

# Is investing in last year's winners a winning strategy?

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Fund Manager

Joined Investment Industry in 1998

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Jason is responsible for managing a range of multi-asset funds including Aviva's £16 billion Defensive, Cautious, Balanced, Balanced Distribution, and Venture (Flexible) Managed unit-linked life and pension funds.

**EXPERIENCE & QUALIFICATIONS**

Jason joined Aviva Investors in 2007 as Head of Research for sustainable and responsible investments and was appointed Fund Manager for multi-asset funds in 2008. Previously, he was a Portfolio Manager for global equities at Bernstein Value, a unit of Alliance Bernstein. Prior to that he was a Quantitative Analyst with Instinet, where he launched their European Investment Strategy Group in London. Jason started his career as an Analyst on the foreign exchange trading desk of the Federal Reserve Bank of New York.

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Numerous academic studies have demonstrated the short-term persistence of active fund performance.<sup>1</sup> The purpose of this article is to introduce a range of multi-asset funds, describe their performance drivers and reveal a statistically significant strategy for picking top performing multi-asset fund managers. Unlike previous studies, our analysis focuses on multi-asset funds and uses 9,280 observations over 20 years to test this strategy.

**Introduction to multi-asset funds**

Multi-asset unit-linked life and pension funds are split across four peer groups; Defensive, Cautious, Balanced, and Flexible Managed by the Association of British Insurers (ABI). Funds in the same peer group can be compared on a like-for-like basis as the ranges of underlying investments are grouped around similar parameters. Currently, the ABI's four multi-asset fund peer groups include over 1,675 managers. Every peer group contains clear criteria that must be followed by funds wishing to belong to that peer group. The main criteria for each of the ABI's multi-asset fund peer groups are set out in the table below.

riskier. Based on this definition, the lowest to highest risk multi-asset fund peer groups are Defensive, Cautious, Balanced and Flexible Managed. Chart 1 on page 2 shows the absolute average annual performance and risk, as measured by standard deviation, of multi-asset fund peer groups over the last two decades. As expected, the performance of the riskier multi-asset fund peer groups has exceeded the performance of the lower risk multi-asset fund peer groups.

There is an important investment relationship shown in Chart 1. For each extra unit of return sought, an increasing level of risk must be taken. Put another way, the relationship between risk and return is not one for one. This well established investment relationship suggests the ratio of absolute return to risk should decrease as the level of return sought, and risk taken, increases. Our findings are consistent with this investment relationship as, over the period studied, the absolute return to risk ratios for the Defensive, Cautious, Balanced and Flexible Managed funds were 0.95, 0.66, 0.59, and 0.56, respectively.

**TABLE 1: ABI Multi-Asset Fund Constraints**

	Max. % Equity	Min. % Equity	Min. % £ Assets*
Flexible	100	0	20
Balanced	85	40	50
Cautious	60	20	60
Defensive	35	0	85

Source: Association of British Insurers.

\* Minimum % in Sterling based assets including fixed interest hedged back to Sterling

**How do multi-asset fund managers out perform their peers?**

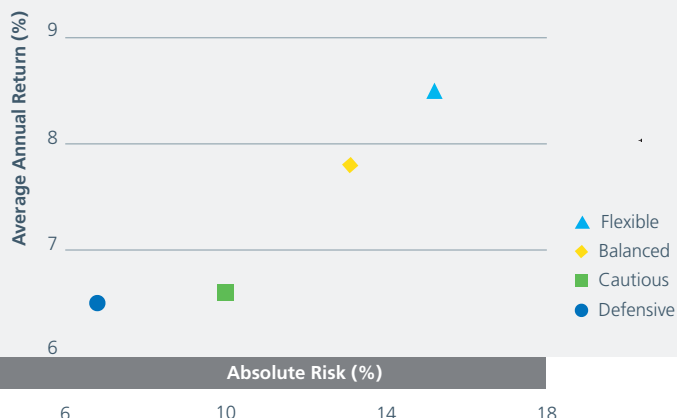
Consistent out performance of a peer group's average or top quartile return is the objective of most active multi-asset unit-linked life and pension fund managers. In order to achieve

As equity returns are more volatile than fixed income returns, multi-asset funds with a greater ability to invest in equity are deemed

1. Kazemi, H., T. Schneeweis and D. Pancholi, 2003, "Performance Persistence for Mutual Fund: Academic Evidence," Isenberg School of Management, University of Massachusetts.

