK regulator intends to do.

If the Financial Services Authority has it its way, from January 2013, the so-called Retail Distribution Review (RDR) will outlaw kick-backs from UK fund managers to IFAs. RDR will make life miserable for the dog funds – those that serially underperform but continue to survive because they pay handsome fees to introducers who are prepared to disregard the dismal performance. Instead, IFAs will have to charge their clients an advisory fee.

This is a step in the right direction for an industry which has undermined its own credibility for years by 'bribing' IFAs to sell poorly performing funds; however, the technocrats in Brussels (as if they didn't have bigger and better things to worry about at the moment) are not entirely happy with the British initiative and have tried to throw a spanner in the works. We can only wait and see what the next twelve months bring.

In the meantime, ETFs and other index trackers are seen by many as the solution to poor performance, but ETFs are not without their share of problems. Hargreaves Lansdown, a leading UK financial services provider, states on its website that it offers access to more than 2,000 funds at no initial charge. On the other hand, as far as I have been able to establish, it doesn't state anywhere that it won't include a fund unless it receives a significant rebate from the fund manager.

With ETFs becoming more and more popular amongst investors, Hargreaves Lansdown has seen the writing on the wall and has responded with an extra charge for holding ETFs and other index trackers on behalf of its clients, potentially undermining the ability of small investors to track indices (see here).

More worryingly, the problems do not end there (and I am no longer referring to Hargreaves Lansdown). Many index trackers are sold without full disclosure – such as commodity index trackers which are subject to the cost of carry and index trackers which are exposed to significant counterparty risk because the underlying collateral is a total return swap (the consequence of which many investors do not understand) – and it is only a question of time before our industry faces its first major mis-selling scandal related to index trackers.

Finally, in my humble opinion, index trackers are more of a bull market than a bear market instrument. I have argued repeatedly over the past seven years that we are in a structural bear market (defined as a market of declining P/E values). The long-term inflation-adjusted return in a structural bear market is near zero and that is precisely the return UK and US equities have delivered since 2000. I can see the point of tracking an index in a raging bull market where it may be difficult to keep up with markets; however, in markets like these I believe other types of strategies are required.

So what can you do? A few ideas spring to mind:

- Stick with people, not firms. In our industry the key assets walk out of the door every evening and, if they do not return the next morning, neither should you.

- Identify an investment strategy you are comfortable with. Whether you believe in value, growth or something entirely different is less important. All active managers have their ups and downs, and it is when the going gets tough that it becomes critical that you are entirely onboard with the fund manager's investment approach.

- Prohibit high frequency trading (HFT). HFT uses powerful computers and sophisticated software to take advantage of microscopic inefficiencies in markets around the world. HFT models will often sell a security within a few milliseconds of having bought it. Does that add any economic value to financial markets? I don't think so. Does it create unwarranted volatility occasionally? I very much believe so. Although I am not in favour of the much discussed financial transaction tax proposed by the Germans and the French, ironically, a modest transaction tax (if it were global) would wipe out all HFT based strategies, and the world would be a better place as a result.

- Don't invest in hedge funds for performance reasons. Do it because it is one of the few areas where you can truly diversify your investment risks. For example, the average managed futures fund was up well over 20% in 2008% when most asset classes collapsed.

- Consider multi-strategy funds as an alternative to funds of hedge funds. The downside is that you concentrate your manager risk but you often achieve better strategy diversification and more attractive returns. Multi-strategy funds outperformed funds of hedge funds by approximately 3% last year and they are on target to do so again this year (see here).

- Do not disregard sound advice. Those of us who have worked in the industry for decades know where many of the pitfalls are and can help investors stay clear of most of them. Just make sure your interests are aligned with those of your adviser.

- Or you can simply do as the 1.5 million people in the UK who, according to a survey conducted earlier this year by Schroders, hold all their equity investments in a single company. Not my preferred approach, but who am I to challenge the wisdom of 1.5 million people?

Niels C. Jensen
5 December 2011

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