

THE AVERAGE FUND MANAGER'S WORST INVESTMENT DECISION - A permanent tilt away from the Resources Sector –

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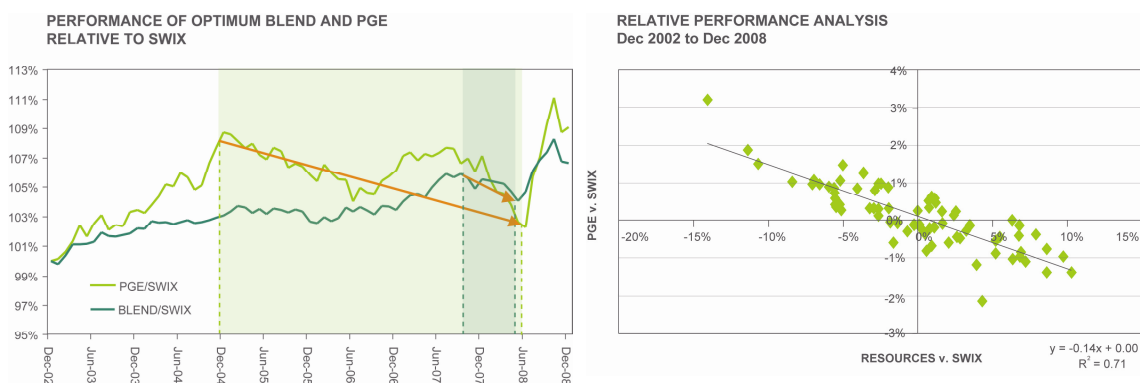
Explaining why he was 14.18% behind his benchmark after a three-and-a-half-year period of underperformance sounds like every fund manager's worst nightmare. However, our analysis suggests that this was exactly what the average – not the bottom quartile - equity fund manager had to do regarding his performance from December 2004 to June 2008.

Our study was done using six years of data from December 2002 to December 2008. We used RisCura's Domestic Peer Group Equity (PGE) return data as a proxy for the return of the hypothetical average equity manager. RisCura calculates average return figures for the equity carve-outs of the funds that participate in the Alexander Forbes SA LARGE MANAGER WATCH™ survey. These funds represent the best investment views of the 11 largest managers of discretionary assets in South Africa.

We assume that the South African institutional equity benchmark is the FTSE/JSE Shareholder Weighted All Share Index (SWIX). The SWIX excludes foreign shareholdings, cross-holdings and strategic holdings. What is left should be the combined holdings of local institutional investors.

While the PGE outperformed the SWIX over the full six-year period, relative performance was cyclical, with distinct periods of out- and under-performance. Chart 1 shows that from the end of 2002 to the end of 2004, and then again from the middle of 2008 to the December 2008, the average manager out performed the SWIX. However, for the three-and-a-half-year period from December 2004 to June 2008 the average manager underperformed the SWIX. While the Information Ratio achieved by the average manager over the full period is an attractive 0.58, it can be shown that the three-and-a-half-year period of severe underperformance was due to a single bad decision that can easily be rectified.

It is widely accepted that the average manager is underweight Resources, and that relative performance of the average manager is largely dependent on relative performance of Resources stocks. Chart 2 clearly confirms his piece of conventional wisdom. There is a significant negative correlation between PGE relative performance and Resources stocks' relative performance. The only conclusion to be drawn is that the average manager's portfolio was consistently underweight Resources.

