OUR TWO CENTS

BY MICHAEL CAROLINE

23 FEBRUARY 2023

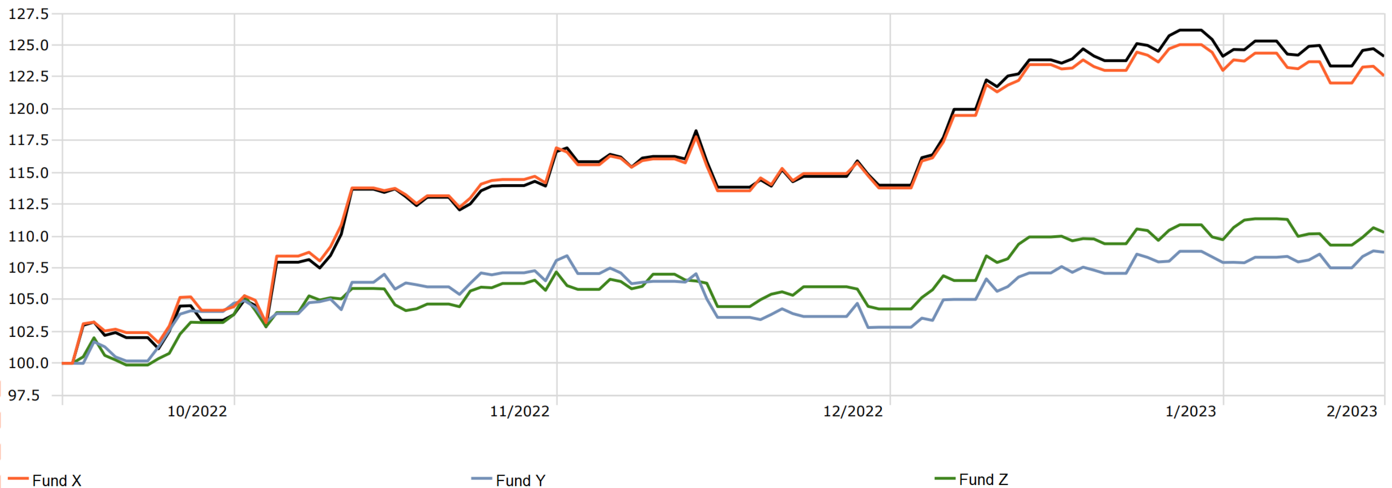
The Active Selection Risk

by Michael Caroline

There are many factors to consider when evaluating the performance of a fund, however, actively managed funds come with an important additional risk factor compared to index funds: security selection. Active fund managers hope to select securities that are expected to add value to the portfolio, but the success of this process varies according to asset class and is typically very low when considering equity funds.

Investing in active funds brings with it the risk that the manager may make the incorrect selection decision despite the investor making the correct asset allocation decision. An example of such a risk playing out can be seen in the graph below.

