Publication: Business Brief
Page: 62
Title: The importance of trust in active fund management
Publish Date: 01 October 2022
AVE: 73911.75
Author: unspecified

The importance of trust in active fund management

Clive Eggers | Head: Investment Analytics | **GTC** | *ceggers@gtc.co.za* |

In a 2016 article titled 'Even God would get fired as an active investor', author and portfolio manager Wesley Gray conducted a fascinating thought experiment. He imagined an omniscient, clairvoyant investment manager who built a 'perfect' portfolio of stocks that were destined to perform the best over the next five years. Once the five-year period was over, another set of stocks would be selected, again those that would return the best performance over the next five years.

To be clear, this is a completely impractical investment approach, relying as it does on perfect, accurate future knowledge. Unsurprisingly, it works exceptionally well.

As Gray put it: 'God' would compound at nearly 29% a year, in theory. In practice, he would run into capacity constraints and own the entire market.

The interesting result from the thought experiment, however, is what 'God's' portfolio performance looked like within those five-year timeframes. The portfolio saw devastating drawdown periods of up to 76%. Even when the perfect knowledge assumed was used to both go long - the most successful - and short - the least successful - equities, a drawdown of 46% was recorded. 46% drawdown under a 'perfect' investment strategy! Hence the title of Gray's piece.

It's all too likely that at least one investor in 'God's' portfolio would have panicked and withdrawn their funds when experiencing a sizeable drawdown. And they would have missed out on the long-term performance.

Gray's conclusion: Clearly, even a 'perfect' long portfolio can bring a long-only investor a ton of pain.

Short-term volatility is inevitable. It happens, quite literally in Gray's example, to the best of us. If we panic when we see underperformance, we're explicitly not letting the fund manager do the job we wanted them to do in the first place.

As investors, we are at a disadvantage - hardwired to think predominantly in the short term. This shortcoming is one of the reasons why we hand over our investments to an asset manager with a long-term horizon. Notwithstanding this decision, we are still inclined to get involved, to overreact to short-term market shocks, and end up sabotaging our better instincts.

The best investors are those that are confident in the investment process, and who don't fixate and obsess over their portfolios. Each of us as investors needs to be able to say: I trust you and will let you get on with the job. It takes faith and conviction to stick with your chosen investment manager. This faith shouldn't be extended without basis. It should be based on your research and an appreciation of the manager's approach, philosophy, track record and goals.

As an independent investment manager we select specific asset managers and investment strategies dispassionately through a formal investment committee process. We have a professional team in the market working in both the active and passive spaces. We evaluate portfolios and build them using both active and passive content. As much as we acknowledge that we have years of experience, formal education in the process, and the support of numerous analytical aids in investment management, we appreciate - and expect - that the short-term returns may differ (often adversely) substantially from expectations.

Together with our client interface platform and through our consultants, we work with our clients to understand what they are looking for in their life planning and what they are trying to achieve with their investments. This objective is then crystallised into an appropriate risk-adjusted investment strategy and built into a portfolio designed to best achieve the goal over the nominated time horizon.

The difference between appropriate attention and interference is relatively fine. Understanding the professional construction of a multi-managed portfolio and how this is continually being managed is of far more importance than the potentially return-destroying interventions that market timing or self-doubt can bring. Achieving investment objectives firstly requires a decision to invest with professionals who understand your needs and are committed to long-term value creation, and then trust that they will do their jobs. ■