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Investment Strategy: The Best Ideas of the Best Funds

Active equity managers know and overweight their best-idea stocks.

by C. Thomas Howard

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Examining investment strategy can be useful when evaluating mutual funds, but what information is contained in fund holdings? Do they reveal stock-picking skill?

The first article in this series introduced investment strategy as an alternative to the Style Grid for forming active equity mutual fund peer groups. The second article discussed the advantage of diversifying equity portfolios based on fund strategy and proposed a six-strategy core equity portfolio. The third article explained how to identify the best funds within each strategy, while the fourth article described when stock picking works best.

Best Idea Stocks

Indeed, as was argued in an earlier article, the best active equity funds consistently pursue a narrowly defined investment strategy while taking high-conviction positions in their own strategy stocks. The result is these best funds outperform. It is obvious that superior performance is the result of stock-picking skill, a conclusion documented in a wide range of studies.

It is only natural to ask if it is possible to identify high-conviction stocks, those that the investment team, after careful analysis, have selected as having the best chance of generating higher returns going forward versus those stocks with low return expectations. Disappointingly, the latter make up the majority of stocks held by the typical fund. Unfortunately, buy-side analysts and portfolio managers, unlike sell-side analysts, do not publish reports on the stocks they analyze. Instead they use this private information for their buy and sell decisions. Consequently, there is no easy route to unlock this information.

Identifying Best Idea Stocks

An interesting question is whether the size of a particular stock holding in a fund's portfolio reveals anything useful. Can holdings information be used to identify best idea stocks and thus point to stock-picking skill?

For this to be the case, funds would have to determine a stock's portfolio weight based on the level of conviction regarding the stock. The simplest solution would be to invest more in high-conviction stocks and less in low-conviction stocks given the incentive to generate superior returns.

Many studies confirm that alpha generating, high conviction, best idea stocks can be identified using relative, as compared to absolute, fund holdings. These studies include Chen, Jegadeesh, and Wermers (2000); Pomorski (2009); Cohen, Polk and

Studies Confirm

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Silli (2010); Shumway, Szeter and Yuan (2011); Wermers, Yao and Zhao (2012); and Yeung, Pellizzari, Bird and Abidin (2013).

My own research has uncovered a unique way of identifying best idea stocks that differs from that used in the studies cited above. First, the best funds are identified using the fund consistency and conviction measures discussed in the third article in this series. The consistency measure is a comparison of a manager's holdings to other managers pursuing the same strategy for a pool of stocks upon which to focus. Best idea stocks are those most held (relatively) by these best funds.

The feeds we use are those from Thomson Reuters Lipper and Morningstar mutual fund data. The advantage of these data sources is they deliver holdings data in a realistic time frame that includes latency from funds reporting holdings once a quarter (some funds voluntarily report monthly), as well as the actual time it takes to gather, organize and deliver the data once it is released. Holdings information from these data feeds is 80% within three months of fund reporting and nearly 100% of the data is 6 months or newer, thus it incorporates a realistic level of latency.

As revealed in the chart below, it is possible to identify stock-picking skill using the relative holdings of best funds. The chart reports the average alpha for the ex-ante identified best idea US stocks, roughly 10% of the 3,000 or so stocks held by US active equity funds. The average alpha over this 15-year period is an amazingly large 10%, with 12 of the 15 years producing positive alpha.

Annual Alpha of Best Ideas US Stocks of Best US Active Equity Mutual Funds. (Jul-Dec 2003 – Jan – Jun 2018)
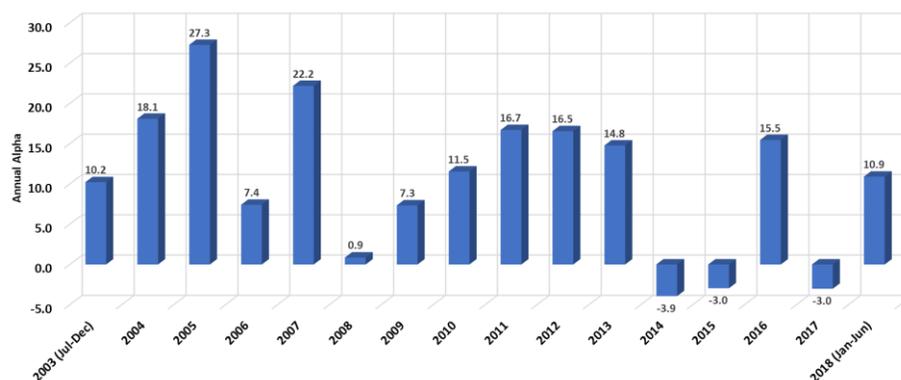
Average monthly alpha of best idea US stocks of best US active equity mutual funds times 12. Monthly number of stocks varies between 200 and 300, roughly 10% of all stocks held by funds. Alpha is AEO adjusted stock return net of the average S&P 500 and Russell 2000 index returns. Sources: Morningstar and AthenaInvest.

Focus on Best Idea Stocks

This information provides evidence that active U.S. equity fund managers are skilled stock pickers. Furthermore, they overweight their best idea stocks, which allows for

identifying these stocks using relative fund holdings. The monthly turnover within the pool of best idea stocks averages 30%, which means that active equity managers are frequently re-evaluating the attractiveness of top holdings and acting on these changing convictions.

The most important conclusion flowing from these results is that a small number of fund holdings represent alpha-generating, best-idea stocks. Every effort should be made to encourage funds to consistently pursue a narrowly defined strategy while investing primarily in high-conviction stocks.

Upcoming Article

In the next and final article in this series, we'll show that investment strategies may be used for tactical allocation. Specifically, the short-term ranks of investor preferences for different strategies are useful for estimating expected market returns

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C. Thomas Howard is the co-founder, chief investment officer, and Director of Research at AthenaInvest. Building upon the Nobel Prize winning research of Daniel Kahneman, Howard is a pioneer in the application of behavioral finance for investment management. He is a professor emeritus at the Reiman School of Finance, Daniels College of Business, University of Denver, where he taught courses and published articles in the areas of investment management and international finance. He is the author of Behavioral Portfolio Management. Howard holds a BS in mechanical engineering from the University of Idaho, an MS in management science from Oregon State University, and a PhD in finance from the University of Washington.

Important notes and citations

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