

AUTIF's poor performance case

The FSA wants consumers to stop being fooled by the myth that past performance is a useful way to select investments. The regulator does not see this as a merely academic argument. It believes that it inflates the cost basis of the industry, creates selling distortions and causes regret that damages confidence in the industry and in the merit of investing. So it has banished past performance from the league tables on its consumer website and is actively promoting public awareness of the myth.

The unit trusts industry's trade body, AUTIF, has struck back by commissioning economists Charles River Associates to try to come up with research evidence that past performance is in fact predictive, to discredit the FSA's approach.

But it is the industry that the report may unintentionally discredit

- By finding only partial evidence of predictability: *poor performance tends to persist*
- By exaggerating how useful that tendency is in practice
- By not relating usefulness of past performance generally to the impact of the performance obsession on the economics of the industry and on the education of its customers

AUTIF's claim

'This study, the most comprehensive of its kind, demonstrates conclusively that taking investment decisions without access to past performance data is unwise. We must conclude that the FSA's decision to exclude this information from its comparative tables was a mistake which is detrimental to consumers...We believe the FSA should now reconsider this decision.'

Richard Saunders, Director General of AUTIF

The Performance Lie

Chapter 9 of the book, which carries this provocative title, deals with active manager performance. The industry's claims about the rewards to active management skill are dismissed as a myth. Active managers' relative returns are *for all practical purposes* a lottery. The consumer's belief in the myth is critical to sustaining the industry's business

model. So it's no surprise firms actively and expensively promote it, regardless of the evidence of its theoretical shortcomings, lack of empirical support and practical damage.

What is the impact of the myth?

- It conceals from investors the real commodity nature of packaged products
- Promoting it becomes the industry's largest cost – raising distribution costs to two to three times the cost of actually managing money
- This is passed on to investors
- It turns active management into a gamble at ridiculous but concealed odds
- Investors' attention is diverted from resource planning and asset allocation – both far more important than implementation decisions
- The industry is diverted from developing the skills investors really need and from applying the best technical resources available
- Far too many funds are kept in business for any economic benefit
- Far too much money is paid to individual portfolio managers and business managers
- Firms become hooked on the drug of the performance game
- Gaming it separates their agenda from their customers' agenda

It is when the myth is seen as the entire basis of the industry's business model and as an institutionalized source of consumer damage that it becomes a lie.

About the protagonists

AUTIF

The Association of Unit Trusts and Investment Funds (AUTIF) aims its conclusions squarely at the FSA. Richard Saunders, Director General of AUTIF, claims that the FSA's decision to exclude past performance is 'unwise' and that the research performed by Charles River Associates (CRA) demonstrates this 'conclusively'. He calls for the FSA to reverse its decision immediately and to include past performance in some standardized format in the league tables and search functions that it offers on its consumer website.

AUTIF is a trade body for the unit trust industry and so in the majority of cases its members' business model is dependent on consumers buying into the myth and not appreciating the commodity nature of their products. Defending their members' interests necessarily requires them to try to support the myth and attack its attackers. This is their job.

Though the FSA is the immediate target, AUTIF's aim is also to provide some ammunition that the industry can use to justify its reliance on the active management model. Be sure that selective quotations from AUTIF and CRA will appear in active managers' marketing literature!

The FSA

The FSA has chosen to attack the myth. It has published its own research paper (referred to in some detail in Chapter 9 of the book) and used that as well as the existing body of academic literature to discredit

- past performance claims by managers
- the use typically made of past performance league tables by product providers, advisers and customers alike.

The decision to exclude past performance from its own 'independent' data tables on its consumer website is a way of raising the profile of its argument and of the educational messages to UK individual investors. Its actual significance may nonetheless be far less dramatic than the headline debate suggests. We just don't know how many people will be influenced by the regulator's direct involvement in consumer education and decision support.

Charles River Associates

Charles River Associates (CRA) is an independent economic research firm staffed by a number of people who previously worked for London Economics. CRA and London Economics have performed research commissions for the FSA amongst others (including work on 'polarisation' which is another topical feature).

Its reputation depends on both its independence and the technical integrity of its work. Any team of financial economists will tend to have biases in their intellectual approach and technical methodologies but this need not impinge on their independence or fitness to perform the work they undertake. In the case of the academic literature dealing with performance persistency, or empirical tests of market efficiency (which is often the context for performance research), these differences account for some of the diversity of opinion to which the CRA report itself refers. Sampling differences (which funds are analyzed and over what periods) also account for some diversity of research conclusions.