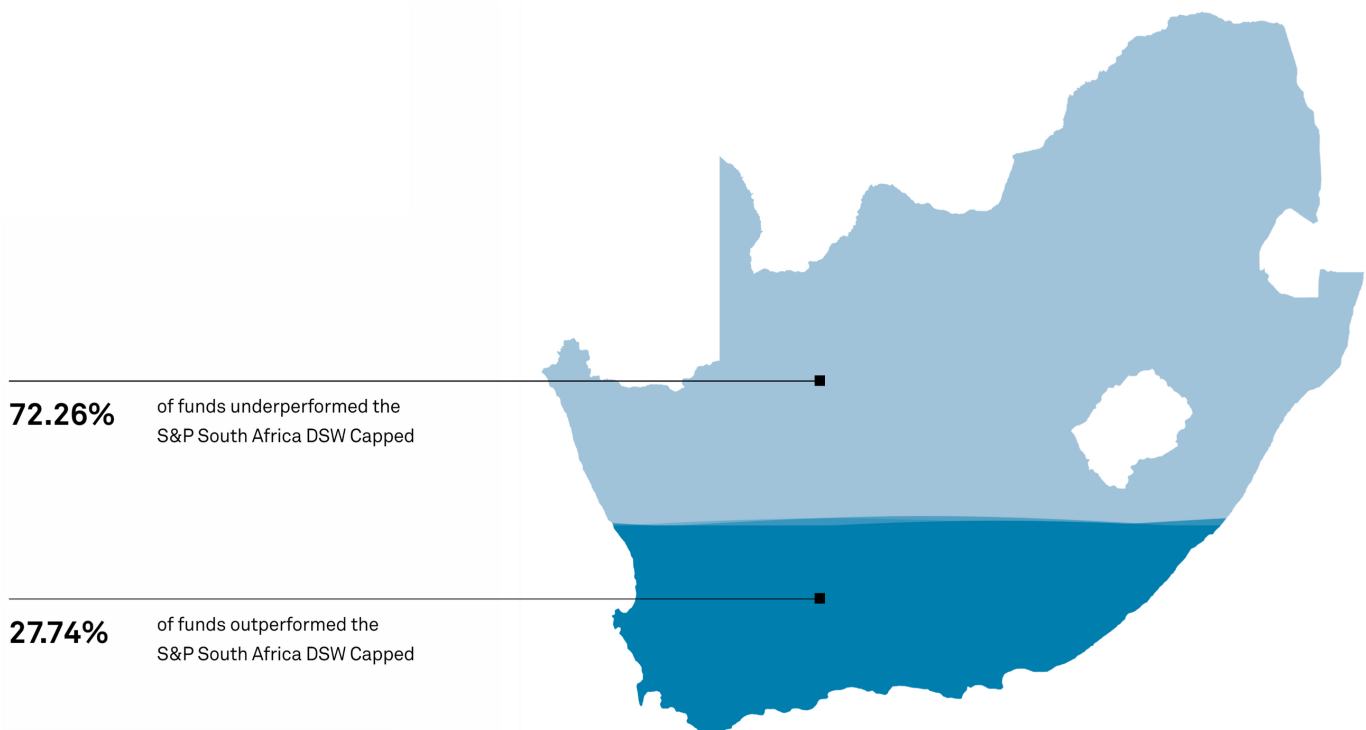
Performance of 3 Equity Funds



Source: Morningstar Direct

Both Fund Y and Fund Z are active equity funds while Fund X is a passive tracker. An investor who correctly predicts the increase in equities would have acted by increasing the equity weight exposure in the portfolio. If the investor chose to increase their exposure through Fund X, they would have enjoyed a 22.59% return. In contrast, had they chosen Fund Y or Fund Z, they would have missed out on that growth substantially. This would have been a bitter disappointment since they made the correct call to increase equity exposure but did not enjoy the full, or even half of, the reward. Research conducted on an ongoing basis by S&P (SPIVA Report) suggests that this underperformance is not uncommon and indicates that 72.26% of active equity funds underperform the passive index in South Africa over a 10-year period.

Percentage of Underperforming Equity Funds in South Africa over the Last 10 Years



Source: S&P Dow Jones Indices LLC, Morningstar

Although tempting to focus on choosing active managers, the importance of asset allocation should never be forgotten. Returns are generated both through security selection as well as asset allocation, but some risks are managed more effectively through asset allocation than by the decisions made by active funds. Consider the following graph illustrating the performance of two hypothetical portfolios, both of which hold identical underlying funds and differ only in their allocation to each fund.

The Effect of Asset Allocation

Source: Morningstar Direct

The change in asset allocation made the difference between underperforming and outperforming the benchmark. In this example, Portfolio A outperformed the benchmark by 2.26% on an annual basis while Portfolio B underperformed by 0.91% on an annual basis, a difference that was achieved through changes in asset allocation alone. In addition to the higher return, both the Sharpe and Sortino ratio of Portfolio A was higher than that of Portfolio B. This shows that the allocation used for Portfolio A not only produced a higher return but also a more efficient portfolio in terms of the tradeoff between risk and return.

This demonstrates not only the importance of asset allocation and the role it plays in the return generating process, but also the risk of choosing active funds, particularly in the equity space. While some asset classes, notably fixed income, offer a lot of potential for active managers to outperform and add value, others offer very little. This illustrates the role of a Fund of Funds (FoF): to determine the optimal asset allocation, both strategic and tactical, and to correctly identify the funds that should be used to achieve this allocation, a decision that includes the question of when to use active and when to use passive funds.

Written by: Michael Caroline