ALGER

One Step to Becoming a Better Investor

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Low Hanging Fruit?

Becoming a better investor is, unfortunately, often a lifelong process. It has been for me. Over my career, I have approached investing bottom-up in both sell-side and buy-side analyst roles. I also have spent years as a strategist looking at the investment world top-down. I have learned by working at value-oriented shops as well as growth-oriented firms. After nearly a quarter of a century and gaining all these different perspectives, I'm still evolving. Like most investors, I sometimes make errors that seem obvious in hindsight. However, there is one mistake that I see many investors make and correcting it may be both easy and extremely beneficial to portfolio performance.

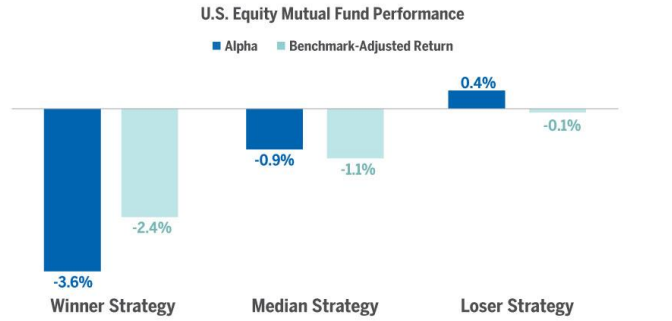
Chasing Performance

In my view, many investors put too much emphasis on short-term past performance, particularly with regard to mutual funds and ETFs. For over 20 years, academic research has shown that investors seem to base their fund purchases on strong past performance.[1] Indeed, one study found a 0.98 correlation between past year decile performance and future fund flows in the large cap space for fund performance from 1996 to 2008.[2] Investors seem to not heed the perennial disclosure that "past performance is not indicative of future performance."

Chasing Your "Tail"

The problem, in my opinion, is that performance chasing is not a good strategy for generating excess returns. A study in the Journal of Portfolio Management found that a strategy that invested in the best performing decile of actively managed U.S. equity funds over a rolling three year period, the so-called "winner strategy," actually underperformed the median performing decile of funds. Ironically, a strategy that chose funds in the bottom-decile of performance, the so-called "loser strategy," or the funds that are normally culled or put on "watch" lists, produced positive alpha, as shown in Figure 1.

Figure 1: **Winners Becoming Losers and Vice Versa?**

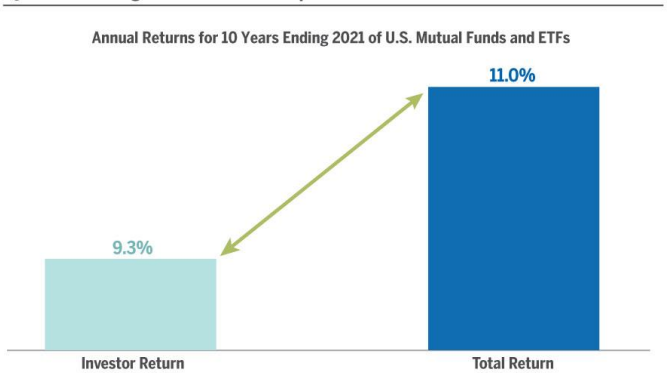


Source: Bradford Cornell, Jason Hsu, David Nanigian, "Does Past Performance Matter in Investment Manager Selection?" Journal of Portfolio Management, Summer 2017. Data based on U.S. equity Morningstar mutual fund performance January 1994-December 2015. Winner strategy represents equal weighted portfolio of top decile benchmark-adjusted returns on rolling 3-year period. Median strategy uses funds ranking between the 45th and 55th percentile of benchmark adjusted returns. Loser strategy uses funds ranking in the bottom decile of benchmark-adjusted returns. Alpha and Benchmark-Adjusted Return are defined within the disclosure page. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

Three years is just not enough time to fully judge a manager's skill. As the authors of one study point out, the T-statistic, which represents the confidence we can have in a historical trend being statistically significant, was extremely unlikely to be statistically significant over a three-year period when analyzing a manager's excess performance.[3] In their study, they found that it actually takes 5-10 years or more for skilled managers to be more easily identifiable by historical excess performance.

In another study, Morningstar found that investors have underperformed the mutual funds and ETFs in which they invest by more than 170 basis points annually over the past decade, as shown in Figure 2.

Figure 2: **The Average Investor Has Underperformed**



Source: Morningstar Mind The Gap 2022. The annual total return calculation is time-weighted, where a lump-sum investment made at the beginning of the period is held throughout the entire measurement term. The investor return calculation is the internal rate-of-return that accounts for timing of all cash flows. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.** This is for illustrative purposes only.

Morningstar's analysis suggests that much of the investor underperformance was due to buying or increasing positions after strong performance or vice versa (i.e., poor market timing). Some sophisticated investors and institutions are beginning to move away from performance chasing. Morningstar, which for years factored past performance into its analyst ratings, has recently revised its methodology to specifically exclude past performance as a separate pillar in its forward-looking evaluation of funds.[4] But if it seems like investors shouldn't study past short-term performance, what should they look at?