# 2

**CHART 1 MULTI-ASSET UNIT-LINKED LIFE AND PENSION FUND PEER GROUP RISK AND RETURN 1989-2009**



**SOURCE**  
Lipper Global Funds Database.

this objective a multi-asset fund manager must make investment choices that differ from managers in their fund’s peer group. This difference introduces a potential to out perform and an element of risk.

For the purposes of this article, we combine and define the three main sources of risk taken to out perform the average or top quartile return of a multi-asset fund peer group as “alpha generating risk.” The three main sources of alpha generating risk for multi-asset funds are strategic asset allocation (SAA), tactical asset allocation (TAA) and security selection.

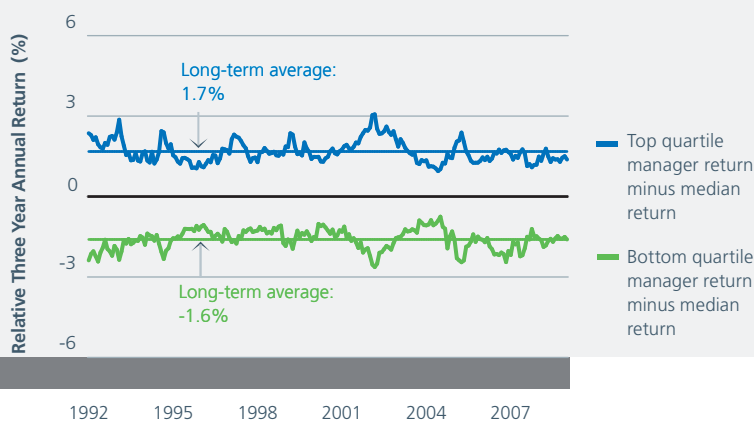
SAA and TAA risk is generated when a fund’s asset allocation differs from the average asset allocation of the fund’s peer group. SAA alpha generating risk is taken to exploit long-term market forecasts. For example, if a manager’s analysis suggests that emerging market equities provide higher long-term risk adjusted returns than developed market equities; the manager may strategically overweight their fund’s allocation to emerging market equities versus the average weight of emerging market equities in their fund’s peer group. Similar to SAA, TAA alpha generating risks are taken to exploit market anomalies based on short-term

market forecasts through asset allocation. The main difference between SAA and TAA decisions is the duration of market forecasts used to generate ideas that exploit market anomalies.

Security selection risk is caused by specific securities within an asset class differing from their benchmark allocation. For example, a multi-asset fund manager holding only five US equity securities to achieve their fund’s US equity exposure, which is benchmarked against the S&P 500, is taking security selection risk. However, if a manager invests passively no security selection risk or alpha versus the benchmark is taken or achieved, respectively.

Allocating, or budgeting, risk to these sources of alpha generating risk is the responsibility, and a potential source of alpha, for multi-asset fund managers. There are times when a multi-asset fund manager will seek more or less risk from each of these sources of alpha generating risk. For example, during times of high cross sectional volatility within an asset class, such as during the 1995 – 2000 dot-com bubble, a multi-asset fund manager may increase their fund’s security selection risk by moving assets from passive to active equity management. Similarly, when cross

**CHART 2 MULTI-ASSET UNIT-LINKED LIFE AND PENSION FUND PEER GROUP TOP AND BOTTOM QUARTILE RELATIVE PERFORMANCE 1989-2009**



**SOURCE**

Lipper Global Funds Database.

sectional volatility between asset classes are unusually large, such as during the recent credit crunch, a multi-asset fund manager may increase their fund's asset allocation risk which would result in larger asset allocation over and under weights versus the peer group.

The alpha generating risk available to multi-asset fund managers is plentiful. If allocated and utilised correctly, these sources of alpha generating risk can consistently produce performance above a peer group's average return.

**How much relative return do top performing managers need?**

As shown in Chart 2, over the last two decades, the level of relative return required to belong to the top and bottom quartile, or 25%, of managers on a rolling three year basis has averaged 1.7% and -1.6%, respectively. In other words, the worst manager in the top quartile of the peer group performers delivered an average return of 1.7% above the median performance of the peer group. Similarly, the best manager in the bottom quartile of the peer group performers only delivered an average return of 1.6% below the median performance of the peer group.

