WORLDWIDE
ASSET MANAGEMENT

Average Thinking does not create Winners

WHITE PAPER

Average Thinking does not create Winners

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Key takeaways

- The average active investment fund will not outperform the market – in the same way that an average football team will not make it to the top of the league.
- There is a distinct trend towards defining risk as deviation from the market return - the technical term is "tracking error" – and not as the risk of losing money. This potentially has a number of negative consequences.
- Index-linked fund management is the ultimate type of momentum investment. The more expensive a stock becomes, the more passive investors will have to buy of it.

Why trends and themes?

Time and time again, the dailies bring headlines such as the following: "Active investment funds underperform the market".

More and more often, you hear people criticise the concept of actively managed funds. The criticism is rooted in research indicating that actively managed funds underperform the market. You cannot expect the average fund to outperform the market, just like you cannot expect the average football club to do better than average. Various investment professionals have argued that people should drop managed funds trying to beat the market and move to index-linked funds, whose objective is to provide a market return. The idea is to cut the costs of active fund management, which they claim, fails to provide a better return.

Index-linked fund manager as an imitator

However, embedded in the concept of index-linked asset management is the seed of its own demise: to a small extent, index-linked management can be a cheap way to achieve the attractive long-term returns available in a healthy market environment, but this can only happen if active managers play absolutely dominant roles and make investment allocations expecting to maximise their future risk-adjusted returns. In this case, the market "correctly" prices shares and bonds through trading between informed counterparties. In such a world, an index-linked manager can act as an imitator on the back of active fund managers in a world of optimal capital allocation.

Figure 1:
Investments in Index Funds globally

Global Equity: Passive Share
Source: EPFR as of April 2019

A danger to the capitalist market system

On the other hand, if passive investment becomes the dominant approach, index-linking could pose a major threat to our financial system and the capitalist market system.

There is already a distinct trend towards defining risk as deviation from the market return - the technical term is “tracking error” – and not as the risk of losing money. This potentially has a number of negative consequences.

1) Misallocation of capital
The market allocates capital relative to size and not to the expected return on invested capital. The biggest stocks in an index receive the highest allocation, not because they have better prospects, but because the company has done well historically.

In the world of bonds, the situation is rather striking: countries like France and Italy are weighted higher in the index because they overconsume and therefore need to issue increasingly more sovereign bonds, which investors then have to buy because they follow the index. At the same time, countries with prudent budget policies are weighted lower and lower, and investors buy inreasingly less of their better quality credit. The consequence is that indexation controls capital allocation.

2) Environment becomes less stimulating
Moving closer to the index and having a computer choose your investments tends to result in an intellectually much less stimulating environment: the Warren Buffets disappear, and other investor types are drawn in instead.

3) Momentum leads to financial instability
Index-linked fund management is the ultimate type of momentum investment. The more expensive a stock becomes, the more passive investors will have to buy of it. This means that index-linked management helps make the financial system even more unstable.

So the notion that various investment professionals are advocating when they recommend index-linked fund management could, at the end of the day, result in more misallocation of capital. This would lead to lower returns on invested capital, which in turn would lead to lower growth and destabilisation of our financial system. Conversely as the move towards indexing continues, it should give the unrestricted active fund manager good opportunities to exploit the misallocation of capital. At one point or another, the momentum will cease, as we saw in 2000 and in 2007, and investors will be reminded that risk is actually the risk of losing money and not the risk of deviating from a benchmark. Index-linked investing comes at a cost.

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Asset management should be active

