INALYTICS

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Running Winners: Presenting Evidence of Skill

RESEARCH PAPER - SPRING 2012

Finding a winning stock may be easy for some. However, recognising that it is a winner, and having the conviction to run it, is considerably more difficult for all but the most skillful.

In this paper we present evidence as to how effectively Fund Managers run their winners, and demonstrate that this is a key characteristic of skillful Managers. This is the first in a series of Research Papers on skill, and follows on from our previous work on behavioural biases exhibited by the typical active Manager. (For more information, see Research Papers 01-04).

This paper demonstrates that skill exists, introduces a way to identify it, and shows that there is almost 500 bps pa difference between the performance of Managers who have skill, and those that do not.

DEFINING INVESTMENT SKILL

Traditional methods: track records fail to tell the difference between luck and skill

Let's start with the industry's focus on track records. Experience and research on the topic show that it is a poor guide to the future as it fails to address the fundamental question of whether track records are attributable to luck or skill. For example, our research into Australian Equity Managers (see Research Paper 04: Australian Equity Managers - Separating Luck from Skill) revealed that Fund Managers had outperformed for several years through luck alone.

Traditional methods: qualitative analysis lacks the evidence to support opinions

Then there is the qualitative approach which looks at people, philosophy, and process. These are important to know, however the process lacks evidence to verify that Managers do what they say and how these "3Ps" feed into returns. This leaves open the question as to how effectively the industry identifies investment skill.

Evidence based approach: characteristics of skill

Inalytics has analysed 760 equity portfolios from around the world and observes that skillful Managers have the following characteristics. They:

1. get more decisions right than wrong;
2. are able to run their winners;
3. cut their losers.

These are simple intuitive characteristics of skill that are capable of being identified and measured.

The first of these characteristics was reviewed in Inalytics' Research Paper 03: Track Records – Luck or Judgement, that showed that Fund Managers typically only get 49.6% out of all of the overweight decisions they take right, and even good Managers only get 51% of decisions right. This paper will focus on the second of these characteristics, the ability to run winners.

RUNNING WINNERS

Introducing winners

Contrary to conventional wisdom, the overwhelming majority of Fund Managers do not run their winners. They do the opposite, and sell them too early *(see Research Paper 02: Are Fund Managers Poor Sellers?).* This is explained in Behavioural Finance as the Disposition Effect, which describes how Investors have an over-riding tendency to "bank their profit".

Defining a winner: a double condition

A winner, in our terms, is a stock that was owned in the past and that added value, and then continued to be held and added value once again. This is a double condition requiring the stock to be held in the past and in the future, and for it to add value in both time periods. Clearly not all prior winners are equal as some will add value in the future and others will underperform.

Inalytics analyses each of these winners and calculates what percentage remain winners, which is the winners' Hit Rate.

Objectives of the paper

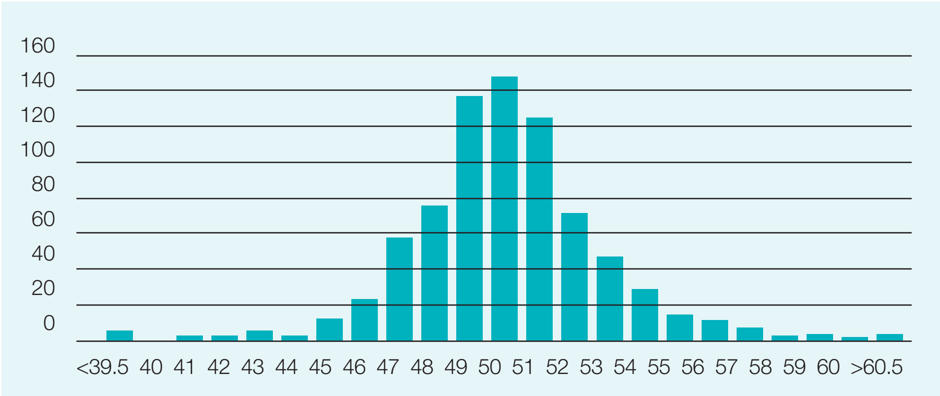
This paper presents empirical evidence on the distribution of Hit Rates. We then demonstrate how significant winners are to generating performance, and that those Managers with this skill significantly outperform those that do not.

We believe this is the first time anyone has analysed skill in this way and we provide evidence to support the hypothesis that running winners is a key characteristic of a skilful Manager.

DISTRIBUTION OF WINNERS THAT REMAIN WINNERS

Chart 1 below shows the number of Managers out of the sample of 760 with their various Hit Rates. Values above 50% are defined as winners, as they satisfy the double condition.

