Info SIGMA

Choosing your fund manager: Avoid mistakes!

The results on the persistence of mutual fund performance published by Standard & Poor's (SPIVA) for Canada are now available for the year 2023. The conclusion remains the same again this year. There is no persistence in their ranking. Managers who have outperformed fail to sustain their outperformance in subsequent years. The past ranking offers no clue about future ranking.

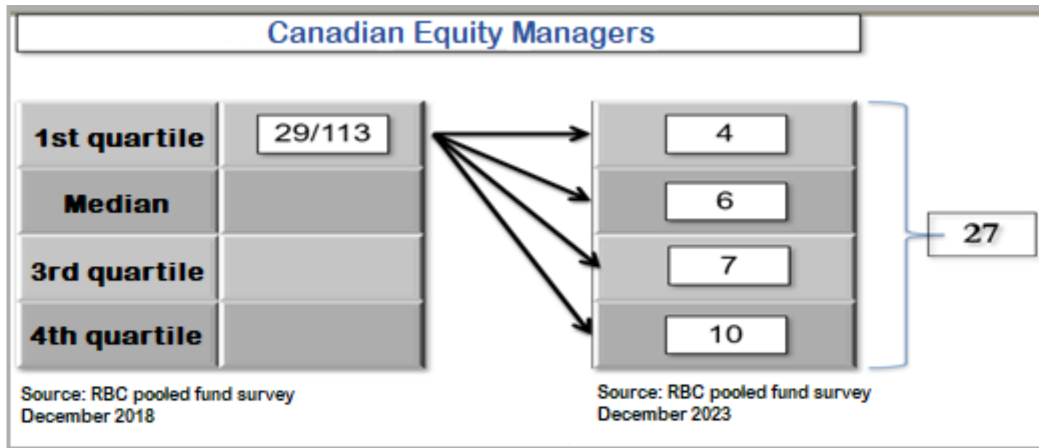
"Only a minority of equity funds in all categories managed to stay in the top quartile for two consecutive five-year periods. 14% of Canadian equity funds remained in the top quartile over two consecutive five-year periods, which is lower than the 25% that would be expected under a random distribution (i.e., pure luck)"
SPIVA Year-End2023

"Maintaining a position in the top quartile has proven challenging for most funds across all categories. None of the top quartile focused Canadian equity, Canadian small/mid cap, international equity and U.S. equity funds maintained their position in the top quartile for the next two years, compared to a randomly based forecast rate of 6.25%."
SPIVA Year-End2023

See SPIVA original publication

Persistence of yields

SPIVA persistence results for 2023 are available and are consistent with past results. It is extremely difficult to maintain an outperformance in terms of returns. Since 2008, we have been monitoring the performance of managers of institutional investment platforms on an annual basis. Let's say it's January 2018 and you have money to invest. If you believe that past performance is a good indicator of future performance, you choose one of the 29 managers representing the 1st quartile of returns (managers who have performed in the top bracket of returns if they were divided into four equal brackets) from among the 113 Canadian equity managers available to you.



How many of these 29 managers managed to sustain their outperformance for the next 5-year period? 25, 20, 15, 5? No, only 4! And how many of these managers ended up in the lowest quartile over the 5 years? No less than 10! **We do this analysis annually and the result is always the same.**

The great difficulty managers have in maintaining outperformance is one of the main motivations behind our adoption of index management almost 20 years ago. It goes without saying that for any given year, there are managers who stand out from the others, the law of large numbers requires it. The problem is that they are never the same from one year to the next. History is full of star managers who have fallen into oblivion after a period of outperformance over the years. Today's star managers seem to have all the answers right now, but if history is anything to go by, a mean reversion is very likely to occur. Wanting to invest with a fund manager or family because it has performed well in recent years can be a perilous strategy.

Why this lack of persistence?

It is one thing to note this lack of persistence, but how can it be explained? Some simply talk about chance, others see it as a major problem. When a fund offers a superior performance, everyone rushes to it. There comes a time when the fund has so much money to invest that it must dilute its portfolio because it doesn't have enough units to buy.

In our experience, the mandate of the manager probably plays the biggest role. The managers all have a specific mandate. The most common mandates are dividend stocks, growth stocks, value stocks, reasonably priced growth stocks (a combination of growth and value), small caps, etc. We also use the term "stock market segment" to describe these different tranches of the stock market, a term that you often hear us mention during our meetings, in our arbitration reports or in an Info-Sigma such as this one.

Depending on a host of factors, the different segments will perform more or less well over different periods. For several years now (except for 2022), growth stocks have been performing excellently while dividend stocks and value stocks are unable to keep up. As a result, growth equity fund managers are enjoying favorable momentum, while others seem to have lost their tact. Studies show that market movements and stock market segments explain 95% of a stock's behavior.

But these trends ALWAYS reverse eventually. They follow unpredictable cycles and are subject to different investor moods. The day the tide changes, all growth managers in turn will look less than infallible.

The risk for the investor is to be influenced by these trends. Too often, there is the temptation to embark hand and foot into a background, a title or a theme that has had a few years of outperformance. What usually comes out of this is a pattern of embarking near a peak of outperformance and experiencing the underperformance that follows. Investing and growing your capital is already a major challenge. If you get into the habit of buying a fund in the 1st quartile position only to see it fall to the 4th quartile repeatedly, you are not doing yourself any favors.

Beware of 'all-in-one' ETFs

Also, while balanced/diversified ETFs seem to offer everything you need to invest in low-fee markets without the help of an advisor, the reality is that there is a real risk that these funds will suffer from significant underperformance in the coming years. Indeed, these products aim to minimize their management costs, but not without cost in terms of risk management. Among other things, their stock market participation is heavily weighted in growth stocks, and therefore susceptible to the moods of the techno stocks that currently dominate.

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I have prepared this report to the best of my judgment and professional experience to give you my thoughts on various financial aspects and considerations. The opinions expressed represent solely my informed opinions and may not reflect the views of NBF.