We also analysed the level of relative return required to belong to the top and bottom quartile of managers on a rolling one and five year basis. Our analysis showed the worst manager in the top quartile of the peer group performers delivered an average return of 2.7% and 1.3% above the median over rolling one and five years, respectively. Similarly, the best manager in the bottom quartile of the peer group performers delivered an average return of 2.7% and 1.3% below the median performance of the peer group over rolling one and five years, respectively.

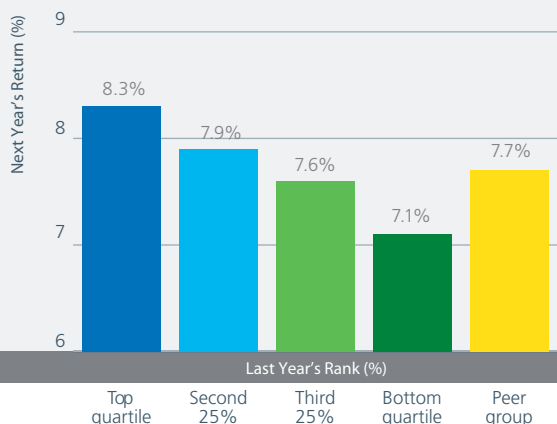
**Does the academic evidence show that performance persistence exists?**

Past performance is used to demonstrate manager skill and to regularly select managers. Therefore linking historic active fund manager performance with future performance has been the subject of various studies. For example, Goetzmann and Ibbotson<sup>2</sup> examined the performance of mutual funds covering 1976 to 1988 and found that 41% of the funds that were ranked in the top quartile in the previous period were ranked in the top quartile in the subsequent period. In another study, Bauman and Miller<sup>3</sup> analysed the behaviour of actively managed mutual funds from 1972

2. Goetzmann, W. and R. Ibbotson, 1994, "Do Winners Repeat?" *The Journal of Portfolio Management*. Vol. 20-2, 9-18.  
 3. Bauman, W. and R. Miller, 1994, "Can Managed Portfolio Performance be Predicted?," *The Journal of Portfolio Management*. Vol. 20-4, 31-40.

# 4

**CHART 3 INVESTING IN LAST YEAR'S TOP MULTI-ASSET FUND MANAGERS OUTPERFORMS ALL OTHER GROUPS 1989 - 2009**



**SOURCE**  
Lipper Global Funds Database.

to 1992 and found the rate of return of the funds that were ranked in the top quartile in the previous period was 18.6% in the subsequent period, while the rate of return of the funds that were ranked in the bottom quartile was 14.4% in the subsequent period. Finally, a study by Ian Tonks<sup>4</sup> analysed a large sample of UK pension funds from 1983 to 1997 and found that the returns on an investment portfolio adopting a long position in a portfolio of fund managers that performed well over the previous 12 months and a short position in a portfolio of fund managers that performed poorly, would have yielded an annualised abnormal return of 1.6% over the subsequent 12 months.

Our analysis seeks to use well established research methodologies to determine if persistence of performance exists for multi-asset unit-linked life and pension funds.

**Is investing in last years winners a winning strategy?**

As shown in Chart 3, the average annual return of all quartiles across all multi-asset fund peer groups over 20 years was 7.7%. Our research shows that investing in an equally weighted, or naïve, basket of the previous year's top quartile performers

delivered a return of 8.3%, while the return for investing in an equally weighted basket of funds that were ranked in the bottom quartile was 7.1%. Therefore the excess return generated by investing in the previous year's top quartile of performers versus the bottom quartile was 1.2% per annum over 20 years.

Our research process rebalances the basket of managers in each quartile on an annual basis and contains 9,280 observations. Put another way, we examined 2,320 observations for each quartile. In addition, all returns used in our analysis were gross of transaction costs and excluded fund loads and expenses.

