Extracting Alpha from Fund Manager Selection

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Seeking Out the Consistent Performers

I remember when I was in primary school, I observed that the top students tended to be the same few students every year and they would compete among themselves for the top 5 positions. One of them was and still is my good friend now. I had asked him then what his secret was for doing well academically. His reply was consistent revision and ploughing through more assessment books.

It dawned on me then that to do well, one had to put in consistent effort not only in school homework but also in revision and in completing assessment books diligently.

As I progressed into the secondary, junior college and tertiary levels, I observed that the same trend continued, the good students tended to be the same few students who had done well as they progressed academically.

Many of you will agree with me that, in the working world, especially in the sales line, the top performers will always deliver results consistently regardless of market conditions. In fact, studies have shown that around 20% of the performers usually contribute 80% to the company's bottom line. As a result, the top performers are usually well rewarded as their employer would want to retain such employees. Hence, if you are the boss of a company, I'm sure you will continuously look out for good performers who can contribute to the company's bottom line.

At Financial Alliance, we adopt the same philosophy when it comes to selecting Fund Managers.

Financial Alliance Fund Screening Process

Here, we filter and select only Fund Managers who have delivered consistent returns over various time periods. We are mindful of the fact that some Fund Managers can have stellar performance over a one-year period but subsequently deliver mediocre results. Hence, it is important for us to discern if the Fund Manager's performance is attributable to skill or to luck. One way to differentiate skill from luck is to look at the Fund Managers' track record over a reasonable time period across different market conditions in comparison with their peers' performance.

Let me illustrate with this example. (refer to ***Table*** below).

Year	Number of Fund Managers
0	100
1	50
2	25
3	12.5
4	6.25
5	3.125

Let's say, we start off with a pool of 100 Fund Managers who are managing the same kind of mandate, say Singapore equities. The key is to eliminate half of those who had performed below the average return every year.

Do You Know?

The Sharpe ratio is a risk-adjusted measure developed by Nobel Laureate William Sharpe.

It is a portfolio performance measure used to evaluate the return of a fund with respect to risk. The calculation is the return of the fund minus the "risk-free" rate divided by the fund's standard deviation. The Sharpe ratio provides you with a return for unit of risk measure.

The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

$$S(x) = (r_x - R_f) / StdDev(x)$$

where
x is some investment
rx is the average annual rate of return of x
Rf is the best available rate of return of a "riskless" security (i.e. cash)
StdDev(x) is the standard deviation of rx

After year 5, you will notice that only around 3 Fund Managers are left from the initial starting pool of 100. And the key takeaway is that the remaining 3 Fund Managers are most likely to have a robust investment process which allows them to consistently outperform their peers.

At Financial Alliance, we developed an in-house Fund Selector software in 2004 to help us identify Fund Managers who deliver consistent performance. The software will rank the Funds with the same investment mandate from inputs using the criteria of performance returns over four time periods (namely, 3-year, 1-year, 6-month and 3-month periods) in addition to the Sharpe ratio. This quantitative screening is the foundation of our fund selection process.

Besides quantitative screening, we also perform qualitative screening by looking at some of the following factors:

1. Fund Manager investment style or strategy

- Growth or Value bias. Value-based Fund Managers tend to outperform in a down and/or volatile market while growth Fund Managers will perform better in a bullish market.

2. Fund Size

- A small fund size might incur high operating costs, leading to a high expense ratio.

3. Fund Management fee structure

- Is the Fund Management fee reasonable?
- Is there high performance fee?

4. Risk Management process

- Is there a strict stop-loss limit?
- Is there proper diversification?
- What are the guidelines to control concentration risk with regard to issuers, countries or sector?

5. Dealing Frequency

- All things being equal, funds with daily dealing are preferred over funds with weekly or monthly dealing as implementation is timely and would not be distorted by the delay in dealing frequency.