The No Monkey Business angle

No Monkey Business has involved itself in the performance debate from a different perspective. It is not really interested in contributing to or judging the academic debate about market efficiency that questions how past performance can be of any use. It has taken a pragmatic approach based on four strands of analysis:

1. The impact of existing beliefs and practice on the industry structure
2. The cost of active management in terms of probable outcomes and investor behaviour
3. The limitations of the data when we do work from evidence
4. The feasibility of individual investors engaging usefully in activities they can avoid by using trackers:
 - selecting advisers who have a skill in selecting managers who have a skill in picking stocks
 - themselves selecting the managers who have that skill
 - selecting the stocks as if they themselves had the skill

The No Monkey Business approach is close to the FSA's in its focus on

- consumer education
- minimizing industry damage to consumer interests
- maximizing individual responsibility.

The report's conclusions

AUTIF's claims about the significance of the CRA research conclusions are pretty assertive. So what does the report actually say that might cause the FSA to rethink?

Conclusion #1

CRA start by concluding that 'many studies' in the UK and US *do* find evidence that performance persists from period to period and that this balance of opinion was not fairly reflected in the FSA's arguments. Taking this other research into account, CRA maintains 'there is valuable evidence in past performance data'. But it is unlikely that the FSA has been careless of the range of alternative interpretations and this has probably influenced their doubts about what is 'valuable'.

Conclusion #2

CRA's second conclusion promptly weakens the impact of the first by suggesting that only *poor performers* present reliable evidence of persistency and that the evidence for past good performers is 'mixed'. They suggest that the FSA's approach, by concealing poor past performers, implies 'significant regulatory risk'.

Mixed messages about poor performers

Chapter 9 contrasts:

- WM Company (*past performers have a greater than random chance of bouncing back and outperforming*)
- Quigley & Siquefield (*past poor performers continue to underperform*)

The book shows how different conclusions can be supported by simply changing the periods! It suggests this stems from dynamic performance effects of fairly passive construction biases in active portfolios that are difficult to control for in statistical analysis.

These 'random tides':

- may cycle quickly or slowly but not predictably
- carry whole categories of managers
- can also carry the entire population of active managers (when compared with a benchmark with slightly different construction features)

Conclusion #3

The methodologies typically applied in the literature do not look at performance persistency from the perspective of the investor. CRA claims to review the literature with practical investor aspects in mind, such as cost effects and whether the observations are based on raw or risk-adjusted data.

Conclusion #4

This balances the imputed penalization of useful information about *poor* performance against the FSA's prime concern which is that investors' use of past performance data focuses above all on *good* past performance and is doomed to disappointment. Hence CRA concede that 'there may be a valid role for regulation in the use of past performance information'. How the distinction between using bad rather than good past performance information should be legislated for is not explained, however.

These are not dramatic or even novel conclusions. The strength of the study is in its comprehensiveness but this is a convenience rather than a proof. Critical appraisal does not add much to the wealth of academic research already conducted on the subject. A second report based on their own statistical analysis (due in the summer) may have something new and valuable to add in terms of methodology or sampling.

The report's emphasis on practical consumer use is in fact at odds with any common-sense view of how investors would actually apply the information about persistency that they recommend. Investor selection of funds, unlike securities, is bound to be too focused to be representative of the subcategories for which systematic features have been observed.

Whether judged in terms of its technical appraisal or its focus on practical consumer impact, CRA's report does not obviously support AUTIF's bullish interpretation of the *significance* of the research. But we should not blame CRA for that and we should expect AUTIF to make the most of the hand CRA dealt it.

How it's playing with the media

There is little in the report itself or in the four page summary to allow a financial writer to get behind AUTIF's campaign and shake the FSA's cage. Without that, there is not much of a story – only another spat in a long-running war of stats.

Several financial writers have seized on the only concrete conclusion that the report offers: the evidence, not new and already disputed, that poor performing funds tend to remain poor performers. The impression then given is 'damning with faint praise' – not what AUTIF was hoping for.