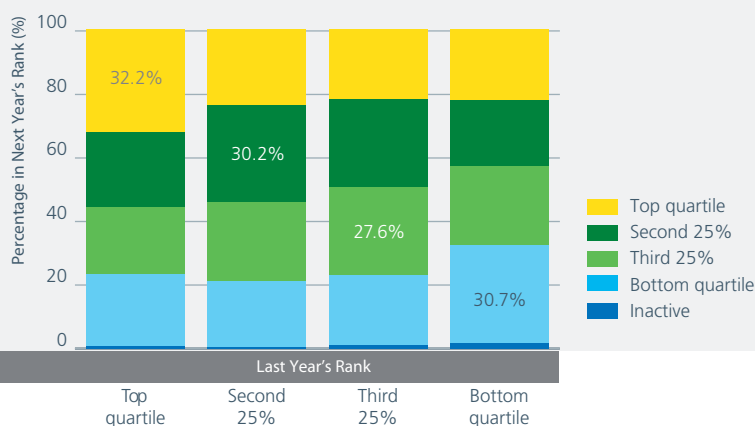
**Why does this strategy work?**

The reason why an equally weighted basket of last year's top performing multi-asset fund managers out performs all other groups is because relative performance of funds persists from period to period.

As shown in Chart 4, performance persists in all quartiles. Over 20 years, 32.2% of multi-asset funds that were ranked in the top quartile in the previous period were ranked in the top quartile in the subsequent period.

4. Tonks, I., 2002, "Performance Persistence of Pension Fund Managers," University of Exeter.

**CHART 4 PERFORMANCE PERSISTS IN TOP AND BOTTOM QUARTILE MULTI-ASSET FUNDS 1989 - 2009**



**SOURCE**  
Lipper Global Funds Database.

On the other side, 30.7% of funds that were ranked in the bottom quartile in the previous period were ranked in the bottom quartile in the subsequent period.

#### Is this strategy statistically significant?

Assuming fund performance was completely random, an equal distribution of 25% in each quartile of the subsequent periods would appear, regardless of the rank the fund obtained in the previous year. With the 2,320 samples we observed per quartile, our analysis is deemed statistically significant at a 99% confidence level.

In particular, our results are statistically significant at a 99% confidence level if the average percentage observed in the subsequent period was greater or less than 27.1% or 22.9%, respectively. Our results found 32.2%, 30.2%, 27.6% and 30.7% of the funds that were ranked in the top, second, third and bottom quartile of performers, were ranked in the top, second, third and bottom quartile of performers in the subsequent period, respectively. Therefore, as these percentages are all greater or less than 27.1% or 22.9%, respectively, our results are statistically significant to a 99% confidence level.

#### Conclusion

Multi-asset unit-linked life and pension funds are split across four peer groups; Defensive, Cautious, Balanced, and Flexible Managed as defined by the ABI. Each of the peer groups has its own set of constraints and risk-return profiles.

Multi-asset fund managers typically allocate three sources of alpha generating risk – SAA, TAA and security selection – within their fund to achieve their fund's performance objective.

Over the last 20 years, the performance of actively managed multi-asset fund performance is persistent. The average rate of return on the funds that were ranked in the previous year's top quartile of performers was 1.2% greater, per annum, than the rate of return on the funds that were ranked in the previous year's bottom quartile. This result is found because top performing managers tend to remain top performing managers in subsequent periods and this relationship is statistically significant. These results are very compelling and warrant conducting further work on whether significant performance persistence exists over longer time intervals.

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Utilising this rebalancing strategy may be very appealing for multi-asset fund investors. However, exploiting this strategy may be difficult because investors would typically not achieve the abnormal returns captured by this strategy after transaction costs were deducted. In addition, past performance can be considered as only one of a number of potential guides to future performance. Other indicators of future performance include a manager's investment philosophy, process and people. Nevertheless, this article gives investors a sensible manager selection tool to increase the chances of identifying future top quartile multi-asset fund managers, an insight into the returns generated by multi-asset fund peer groups and how multi-asset fund managers achieve their performance objectives.

## KEY POINTS:

- Multi-asset fund peer groups are available in a range of risk and return levels and have historically returned between 6.5% and 8.5% per annum.
- Multi-asset fund managers typically allocate three sources of alpha generating risk – SAA, TAA and security selection – within their fund to achieve their fund's performance objective.
- Our research, which is supported by academic studies, suggests that top quartile multi-asset fund managers tend to remain top quartile managers and bottom quartile managers remain bottom quartile managers over one year periods.
- Investing in top quartile managers in the previous period has delivered an annual rate of return of 8.3%, while investing in managers that were ranked in the bottom quartile delivered 7.1%.
- 32.2% and 30.7% of multi-asset fund managers that were ranked in the top and bottom quartile in the previous period were ranked in the top and bottom quartile in the subsequent period, respectively.

### Past performance is not indicative of future results.

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