INALYTICS

Does Investment Skill Exist?

/ WHITE PAPER - RICK DI MASCIO

/ Introduction

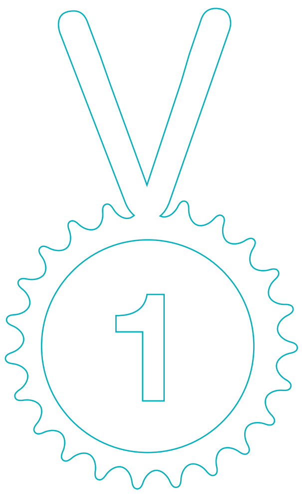
EXECUTIVE SUMMARY

- Investment skill exists but has an inequitable distribution.
- Elite Managers are defined by their ability to persistently find winners.
- Skilful Managers have a high active share.

In recent years the debate over investment skill has been joined by academic voices who have questioned the very existence of skill at stock picking. Our quantitative research rebuts this thesis; skill exists but it is highly concentrated in a subset of Elite Fund Managers.

This paper makes the case for the existence of investment skill in fund management, examines what the skill entails and how it can be measured.

/ Have We Been Looking for Skill in the Wrong Places?

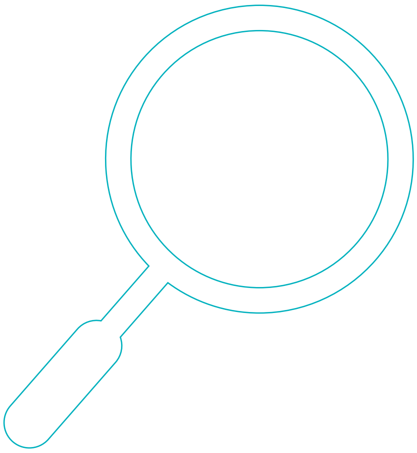


Traditionally, academics and regulators have hunted for evidence of investment skill in industry wide databases of track records. It's fair to say that the popular belief is that they didn't find it in the 'average Fund Manager'; particularly once fees have been taken into account.

However, just because skill is absent in the average that doesn't mean skill is missing in the exceptional. This paper focuses on the Managers whose skill makes them an exception to academic studies which contest the existence of investment skill.

In any competitive field, music or sports for instance, there is always an elite cohort whose performance differs demonstrably from the average participant. In sports we don't accept that the average runner's inability to complete a 100 meter sprint in sub-10 seconds is evidence of the absence of skill at the Olympic level. In these other fields we don't hesitate to focus on the elite when looking for skill at a particular discipline - fund management should be no different.

/ What Does Skill Look Like?



In sports the score tells us the outcome, but to gain insight on whether the outcome was the result of luck or skill, elite athletes and sports teams use sophisticated analytical tools to examine and interrogate every aspect of their performance. For example, Wimbledon champions and their coaches will know how the percentage of unforced errors in their game changes as they reach the later rounds.

This discipline is possible in fund management. Investment decisions can be captured and analysed to understand how alpha was generated and how it was lost. By looking at the success of individual investment decisions the link between the strength of an investment process and performance can be established.

This paper is based on analysis of the decisions that elite Fund Managers take, how successful they are at taking them and what a typical portfolio of an elite Fund Manager looks like.

/ Why Persistency in Finding Winners Matters

ELITE MANAGERS ARE MORE SUCCESSFUL AT FINDING WINNERS

This is quantifiably and anecdotally incontestable. Traditional methods of identifying stock picking skill through analysis of the holdings are ineffective. A Fund Manager's holdings contain too much noise in contrast to the buying decisions which provide a much clearer and purer signal of skill.

The ability of a Fund Manager to persistently make buying decisions that out-perform their benchmark represents a key determinate of whether their performance is the results of luck or judgement. This concept of persistency is found in the world of sport. In order to be selected to compete at the highest levels a diver must be able to consistently replicate successful dives under high levels of competitive pressure. Inconsistent execution in training will prevent their selection for competitions as the Coach must have complete faith in their ability to consistently execute their dives. Intermittent expressions of skill are of little use.

Fund Management mirrors diving in this regard: both require high degrees of technical skill which must be successfully and consistently applied over time. Consequently, skill in these terms is primarily the ability to persistently buy winners. That is the main skill for which active management fees are being paid.

This measure of persistency, when applied to Fund Managers' decisions, is most effective at helping to determine whether skill exists and what shape it takes.