Even if this is a convincing conclusion, its significance in the general context of active management is that *it is a problem that typically arises as a result of having made an active fund choice in the past*. That is hardly a recommendation for choosing actively managed funds! Knowing how funds are typically selected, we can assume that the poor performance outcome will be at variance with the previous history. Unrecognized randomness leads to regret.

Of dogs and stars

Imagine you are buying a fund which you believe will outperform its market benchmark (whether by luck or judgement) by 1% pa over a long holding period. Consider that the variation in its short term relative returns consistent with getting that far ahead cumulatively is so great that at some stage during that holding period *it will probably be indistinguishable from a dog*. How will you then know it is not another CRA dog but is still the future star or lucky winner you first thought it was?

In the specific context of the exclusion of past performance data from the FSA league tables, it can be argued that an investor might select a poor performing fund that has already done badly but would not have done so knowing the data. In other words, buyer's regret stems from a *new* decision not an old one which, randomly or through mean reversion, went wrong.

For this subtle distinction to justify backing AUTIF, we would have to be fairly sure that the persistency to which the report refers is significant and can be turned to good use in practice. This is partly a technical issue but we can also think about whether the

way the investor selects funds means that they are likely to pick up the systematic feature analyzed.

This brings us back to No Monkey Business strand #3, *the limitations of the data we have to work with*, and strand #4, *practical feasibility*. The one finding of the CRA's that attributes significant value to past data is in fact limited in significance.

- The systematic feature, persistency amongst past poor performers, is weak enough to be explained by data deficiencies or data differences – hence the differences of opinion about it in the literature
- If an investor typically selects only one or a few actively managed funds, the actual experience is not likely to mimic the feature determined from an entire subsection of the population of funds

All of the research that the FSA's paper set out and all of the research that the CRA paper looks at, including the resources that it argues the FSA ignored and should not have done, are limited by data deficiencies and potentially imperfect model specification. They must be acknowledged and their possible impact on conclusions based purely on statistical analysis must be referred to. Even mathematicians have to think about what is going on behind the numbers they analyze.

How the book deals with 'stats wars'

The statistical issues relevant to the CRA conclusion about poor performance persisting are dealt with in the book in a way that is approachable for lay people. They are:

- Persistency findings vary as between different research (which CRA also quotes) based on different periods and samples of funds
- Evidence based on 'alpha', the element of a manager's return not explained by exposure to systematic market risk factors, is only as valid as the model specifications for market risk (yes, alpha is explained in layman's terms!)
- There are fairly passive construction differences between categories of funds and between most active managers and their benchmark that are not captured in style or factor models and these cause persistency to shift randomly over time

The book also examines the usefulness of fund risk characteristics derived from past performance. This is often advanced by fund managers and advisers as the main reason for looking at past performance.

The book shows that a fund's risk character relative to a benchmark is not stable over time, either because this is not or does not remain an objective of the manager or because the random dynamics of share and sector relative returns makes it an impossible objective to achieve. Unstable relative risk impacts all the uses to which past data are typically put:

- Stars and rankings
- Suitability for customized needs
- Risk-adjusted return comparisons
- Distinguishing systematic and specific risk
- Optimizing combinations of funds

The industry needs to improve its techniques for managing active risk and then communicate clearly what the tolerance ranges are for relative returns. The experience of Mercury (now Merrill Lynch) with the BARRA UK equity risk model, as revealed by the Unilever lawsuit, suggests that even relying on state of the art techniques will not necessarily meet this challenge. Until it does, investors are likely to opt increasingly for trackers. If this already applies in the institutional market, where active implementation costs are quite low, it certainly should in the retail market where costs are way too high to make it a rational choice (see the feature *Costs kill*).

To the extent that individual investors still want to make some active bets, Chapter 16, *Selecting the right products*, provides simple and intuitive guidelines.

These guidelines are also good practice for professional advisers! Adopting more elaborate and expensive approaches is not only a waste of time and money but will also set themselves and their clients up as unwitting victims of randomness.

Q Who said this?

'Another unrealistic consumer expectation is that an above-average return can be secured by careful selection of investments or by employing an investment manager with such an ability'

'Removal of supposedly superior investment performance as a marketing tool should ensure that competition takes the form of price competition, that is, suppliers compete to provide a homogenous product with the lowest level of expenses'

A London Economics
Report commissioned by the Office of Fair Trading (July 1997)
'The potential for minimizing consumer detriment in pensions'