Chart 1



For example, 145 Managers out of the total of 760 have between 49.5% and 50.5% of their prior winners that remain winners. The distribution of Hit Rates is centred around 50% with an average of 49.8%. 295 Managers out of the 760 (39%) have hit rates above 50.5%.

The acid test: does having winners increase the chances of winning?

Having successfully identified Managers with the skill to find winners and run them, the issue now is whether those Managers are the same ones who perform well.

Taking the Managers in Chart 1 and placing them into quartiles for ease of interpretation, we then look at how successful they are at generating performance from their holdings. This analysis focuses solely on the overweight or held stocks. They represent a higher hurdle rate when assessing if a Manager has skill, as indicated in Inalytics' *Research Paper 01: Identifying Real Skill and Behavioural Biases in the Active Management Industry.*

Taking the 2 quartiles made of skilful Managers:

Table A

Comparison of Skilful Managers at finding and running winners against their performance

Quartile Ranking	Average Annualised Performance Relative to Average
1	242 (bps pa)
2	102 (bps pa)

Table A indicates clearly that the best Managers at finding and running winners perform better than those with lesser skills.

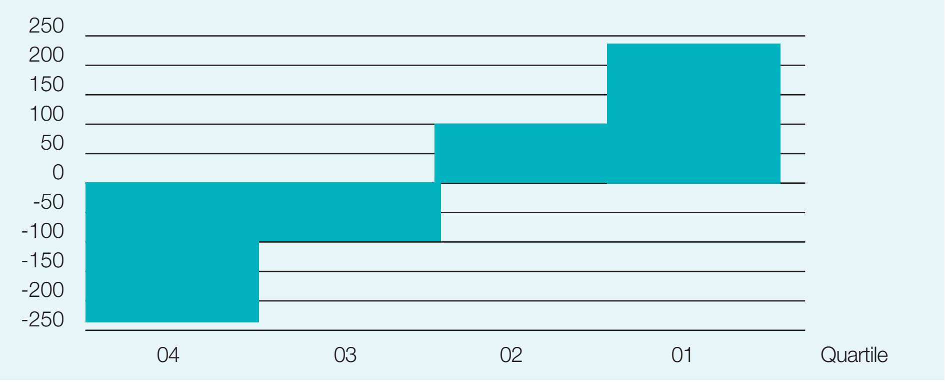
Turning to the remaining 2 quartiles:

Table B

Comparison of Unskilful Managers at finding and running winners against their performance

Quartile Ranking	Average Annualised Performance relative to Average
3	-101 (bps pa)
4	-238 (bps pa)

In Chart 2 below we present these results in graphical form. Identifying Managers who are able to run winners consistently is extremely important for a portfolio as a whole. It means that asset owners and asset managers can objectively measure skill over the long term.



The bottom line

These results are highly significant as they demonstrate that the difference in terms of performance between Managers who have the skill to find and run winners, and those who do not, is 481 bps pa. This is the first time, as far as we are aware, that evidence of this nature has been presented.

CONCLUSION

This paper demonstrates that skill exists, introduces a way to identify it, and shows that there is almost 500 bps pa difference between the performance of Managers who have skill, and those that do not.

THE NATURE OF SKILL

This research paper, the first in a series of papers specifically on the nature of investment skill, ties into other research that Inalytics has conducted in the past. Inalytics works with asset owners to help them make informed decisions, and with asset manager clients to help them improve the solutions they offer their clients.

In Research Paper 01: Identifying Real Skill and Behavioural Biases in the Active Management Industry, we highlighted the fact that managers are able to consistently pick stocks that outperform, but not stocks that underperform.

In Research Paper 02: Are Fund Managers Poor Sellers? Presenting Empirical Evidence of the Disposition Effect, we found that Fund Managers hold on to their losers and cut their winners, and it hurts performance. Using our proprietary tool Trading P&L, Inalytics found that poor selling negatively impacts returns on average by 94 basis points per annum. To some extent this is offset by favourable buying skills which contribute 47 basis points per annum, but it is clearly not enough to fully offset the losses from the sales.

In Research Paper 03: Track Records – Luck or Judgement, we found that Fund Managers typically only get 50% of their decisions right, and even good Managers only have Hit Rates of 51%. The typical Manager compensates for a mediocre Hit Rate by generating good returns from winners which offset the losses from the poor decisions.

The starting point for Research Paper 04: Australian Equity Managers - Separating Luck from Skill was that Australian Managers' track records and consequently their level of skill, was seen to be superior to their peers around the globe. However, we found that the skill level was in fact very similar to those of the rest of the global investment industry, and for some a significant proportion of the outperformance came from the Managers' underweights, rather than their active management.

Inalytics will continue to produce papers on the nature of investment skill. Tied together, these papers convey the importance of understanding Fund Managers' decision-making and behaviour in order to truly appreciate their ability to perform.

MEASURE OF SKILL

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