The illusion of superior professional investment manager performance

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Why only one Warren Buffett? The illusion of superior professional mutual fund manager performance.

If investment mutual fund managers were truly skilled at beating the market, then you would expect mutual fund manager performance prowess to persist over time. Unfortunately, the evidence indicates that superior past professional performance among mutual fund managers tends not to persist. Past superior mutual fund performance is simply not a predictor of future superior mutual fund performance. Over time, securities prices change, because risk and return expectations change. Older concerns are resolved and new risks arise. As time and events roll forward, new information becomes available, that influences whether investors find a particular security to be more or less attractive. A vast array of financial, competitive, managerial, political, natural, technological, and numerous other factors will influence the evolution of securities market values. Securities market prices are risk adjusted or risk weighted forecasts of unknowable future events. Just because the price of an investment security changes over time does not mean that investors were right or wrong before when they purchased or sold short a security. It simply means that the future did not unfold according to the projected risk-adjusted market consensus that existed when the security was acquired. (See: Distinguishing between true investment skill and luck) Securities prices are bound to change and there will be supposed "winners" and "losers." Winners will take credit and boast of their supposed wisdom, while losers will tend to keep quiet and lick their wounds. The problem is that rarely do either winners or losers actually win or lose because they made a precise and accurate prediction of future events that actually did occur. (See: Chance creates the illusion that investors can beat the stock market) When the investment portfolio performance of money managers is measured on a risk-adjusted basis, winners are judged to have captured "positive 'alpha' " (a statistical performance comparison to a benchmark) and losers will have "negative 'alpha.' " Are these positive and negative deviations from the average the result of skill, or are they just due to random price fluctuations? If mutual fund managers were truly skilled at beating the market, then one would expect their excess investment returns performance to persist over time. Most individual investors have long-term financial objectives and hope that money managers who are entrusted with their assets will deliver relatively high future performance. Unfortunately, the scientific finance literature does not support this expectation. The evidence indicates that superior past professional performance tends not to persist and is not a predictor of future performance. The most reasonable conclusion to reach is that relatively competitive and efficient financial markets are not reliably "beatable" on a long run, risk-adjusted basis. The absurdity of the "positive alpha, superior mutual fund manager" assertion increases with the fees charged and the excess taxation resulting from over-active professional portfolio management. From the point-of-view of the individual investor, affordable alpha simply does not exist. Before costs and taxation, on average an investor can only expect to match the market return. Some will exceed the market return and some will fall short. However, it will tend to be luck rather than skill that will determine who wins and who loses. Once costs and taxation are factored in, the average investor will under-perform the market index. The effort to find those few supposedly superior money managers willing to sell their services sufficiently cheaply is a costly, time consuming, and futile, "Where’s Waldo?,"* searching exercise for the individual investor.Many money managers will claim to be superior and few or none actually will be. If

such superior money managers did exist, then there should be dozens or hundreds of them who prove their superiority year after year after year. Unfortunately, the scientific finance literature indicates that this is not the case. This year’s star money manager tends to be next year’s average or laggard money manager.Individual investors need to understand that proper evaluation of the potential skill of investment managers is not a trivial exercise. Institutions with assets to invest must select and monitor investment managers. They have fiduciary obligations to hire the best and the brightest of portfolio managers, who will in turn select and manage the actual investment portfolio. The scientific finance literature on investment manager selection is very extensive, goes back roughly four decades, and provides no easy, surefire answers.For the individual investor, using something like a 4 star or 5 star rating to over-simplify the fund selection decision is no different than tossing darts to decide. (For some ideas on how individual investors might approach the investment fund selection decision more efficiently, see this category of articles on *The Skilled Investor* website: Selecting Investment Funds. Also, see the articles in this category: Rating Services - Morningstar.)Instead of highlighting dozens or even hundreds of perennially superior mutual fund money managers, the media conversation has become a repetitive chant about Warren Buffett. While highly successful and very worthy of respect, it is interesting that the "Sage of Omaha" gets so much press as a successful money manager. Warren Buffett is not a traditional money manager, because he tends not to buy small positions across a large number of securities like those that a mutual fund portfolio manager does. Instead, he often buys significant minority and controlling interests in firms and directly influences their management and thus the outcome. While managers of open investment fund take in investor deposits continuously, it has been a very very long time since Berkshire Hathaway Inc. has tapped the public markets for equity capital!