The Importance of Discipline and Sticking to a Fundamental Investment Strategy

As Ben Graham, Warren Buffett's mentor, said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." He meant that market sentiment drives short-term stock price movement, but long-term price appreciation is driven by sales, earnings, and cash flow. We believe this implies that assessing performance in the context of market sentiment provides little support for a long-term investment decision.

By assessing the underlying fundamentals of a portfolio's positions, we believe investors can gain a better understanding of whether a manager's performance is a result of a correct view of the sales and earnings power of their holdings, or if the strategy just happens to be in style.

The fundamental framework for long-term performance first looks at how the underlying sales, earnings or cash flows of a company or portfolio are performing. Are they growing or shrinking faster or slower than those of the benchmark? These considerations can help evaluate whether the manager has been correctly anticipating the sales and earnings progression of their portfolio or instead have been getting the fundamentals wrong and may be less skilled at fundamental analysis. We believe a manager exhibiting poor fundamental analysis when executing investment decisions, repeated over multiple periods, may be a reason to change managers, while a manager's underperformance that belies strong fundamentals may be a reason to invest in, rather than redeem from, their fund (see Figure 3).

Figure 3: **Four Potential Scenarios for Holding, Selling or Adding to a Portfolio**



Source: Alger. This chart is for illustrative purposes only. The chart above describes four potential investment scenarios an investor may consider when focusing on the fundamentals of a portfolio's positions. Company fundamentals typically refer to the financial and operational information about a company that investors use to assess its overall health and potential for future growth. This includes considerations around the company's revenue, earnings, assets and liabilities, and cash flow.

Anticipating Outperformance

There is evidence to suggest that there are some factors that can help investors anticipate sustained outperformance. Research suggests that investors would be well served by looking at the following fund manager characteristics:

1. Independence - lack of affiliation with an investment bank seems to help avoid a potential conflict of interest in holding a disproportionate amount of a company's shares[5]

2. Ownership - board of director and manager ownership of funds are generally good signs of shareholder alignment[6,7]

3. Long-term performance – while investment skill is very hard to identify when looking at short periods of time, it is easier to see over longer periods such as 5-10 years or more[8]

While getting the formula right for selecting fund managers is certainly difficult, sometimes the best thing we can do for our portfolios is to eliminate mental errors. Warren Buffett and Charlie Munger often talk about one of their top priorities being to avoid mistakes. For many investors, that may be as simple as looking less at short-term performance and taking a broader view of fund selection criteria.

[1]Erik Sirri and Peter Tufano P. “Costly Search and Mutual Fund Flows.” Journal of Finance, October, 1998.

[2]David M. Blanchett, “Fund flows, Momentum, and Mutual Fund Performance.” Journal of Investing, Summer 2012. Correlation is a statistical measure that shows how two variables are related to each other. If two variables are correlated, it means that they tend to move together in some way. The strength of the correlation is measured by a number called the correlation coefficient, which ranges from -1 to 1. A value of 0 indicates no correlation, a value of 1 indicates a perfect positive correlation (i.e., as one variable increases, the other increases as well), and a value of -1 indicates a perfect negative correlation (i.e., as one variable increases, the other decreases). In the context of correlation referenced in the paper, the study found a strong positive correlation between the one-year performance of large cap equity mutual funds and the amount of new monies invested in them, with a correlation coefficient of 0.98 across the ten decile groups. This suggests that investors tend to invest more money in equity mutual funds that have performed well in the past year. However, it is important to note that correlation does not necessarily imply causation, and other factors may also contribute to the observed relationship. **Past performance is no guarantee of future results.**

[3]David L. Donoho, Robert A. Crenian, Matthew H. Scanlan, “Is Patience a Virtue? The Unsentimental Case for the Long View in Evaluating Returns,” Journal of Portfolio Management, Fall 2010. Excess performance is defined as the return of an investment compared to the assigned benchmark.

[4]Morningstar. (2019, April 3). Introducing the Enhanced Morningstar Analyst Rating™ for Funds. Morningstar.

[5]Hao, Q., and X. Yan. “The Performance of Investment Bank-Affiliated Mutual Funds: Conflicts of Interest or Informational Advantage?” Journal of Financial and Quantitative Analysis, 2012.

[6]Cremers, M., J. Driessen, P. Maenhout, and D. Weinbaum. “Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry.” Journal of Financial and Quantitative Analysis, 2009

[7]Khorana, A., H. Servaes, and L. Wedge. “Portfolio Manager Ownership and Fund Performance.” Journal of Financial Economics, 2007.

[8]Donoho, Crenian, Scanlan, 2010

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Benchmark-adjusted return measures the difference between the return of an investment or portfolio and the return of a benchmark index or passive investment strategy, without adjusting for the risk associated with the investment.

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