Northill Capital

Nowhere to Hide

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Barely a month passes without some new piece of research being published with the headline 'Most active managers underperform.' Even where this research identifies a subset of managers who do outperform the subtext is that this is due either to luck or the law of averages rather than any innate skill or inbuilt advantage. So, against this back-drop, *if it is true* that most managers underperform and the factors determining the minority of managers who do perform are largely random it is not hard to see why many clients are moving towards higher levels of passive investment.

We find the first part of this conventional argument hard to dispute; there are simply too many managers out there offering poor or mediocre results that do not justify the fees they charge. However, we believe passionately that the second part of the argument is flawed; consistently successful managers are hard to find but those that do exist generally share some common characteristics which may enable clients to identify them.

Investors can choose from a diverse population of active managers each competing for their business, from industry behemoths running trillions of dollars to focused specialist boutiques. Over the years the Northill team – in our current business and in our past careers as successful acquirers of asset management boutiques – have consistently noticed that specialist managers who focus on a single core asset class and single investment process tend to perform better for their clients (and as businesses) than larger, more diversified firms. We believe this outperformance is a result of focused asset managers' operating business models which naturally create a stronger alignment of interest between the manager and its investors. We have noticed this apparent correlation across the last twenty years, across markets and across asset classes; but finding no meaningful research to support our beliefs, my colleague Ryan Sinnott set out to investigate this apparent link using Mercer's GIMD manager research database as source material, publishing his results in a paper entitled 'Nowhere to hide' in August this year.*

What we found was that across a range of asset classes including US Equities, Global Equities, US Fixed Income, Emerging Market Equities and European Equities, managers who had a focus on a single asset class consistently outperformed managers who were generalists with a wide range of capabilities and products. Of course sometimes even these focused managers had periods of underperformance; yet what was striking was that not only did they outperform more often than not, when they did underperform it was by a far smaller margin than more diversified managers. By the way, we are not suggesting that focusing on a single asset class will make a bad manager a good one – the skill and the process have to be there to succeed – but talented asset management teams seem to perform better when they focus only on doing one thing and doing it really well.

So, why is this? Think about how an asset management firm gets started; they rarely start as generalists. The firm is formed because an individual or team build a track record and an 'edge' in a particular asset class or style of investing and decide to stop working for someone else and build their own firm. If their efforts are successful – and we acknowledge there is some 'survivorship bias' in our research – the firm becomes established, successful and grows in size. At some point in this development there is a choice to make; stay a specialist and continue to refine their process and offering so that they are a recognised leader in their field or diversify into other related or even unrelated areas.

Unfortunately too many investors have drunk the Kool-Aid of diversification – or as the legendary investor Peter Lynch called it 'diworsification'. In the mistaken belief that they are protecting the value of their equity interest in the firm, these firms bring in other teams of investors in other fields. To hedge against market risk they may seek to offer investment strategies which are correlated to different sources of market beta, such as an equity specialist developing a fixed income capability. To protect for a scenario where their investment style is out of favour, they may seek to develop a range of different investment approaches with the hope that, at any one time, one of the strategies will outperform. Amongst these firms you can guarantee that there will always be a few funds or strategies which are first decile and attracting assets – but you can almost always guarantee that those same firms will have similar numbers of strategies which are bottom decile; for them it's a numbers game – as long as more than say 50% of their products are beating the benchmark this constitutes success. Clients may not agree.

Diversification away from areas of core competence may risk damaging outcomes for investors. Management teams may be distracted by the latest new and exciting product. They may become focused on marketing, perhaps at the expense of running their existing portfolios. Talented investment staff start to spend more and more of their time in product development meetings, global strategy sessions, marketing liaison sessions and endless cycles of product launches as the firm seeks to meet the needs of every single client sector or geographic market. More complex operations, compliance and IT systems require additional staff, increase operational risk and may distract senior management from delivering investment performance.

Over time the firm becomes a complex beast with more marketing, operations and finance staff than portfolio managers or analysts. The firm requires growth in assets, growth in products and perpetual expansion simply to stand still and, amidst all this, what made the firm great; the track record and the 'edge' that the founders had gets lost; the industry is littered with examples of once-successful asset management firms which have become overly diversified and as a result end up delivering no single strategy particularly well.

In focused asset management firms everyone in the firm is devoted only to ensuring that their single strategy is successful. There are no conflicting priorities, no new product initiatives, no resource allocation discussions and no new launch roadshows. The firms' clients know that every single person on the organisation chart is solely devoted to the strategy they are invested in – and nothing else. Ultimately what it comes down to is that those within the firm have the best motivator of all – if their investment process fails to deliver; the firm ceases to exist. In other words they have nowhere to hide.

*The full report *'Nowhere to hide: Focused active asset managers outperform'* is available at www.northill.com/Perspectives

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