Investment Strategy: Identify the Best Active Equity Funds

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Fund manager behavior is predictive while past performance is not. The second part of that statement, we hear often. The importance of fund manager behavior is less known and discussed as part of this article series.

The first article 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. This article explains how to identify the best funds within each strategy.

Strategy Consistency

An important fund manager behavior is the consistent pursuit of a narrowly defined strategy. The challenge is how to measure consistency. A common approach is to demand consistent returns over time. But we know that the best funds outperform at times and underperform at others. While this is emotionally difficult for investors, it is an unavoidable fact when investing in successful active funds as strategies don't perform well in all types of markets.

Another common approach is to demand that funds closely track their style box benchmarks. Such funds, however, while acting like their benchmarks, underperform as demonstrated in this study. Benchmarks have little to do with a manager's strategy so asking them to minimize tracking error is tantamount to asking them to deviate from their strategy. This is because they are being required to purchase stocks for the sake of staying in their assigned style box, rather than investing in their preferred stocks.

An alternative is to examine the type of stocks in which a manager invests. For example, is a value fund invested in value stocks or is it chasing an unrelated trend such as favoring growth stocks?

Using a more definitive process, we evaluate consistency of a manager by comparing their holdings to other managers pursuing the same strategy for a pool of stocks upon which to focus. For a manager following a "Competitive Position" strategy, for example, the pool is comprised of stocks most held by other "Competitive Position" funds.

It makes intuitive sense to use a screen driven by those who are looking for similar stock characteristics. In addition, strategy pools are in constant motion, as managers make buy and sell decisions based on ever-changing economic and market conditions. A stock stays in a particular strategy pool for 14 months on average. (See this study for details on how strategy stock pools are created.)

Consistency Evaluation

We evaluate consistency of a manager by comparing their holdings to other managers pursuing the same strategy for a pool of stocks upon which to focus.

Focusing on similar strategy stocks is not only intuitively appealing but it leads to better performance, as shown in this study.

Figure 1 demonstrates that the active equity funds holding the most similar strategy stocks (Quintile 5 in Figure 1) outperform those holding the least by 212 basis points. This confirms the advantage of focusing on stocks most held by others following the same strategy. Collective intelligence provides valuable information.

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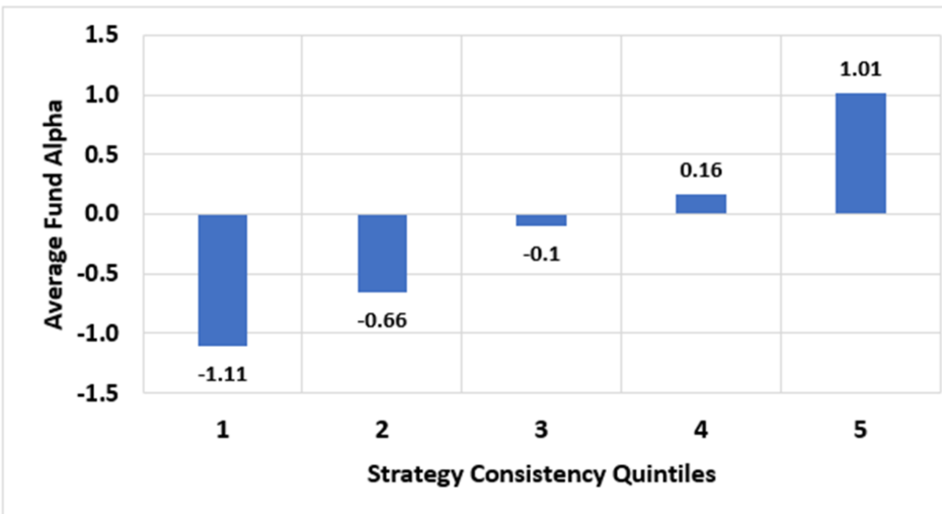
Figure 1: Strategy Consistency: 1997-2017



Sources: Morningstar and AthenaInvest.

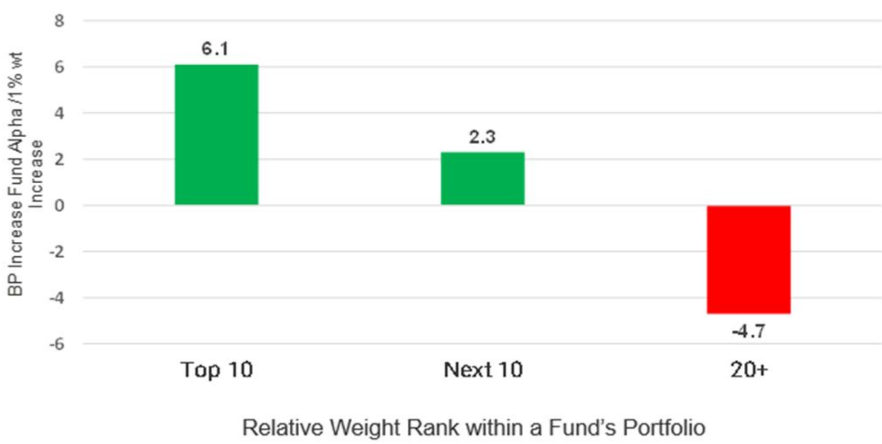
These strategy-consistency results are in stark contrast to what has been uncovered regarding style-box consistency. This study demonstrates that equity funds experiencing the largest style drift outperform those with the least by about 300 basis points. Asking a fund manager to stay style-box consistent hurts performance because it forces them to invest in stocks outside their own strategy simply to track the style benchmark. Style consistency begets strategy inconsistency and, in turn, poor performance.

High-Conviction Stocks

There is an additional performance advantage if a fund invests exclusively in high-conviction stocks. A fund applies its investment strategy to hundreds of its own strategy stocks to come up with a manageable set of high-conviction stocks. Even though two funds might pursue the same strategy, their implementation is unique. Thus, funds pursuing the same strategy can hold quite different high-conviction portfolios.

The benefit of holding only high-conviction stocks is demonstrated in Figure 2. Increasing the amount invested in the top 20 high-conviction stocks (captured by the highest 20 relative weights in the portfolio) improves fund alpha, represented by the two green bars in Figure 2. Increased investment in the non-top-20 stocks hurts performance, as represented the single red bar.

Figure 2: Fund Alpha Improvement for Increasing Investment



Based on single variable, subsequent gross fund alpha regressions estimated using a data set of 44 million stock-month equity fund holdings over Jan 2001- Sep 2014.

Figure 2 reveals that funds display stock-picking skill as evidenced by investing more money in their best-idea stocks, which subsequently outperform. It also reveals that the typical mutual fund holding 75 stocks (the median number of holdings) is badly overdiversified, investing in three times more alpha-destroying stocks than in alpha-building stocks.

This provides further support for the argument that active equity funds should not grow too large (no larger than $1 billion in assets under management) nor be asked to minimize tracking error, both which encourage investing in non-high-conviction stocks.

Consistency and Conviction Are Key

Forming active equity funds into strategy peer groups allows for superior portfolio diversification along with the ability to select funds with the best chance for outperformance.

Funds that consistently pursue a narrowly defined strategy while taking high-conviction positions perform best. Past performance is not part of this fund selection process because it is not a reliable predictor.
In the next article in this series, I will describe market environments that favor active equity fund outperformance.

About the author

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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