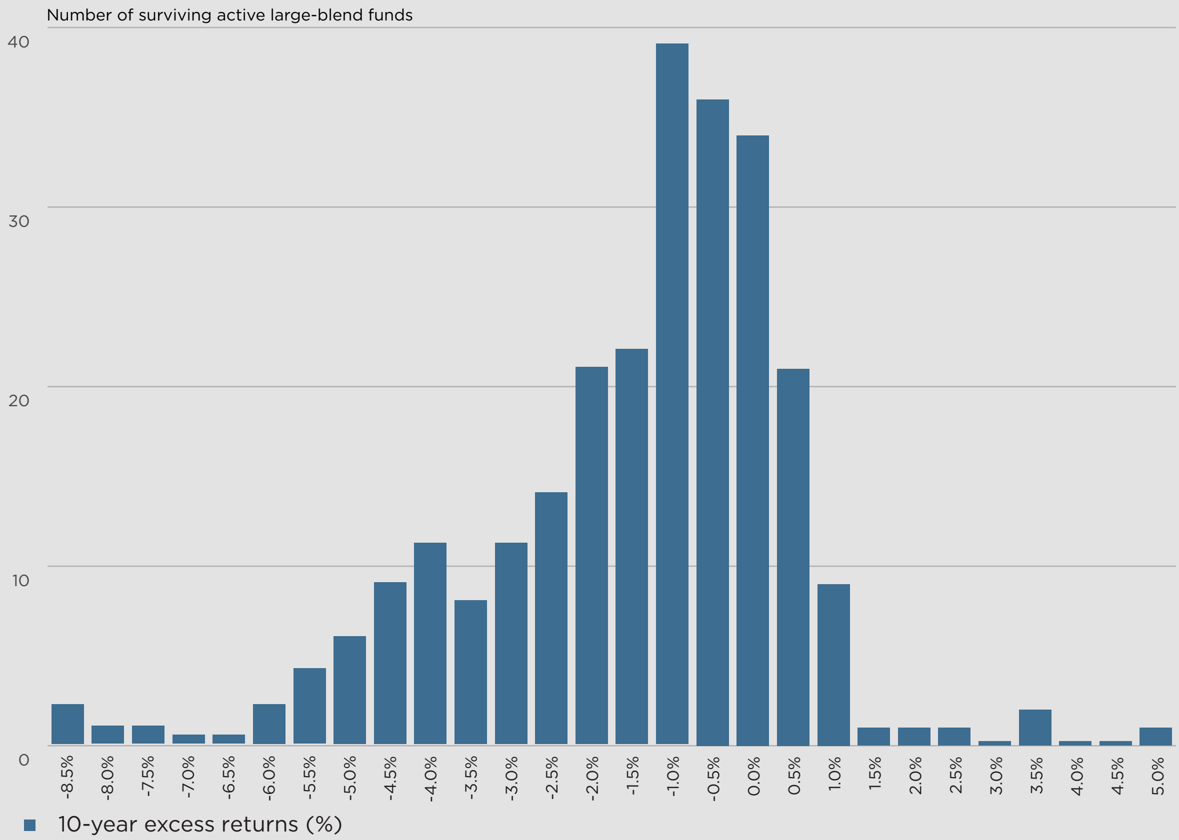
We believe that the world of active asset management is a world we should safeguard and make sure we do not lose. Asset management should be the domain of entrepreneurs and investors and should not be managed passively by administrators who do not consider the price of the product they are buying or selling. Otherwise, the consequences will be investment strategies based on minimising risk for the investing organisation rather than on maximising the risk-adjusted client return.

Let there be no doubt; the average active investment fund will not outperform the market – in the same way that an average football team will not make it to the top of the league. Everyone plays to win, but the winner's podium can only accommodate a limited number of players. Performing in line with the broad equity market is quite a feat; something many private investors have had to acknowledge. For every investor outperforming the market, there's an investor who underperforms it. Combined, all investors earn the market return before expenses, and as active management involves expenses, the industry as a whole will generally underperform.

Even professional investors acknowledge that it is difficult to outperform the market. More and more often, we hear that the level of cost is the key parameter when selecting an investment fund.

The fact that many funds fail to outperform the market merely shows that it is no easy task. However, in the world of equities and in the world of football, extraordinary results do occur now and then. Occasionally an ordinary team manages to beat the best teams and make it to the top of the podium. It rarely ends up there again the following year.

Figure 2:
Distribution of 10-year annualized excess returns



Source: Morningstar as of June 2019

In the most prestigious of football club tournaments – the UEFA Champions League – its been many years since a team outside the five big European football nations made it all the way to the final. Year after year, we see the same group of top teams qualify for the final games.

It is the football clubs that manage to attract the most skilled and hardest-working team players who can successfully form a strong team in a solid and dedicated winning culture. These are not the clubs with the lowest running costs. You won't find football pundits pointing to the clubs with the lowest costs when asked to identify the coming decade's winning teams.

There is a high degree of randomness in relative investment returns and to be statistically significant a performance record should be intact for nearly 15 years. Winning consistently in the equity markets is difficult, but it can be done.

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We look forward to the next decades, competing in the Champions League of the asset management industry and safeguarding the important role of active asset management.

Focused to succeed

Similarly, over the next ten years, some investment funds stand a better chance of outperforming the market. The various investment funds differ widely, as do the various football clubs. In asset management, as in football, there's a world of difference between having one good year and consistently being able to compete with the best.

In football, success is all about having the right team players combined with strong individuals who are able to make the right choices. As is the case in football, the top-performers of the investment community are not attracted by the lowest costs but by the greatest potential. With potential, we don't just mean net income but also the framework and the environment, networks, level of am-


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bition in the business, the corporate culture and the way people treat each other.

For more than three decades as a global active asset manager we have constantly invested in building a winning culture and the foundation for not just one good year, but for long-term and consistent success. Since 1990, our Global Equities Strategy has yielded an satisfying return. This has been a result of high stability and significant experience of the investment teams coupled with continuity in philosophy and process.

Today our clients pick us in fierce competition with asset managers from around the world, and our clients choose us because they are confident that we will continue to deliver an excess return. We look forward to the next decades, competing in the Champions League of the asset management industry and safeguarding the important role of active asset management.

Active Investments

C WorldWide Asset Management Fondsmaeglerselskab A/S is a focused asset manager. Our objective is to deliver consistent, long term capital growth for clients through active investments in listed equities on global stock exchanges.

Our clients are primarily institutional investors and external distribution channels. Our product range includes discretionary asset management services and commingled fund products.

The combination of a unique investment philosophy based on careful stock picking and long-term global trends coupled with a stable team of experienced portfolio managers, has since 1986 resulted in world-class investment performance.

Please find more of our White Papers on cworldwide.com

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