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Good Fund Managers Outperform Poor Fund Managers by up to 20% p.a. Whether in Good or Bad Markets

As I have said before, at Financial Alliance, we have been tracking Fund Managers since 2004 when we first developed our in-house Fund Selector software. We observed that top Fund Managers usually outperformed poor Fund Managers by up to 20% whether in a bull market or a bear market. Let me show you some observations to prove my point.

Table 1: Top Fund Performance in Feb 2007

Fund Name	1-year return
Lion Capital Asia Pacific	26.0%
Schroder Asian Growth Fund	24.6%
Fidelity Asian Sp Sit USD	24.5%
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Schroder Asian Equity Yield Fund	5.0%
APS Alpha Fund	2.6%

Source : iFAST Website (8 Feb 2007)

Table 2: Top Fund Performance in Feb 2010

Fund Name	1-year return
Fidelity AP Growth & Income A - SGD	-30.6%
Aberdeen Asian Smaller Cos	-34.3%
First State Dividend Advantage	-35.1%
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FTIF-Templeton Asian Growth A (acc)	-52.7%
Legg Mason Asian Enterprise	-53.7%
United Asian Growth Opportunities	-58.3%

Source: iFast Website (6 Feb 2009)

Table 3: Top Fund Performance in Nov 2010

Fund Name	1-year return
Aberdeen Pacific equity	19.0%
Schroder Asian Equity Yield	14.9%
First State Dividend Advantage	12.9%
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Henderson Horizon Asian Div Inc-A2 SGD	4.5%
LionGlobal Asia Pacific Recovery	3.0%

Source : iFAST Website (20 Nov 2010)

“At Financial Alliance, we place a heavy emphasis on our fund screening process. We screen funds on a monthly basis using the quantitative and qualitative methodology I have highlighted. We ensure that our clients are only invested with the top Fund Managers on a consistent basis.”

The above three tables show the performance of funds belonging to the Asia-Pacific ex-Japan equity category over a 1-year period captured over three different market conditions over the last 3 years.

Table 1 shows the performance of the funds as at 8 February 2007. If you recall, the global stock market was in the midst of a bull run which peaked around October 2007. The top few funds outperformed the bottom few funds by around 20%.

Table 2 shows the performance of the funds as at 6 February 2009. If you remember, the global stock market then was in the midst of a deep slump after the global financial crisis and it only bottomed around March 2009. While all funds showed negative returns, the top few funds again outperformed the bottom few funds by around 20%.

Fast forward to the time that this article was written in November 2010, ***Table 3*** shows the performance of the funds as at 20 November 2010. The global stock market has recovered more than 18 months since it bottomed in March 2009. Equity funds posted positive returns and again the top few funds outperformed the bottom few funds by close to 20%.

Table 4 below illustrates that if you start with an initial capital of $10,000 and let it compound at 10% p.a. over 5 years, you will get $16,105. However, if you compound it at 30% p.a., you will get $37,129. Over a longer period of time, say 20 years, your starting capital of $10,000 will grow to $67,275 if compounded at 10% p.a. However, it will grow to $1.9 million if it is compounded at 30% p.a., and that is a whopping increase indeed! Hence, this shows that if we can find a vehicle that consistently outperforms by 20% p.a., the compounding effect over a long period of time is significant.

Table 4: $10,000 compounded over time with different returns

Year/Return	5%	10%	20%	25%	30%
5	12,763	16,105	24,883	30,518	37,129
10	16,289	25,937	61,917	93,132	137,858
15	20,789	41,772	154,070	284,217	511,859
20	26,533	67,275	383,376	867,362	1,900,496

That is why at Financial Alliance, we place a heavy emphasis on our fund screening process. We screen funds on a monthly basis using the quantitative and qualitative methodology I have highlighted. We ensure that our clients are only invested with the top Fund Managers on a consistent basis. The extra alpha that the top Fund Manager produces will go a long way to help our clients achieve their desired investment objectives over the long run. ◆