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Fund Selection 101

by Tom Delic

The CEO of a business has many responsibilities, two of the most important being the strategic and operational oversight of the company. Another vitally important aspect of their role is capital allocation, an area that is often underappreciated by an investor but also poorly carried out by many CEOs. When researching a fund, it is often useful to view the fund manager as a CEO of a conglomerate, responsible for making investments in a portfolio of businesses, with none of the strategic and operational pressures, thereby making capital allocation of primary focus. Viewed through this lens, making an investment through a fund is a partnership with the fund manager, who you are entrusting to manage the capital of your clients in the best possible way. Just like the listed equity markets represent a huge variety of businesses that you can choose to own a piece of, a universe of funds represents a list of potential long-term business partnerships. Below is a summary of a growing body of studies that can help form a filter for the universe when picking who you should partner with.

First, let's look at how we would like a fund to be structured. A study of hedge funds in 2015 (Yin)[1] , showed that fund managers have a strong incentive to grow assets under management, as the absolute dollar amount earned from management fees outweighed the benefit of earning an incentive fee on excess performance. Importantly, the diseconomies of scale were found to occur before fund performance deteriorated. As fund selectors, we therefore must look for a manager that not only commits to a fund capacity limit, but we must also consider if that maximum level is still too large for the manager's specific strategy.

Secondly, we turn to skin in the game, a term popularised by Nassim Taleb in his 2017 book of the same name. A 2017 study by Gupta and Sachdeva[2] found that funds with high inside capital outperformed those funds that largely relied on outside capital. Interestingly, the two also found that those managers with their own wealth at stake, were much more likely to limit fund flows, resulting in a persistence of excess returns.

In terms of portfolio strategy, perhaps one of the most well-known studies is by Martijn Cremers and Antti Petajisto (2009)[3] , which gave birth to the now often quoted 'Active Share' statistic. In the paper, Cremers found that those funds which were most different from their respective benchmarks, significantly outperformed. In a follow up paper in 2017[4] , Cremers also found that the best performing funds were those that had both a high active share and longer holding periods. These funds were in the minority, only accounting for 1.6% of total fund assets across the US equity mutual fund universe.

The above quantitative analysis is by no means exhaustive but can be used as a quick checklist when reviewing a new manager. These characteristics also provide important clues into the qualitative, or fuzzy aspects of manager research, which can't be boiled down to hard evidence. We are dealing with human nature after all, which makes a scientific method to fund analysis a useful contribution to the jigsaw, but some important pieces are missing to complete the picture. Assessing areas such as independence of thought, temperament, decision making under periods of poor performance, and integrity are just a few of the traits that are difficult to measure numerically, therefore requiring the fund analyst's judgement which is built from their experience of many interactions with fund managers.

Perhaps the final word should be on past performance, which when said aloud, feel like they now only belong in the frequently cited disclaimer. While most will measure the "short-term" in months, it can be much more beneficial to stretch your own definition of the short-term out further than the crowd's. If for example your period to measure short-term performance is 3 years, what would you consider to be long-term? A sensible approach can be to identify a manager who has outperformed over a full market cycle (e.g. peak to peak or trough to trough). If meeting your other quantitative and qualitative characteristics, your definition of short-term periods of underperformance (i.e. 1-3 years) could offer an attractive time to make an investment, as other investors are selling.

[1] Yin, Chengdong, The Optimal Size of Hedge Funds: Conflict between Investors and Fund Managers (November 24, 2015)
[2] Gupta, Arpit and Sachdeva, Kunal, Skin or Skim? Inside Investment and Hedge Fund Performance (December 13, 2017)
[3] Cremers, K. J. Martijn and Petajisto, Antti, How Active is Your Fund Manager? A New Measure That Predicts Performance (March 31, 2009)
[4] Cremers, K. J. Martijn, Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity (May 2017)

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