Concerning Mr. Buffett's Berkshire Hathaway conglomerate, you may find some studies of its equity holdings, as if it were managed as an entirely independent equity mutual fund. Yes, the numbers do indicate that Warren Buffett and his key lieutenants have demonstrated superior stock picking skill over time. Warren Buffett has generated so much cash over the long-term that he could not just keep it all in cash under the Berkshire mattress. Back in 2005, *The Skilled Investor* took an overall look of the enterprises and investment assets under Warren Buffett's control. As of mid-2005, both Berkshire Hathaway's cash positions and its equity positions were close to $50 billion each. In addition to that, it held substantial positions in bonds and wholly owned businesses. The overall percentage distributions were about 30% cash, 16% bonds, 29% publicly traded equities, and 25% in businesses owned outright. The equity portion was invested in about 30 firms with 10 accounting for more than 90% of the equity valuation. Within the rules of law and its prospectus, which mutual fund would be allowed to play Warren Buffett's game? The answer is none.Shrewdly buy companies at bargain prices ... fix them up and manage them for the long run ... let them spin off barrels of cash ... invest some of the cash in equities and bonds ... buy more companies and fix them up ... hold on to a huge amount of cash under the mattress for very long periods because bargains are cyclical and sometimes impossible to find ... keep repeating the cycle... What mutual fund could sit on as much cash as it had in equities waiting for an opportunity to buy another firm outright? They simply would not legally be allowed to do so. And, if they sat on huge cash positions, shareholders would hammer them for not deploying their money, deviating from the benchmark index, etc. Warren Buffett's game only works when the whole picture is taken into account -- successful acquisitions, majority control, investing some of the cash flow in marketable securities, keeping a large amount of dry powder (cash) for when the opportunity arises, etc. These are not the tools available to a mutual fund portfolio manager. So, where are all the other perennially superior traditional money managers who can be hired economically to manage your money and that of thousands of others for a superior return? They are not to be found. Individual investors spend an excessive amount of time and money looking for investment mutual fund managers who will all turn out NOT to be the next Warren Buffett in the long run. Mutual fund managers simply are not allowed to play his game.   Individual investors

chase past superior mutual fund performance in the futile hope that past investment fund performance will predict superior future mutual fund performance. This strategy is just a mirage, but the mutual fund industry willingly reinforces it. If a mutual fund family opens and promotes enough funds, random portfolio fluctuations will allow almost any fund family to brag selectively about only those of their funds that were past winners. Simultaneously, they quietly ignore their laggard funds. After investors repeatedly search the crowd for Waldo, after they have put their money into past winners, and after time has passed, only then do a few of these investors realize that Waldo was never there to found in the first place. (See: Can you really beat the securities markets?)   Given this bleak assessment of the chances of finding affordable, risk-adjusted, and sustained mutual fund money manager performance, *The Skilled Investor* has concluded that all forms of active management that cannot be cost justified should be mercilessly driven out of individual investors investment strategies. Individuals first need to decide on investment strategies that are risk preference appropriate. Then, they need to choose very low-cost and very low-tax investments that they can let run over time. Maintenance should always be very minimal and very low-cost, and the urge to chase performance mirages should be heavily restrained. It is just a fool's waste of money and time.* "Where’s Waldo" by Martin Handford is a series of illustrated children’s books. The objective is to locate Waldo wearing his little red cap within drawings that contain many many hundreds of other people. Finding Waldo is often challenging and time consuming. As opposed to searching for superior mutual fund managers, you actually can find Waldo with enough time.