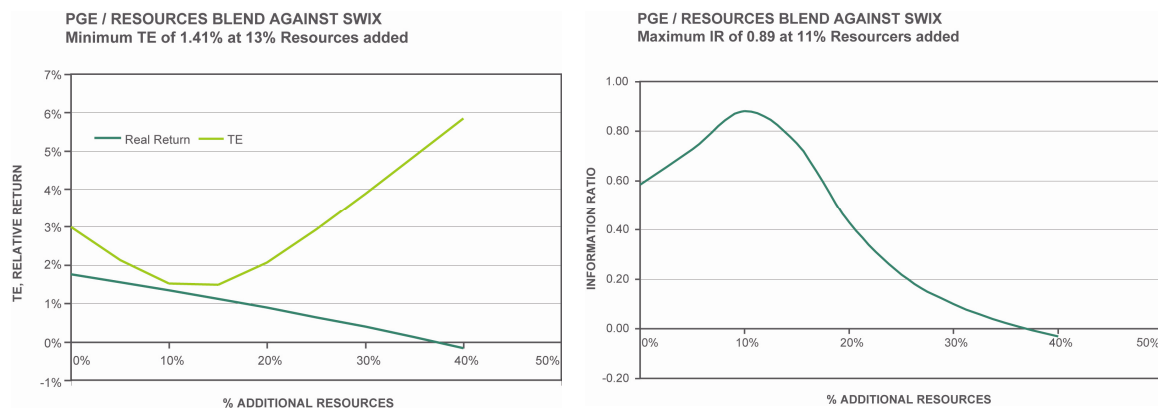


Charts 1 and 2

Let us assume the PGE is a multi-managed portfolio that invests at equal weights in the equity offering of each the eleven large managers participating in the Alexander Forbes Survey. We then introduce a Resources tracker fund, that tracks the FTSE/JSE Africa Resources Index (RESI) to the PGE blend and progressively transfer slices from the PGE blend to the Resources tracker fund. We assume monthly rebalancing and analyze how the newly blended PGE/Resources portfolio would have performed, at various levels of exposure to the Resources Tracker.

The underweight Resources position caused a significant reduction in the Information Ratio

The Information Ratio (IR) is widely accepted as a proper measure for assessing an active equity portfolio manager's skill. It is an indicator for the excess return that a client receives for each unit of risk that the portfolio manager takes by deviating from his benchmark. A fund with a lower IR provides a lower return per unit of risk taken.



Charts 3 and 4

Chart 3 shows that as the Resources weight in the blend increases, the Tracking Error (TE) declines from 2.99% at the pure PGE blend until a low of 1.41% is reached at a 13% Resources, 87% PGE blend. This is additional confirmation that the average portfolio manager avoids Resources stocks. Beyond 13% additional Resources exposure, the TE increases again.

Furthermore, Chart 4 shows that as the Resources weight in the blend increases, the IR increases from 0.58 for the pure PGE portfolio until it peaks at 0.89 when the Resources component is at 11% (at a TE of 1.45%). This is despite the fact that Resources underperformed the SWIX over the period under review. See Table 2. The IR remains above 0.75 for Resources exposure levels between 6% and 15%. This allows for a significant margin of error when deciding on the target Resources exposure in the mix. To use a metaphor - the average fund manager's performance as measured by an IR of 0.58 was a "pass", but not a "first class pass". However, if he did not make the mistake of being underweight Resources, he could easily have achieved "cum laude" by achieving an IR of 0.75 or more!

The underweight Resources position and the resulting higher TE caused a lengthy period of severe underperformance.

Table 1:

MAXIMUM RELATIVE DRAWDOWN ANALYSIS		
	PGE v. SWIX	OPTMUM BLEND v. SWIX
Worst Period	Dec 04 to Jun 08	Sep 07 to May 08
Duration	42 months	8 months
Portfolio Return	122.82%	4.23%
Swix Return	136.99%	6.05%
Return Difference	-14.18%	-1.82%

A powerful indicator of relative - and also business - risk, the maximum relative drawdown to the SWIX, tells it all. The PGE underperformed the SWIX by 14.18% from December 2004 to June 2008. See Table 1. The maximum relative drawdown of the optimum Resources/PGE blend was only 1.82%. This occurred over the period from September 2007 to May 2008. While our study illustrates the behavior of the optimum blend with perfect hindsight, additional Resources exposure to any level around the optimum blend would have significantly reduced both the magnitude and duration of the under-performance.

