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— Opinion

Ten factors to help find the best fundies

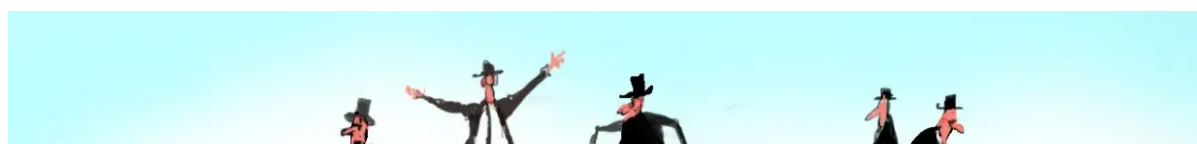
Corrections can make or break fund managers. A landmark research project can help spot the factors that set the best active managers apart.

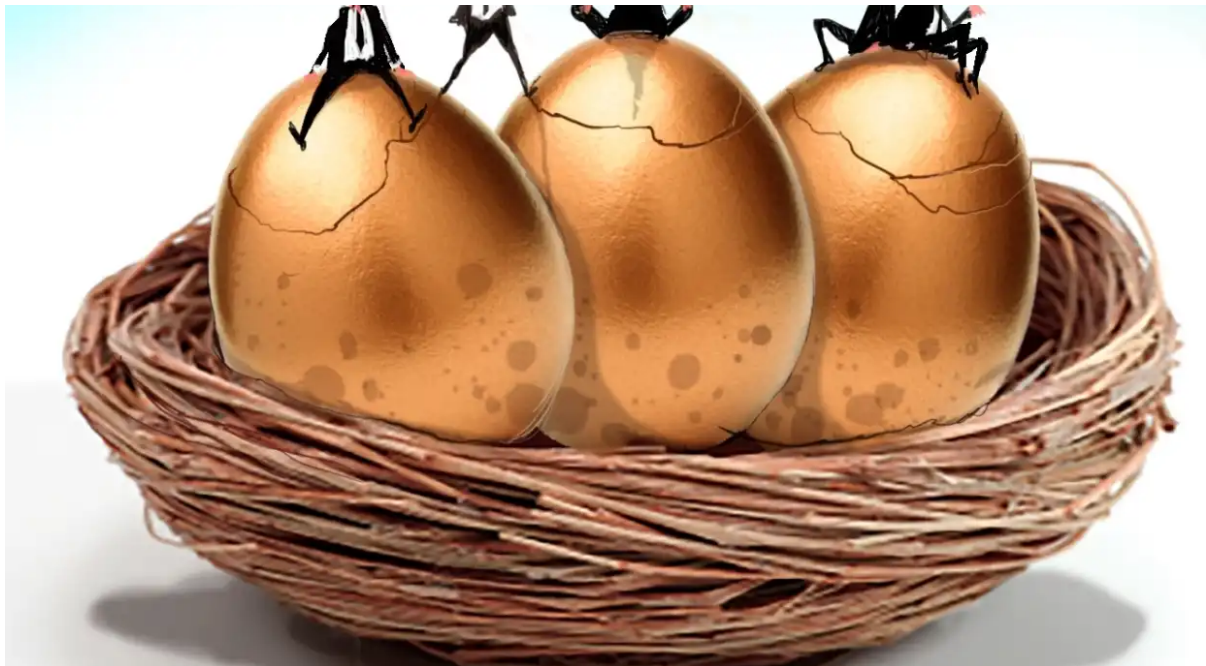
James Thomson*Columnist*

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While the world frets over the [damage the coronavirus is doing to global markets](#), fund managers are torn between wincing and quietly rubbing their hands together.

There are two good reasons for the latter reaction. First, many of the stocks they've lusted over [but thought too expensive will now be within reach](#), even if it might be hard to know exactly when to buy. And second, it's often in market corrections that star stockpickers make a name for themselves, both by dodging the biggest traps and picking the most resilient stocks.





A correction can make or break a fund manager, but not everyone is made to deliver through the cycle. **David Rowe**

Of course, spotting those fundies that can withstand and even flourish in times like this is no easy task. For allocators of capital – be they giant superannuation funds or humble retail investors – the correction is a reminder that picking a fund manager that can deliver through the cycle is tough.

But US giant Capital Group, which manages a staggering \$3 trillion, can at least give us some clues.

The firm's research director, Stephen Deschenes, who was in Melbourne last week to speak at [the Active Advantage event organised in conjunction with fellow investment giants MFS and Baillie Gifford](#), recently completed a six-year research program to study every actively managed fund in the US since 1934 to try to determine the factors which actually add value for investors.

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Deschenes said he started hunting for these factors with four objectives in mind.

First, they needed to be predictive of future success, not just explain past results. Second, they needed to be stable over time, and third, they needed to be robust – that is, they needed to work across different asset classes, time periods and market conditions.

And finally, they needed to be intuitive – as Deschenes points out, he could well have used the data to work out which day of the week the most successful fundies were born on, but that would simply be a correlation, not a useful metric.

Deschenes divided his top 10 into two categories: stewardship and the investment process.

His first insight is that privately owned fund managers deliver better returns than publicly traded managers, with an average median return gap between the two of 47 basis points over the period from 1997 to 2016. It's an interesting point for Australian investors given some of our biggest investors, Magellan Financial Group and Platinum Asset Management, are ASX listed.

Following on from that, the Capital research found that funds where managers have the highest ownership stakes tended to deliver the best returns. Deschenes feels this isn't so much because these fund managers try harder, but because they think the right way. "I think it gets at culture in a more direct way," he says.

The importance of private ownership also helps to explain Deschenes' third key metric: managers who keep their expenses lowest tend to do best.

Longevity matters, with three factors related to this. Fund managers whose individual strategies survived the longest – that is, they didn't open and close strategies frequently – also delivered better results. And flowing from that, funds with a longer investment orientation were also stronger performers, as were managers who held individual investments the longest.

Importantly, given current conditions, fund managers that use downside protection strategies to limit losses were among the best performers. Perhaps connected to that, managers who strategically used cash at the right times also delivered more value.

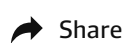
One interesting feature of the best managers, according to Capital, was what Deschenes calls disciplined flexibility, which he describes as a willingness for firms to look outside their home market, even when it hurts them.

For example, over the past decade, investing outside the US dragged down your returns because it was easily the best performing market in the world. And yet Deschenes says the 50 best managers in the US all had global funds; he suggests this willingness to look outside the “nine square grid” might make them better investors.

The final metric on Deschenes' list says firms where multiple managers look after a strategy outperform. It's probably the most questionable item on the list, given this is mainly a nod to the fact this has long been Capital's approach to investing.

Deschenes admits the data isn't strong for this factor, although historical data does show some correlation between multiple managers in a range of firms and outperformance.

Deschenes emphasises his list isn't a silver bullet, but rather a way for investors to improve their margin of safety when picking active managers. And in the current environment, a margin of safety is a pretty valuable thing indeed.



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James Thomson is a Chanticleer columnist at The Australian Financial Review based in Melbourne. James was previously the Companies editor and the editor of BRW Magazine. *Connect with James on [Twitter](#). Email James at j.thomson@afr.com*