/ The Distribution of Skill

ABOUT THE FOLLOWING ANALYSIS

This is based on a database of some 389 equity portfolios, almost exclusively of elite Managers. Elite Managers are those who consistently out-perform their benchmarks. The database is populated by a global spread of equity Managers and has been built up over 8 years. It comprises well over 100 million individual investment decisions and is thought to be one of the largest private databases of investment decisions of its kind.

The headline statistic is that these Managers buy stocks that out-perform their respective benchmarks over the next 12 months in 60% of months. In effect not only do they pick winners, but do so persistently through time. This is a clear expression of good decision making when buying.

Based on this statistic, these Managers pass the first order criteria of being able to find winners and therefore owning out-performing stocks in the majority of months. In some respects this shouldn't be too surprising as professional stock pickers tend to be educated, well-resourced and focused on winning.

Good decision making when buying isn't the whole story; it is also necessary to add value through the stocks a Manager chooses to hold. When we look at whether successful buying produces successful portfolios, we see that the stocks held add value in performance terms in 57% of the months. This is again significantly higher than the random outcome of 50/50 based on chance.

One of the curious observations from the database is that there is virtually no difference between Managers specialising in Developed or Emerging Markets. In both cases the persistency at finding winners when buying is 60%. In terms of holding winners in the portfolio, these elite Developed Managers hold stocks which add value in 58% of the months, whereas the corresponding value for Emerging Market Managers is 57%. Perhaps this indicates that the opportunity to find undiscovered value in Emerging Markets has long diminished.

An interesting observation is the regional distribution of skill. The average persistency at finding winners in UK equities is 76% and 54% for US equities. The latter is the most interesting as it demonstrates that elite Managers can consistently out-perform their respective benchmarks even in the most 'efficient' or heavily researched market.

TABLE 1 – MANAGERS' DECISIONS WHICH OUT-PERFORMED

This table shows the average percentage of months which the percentage of Managers' decisions out-performed over a 36 month time period.

Source: The Inalytics Database

Buying Winners – Percentage of months the bought stocks subsequently go on to out-perform.

Holding Winners – Percentage of months the overweight positions added value.

Strategy	Persistency – Buying Winners (%)	Persistency – Holding Winners (%)
Developed	60	58
Emerging	60	57
UK	76	70
US	54	54
Overall	60	57

The ability to identify stocks that out-perform their benchmark in 60% of the months demonstrates a level of skill that can be reasonably relied on, consequently it passes the test to assert that skill exists.

/ Elite Managers’ Appetite for Risk

ONE THING IS FOR SURE...

...Elite Fund Managers are not ‘closet indexers’.

These Managers have skill and are able to express it in the way they construct their portfolios. This paper focuses on Active Share as a measure of risk. This metric has gained popularity in recent years, and is in our opinion no better or worse than tracking error. The advantage Active Share has for this purpose is that there is anecdotal evidence that it reflects the Managers’ own perspective on how much risk they are carrying. Also the measure is unambiguous and not dependent on assumptions.

We can see from the table below that the average Active Share is 80% for the Managers in our database. The interesting aspect is the range, with a typical active share of 93 for Global mandates against 65 for the UK. The value for the UK market is a clearly a reflection of the corresponding index’s concentration.

TABLE 2 – COMPARISON OF ACTIVE SHARE

This table shows the comparison of Active Share across Different Geographical Benchmarks.

Source: The Inalytics Database

Strategy	Active Share (%)
Global	93
UK	65
USA	81
Overall	80

As a subsidiary point, the table demonstrates that it is difficult to compare Active Share between benchmarks, but within each category they are effective for comparing similar strategies.

The most important point is that the data indicates that Elite Managers are not ‘closet indexers’ and are prepared to apply their skills for the benefit of their clients.

/ Conclusion

SKILL QUANTIFIABLY EXISTS;

Our database of active equity Managers is conclusive.

There is a cohort of Fund Managers who are able to select stocks which out-perform with a high level of persistency. This skill is highly concentrated in an elite who have a high active share. With all the debate surrounding Fund Manager skill it is important to identify that skill exists, and that this ability can be capture and measured.

A version of this article will appear in Professional Investor, the journal of the UK’s CFA chapter.

INALYTICS

/ Inalytics by numbers

100,000,000

and growing database of investment decisions

128

years of combined investment experience in Fund Management

945

portfolios currently in our global peer group

16

years helping clients

45

current institutional clients in 9 countries, 14 new for 2014

21

asset managers

21

asset owners

3

investment consultants

$124,000,000,000

measured for transitions clients since 2012

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