Table 2:

COMPARATIVE DATA: 72 MONTHS DEC 02 - DEC 08				
	SWIX	BLEND	PGE	RESI
Annualized Return	19.97%	21.27%	21.72%	15.47%
Annualized Tracking Error		1.45%	2.99%	18.21%
Information Ratio		0.89	0.58	-0.25

When portfolio managers are asked about their permanent tilt away from Resources, the usual answers are:

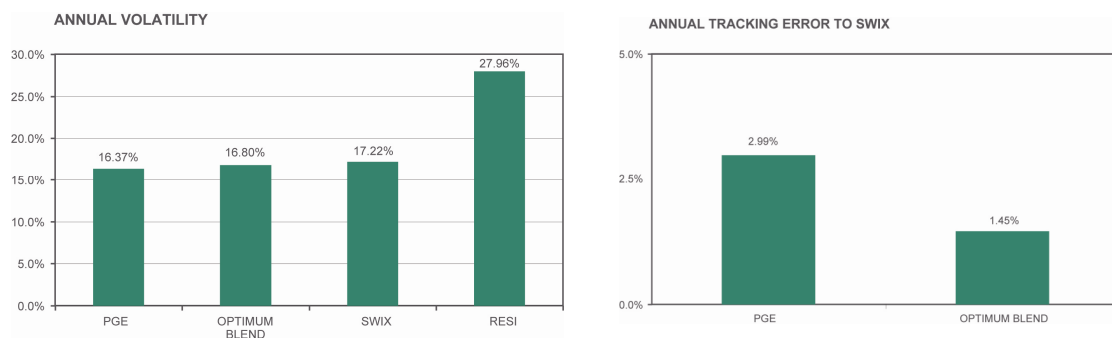
- “I prefer to invest more in the Financial and Industrial sectors where earnings are more predictable and alpha easier to achieve. Resources stock earnings are much more difficult to forecast due to the impact of volatile macroeconomic variables,” or
- “The Resources sector is more volatile than the other two sectors and I want to reduce overall portfolio volatility.”

A better result: Resources at index weight

At first glance both arguments make sense. However, the first answer reflects a lack of understanding of the implications of running a high TE. A fund manager who is uncertain about his ability to pick Resources stocks should rather put his Resources holdings at index weight instead of down-weighting the sector. Paradoxically, by underweighting the sector due to uncertainty, he is actually increasing risk by moving further away from his benchmark. If there is uncertainty, it does not mean that Resources stocks are likely to under-perform. It means the stocks may either out- or under-perform. If the Resources sector is indexed and kept at index weight,

the fund manager can afford to take even bigger high-conviction bets on Industrial and Financial stocks around his benchmark, while maintaining the same TE.

The fund manager who wants to reduce overall portfolio volatility should consider if this is a requirement of his mandate. If not, why is he doing it? By avoiding Resources, he is taking on another type of risk – increasing the TE - without getting compensated. If he still wants or needs to reduce total risk, he should aim to find a balance between the targeted TE and portfolio volatility. In our example, the volatility of the PGE/Resources blend (16.80%) is only marginally higher than that of the pure PGE (16.37%). However, it is still lower than, and thus an improvement on, the volatility of the SWIX benchmark (17.22%). Furthermore, the marginal increase in volatility (above that of the current PGE) in our optimum blend is an insignificant price to pay for the huge reduction in tracking error (from 2.99% to 1.45%) and the resulting reduction in both magnitude and duration of the maximum relative drawdown.



Charts 5 and 6

For multi-managers, up-weighting their Resources exposure is easy. The benefits and optimum size of a Resources tracker satellite can easily be quantified and implemented, given the current manager mix. Traditional asset managers, however, need to carefully reconsider the assumptions on which their Resources bet was based and then adapt their investment process and portfolio construction methodology accordingly.

Data suppliers: INET and RisCura