

Fund outperformance may be luck, not skill, new study shows

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For Immediate Release

Just because a managed fund beats a benchmark doesn't mean the manager has exercised any degree of skill, according to a new study released today by Morningstar and commissioned by Vanguard Investments Australia Ltd.

The study used Morningstar data to look for funds that not only beat the index, but also demonstrated a degree of skill. 'Skill' is a subjective term which can be assessed in a number of ways both qualitatively and quantitatively. This study applied a statistical test to measure the consistency with which funds added value against an index over the five and seven year periods to 30 June 2003.

Lesson #1: One good result does not equate to skill.

While any number of funds can beat a benchmark over a period of time, few can demonstrate that they have done this with any degree of skill. The study judges skill by both the level of excess returns over an appropriate benchmark **and** the consistency with which this has been achieved month in and month out. Retail Australian equities funds are the most striking example, with 61.0 percent of funds beating the benchmark, but only four percent demonstrating skill.

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"One contributing factor to a fund beating its benchmark, but not satisfying the skill test, is the level of outperformance," said Morningstar's Head of Consulting, Anthony Serhan. "For instance, 52.0 percent of wholesale listed property funds have been able to beat the index. But the level of these excess returns has been so small that you couldn't say with any statistical confidence that this demonstrates skill, and is something the funds would be able to repeat. Actually, only two of the listed property funds were able to generate excess returns of greater than one percent per annum," Serhan noted.

An even greater factor, particularly within the equities categories, is the impact of risk. While a number of funds in the study produced high levels of excess returns, the variability of these excess returns from month to month was so high that, once again, one could not be confident of the pattern repeating.

Lesson #2: Fees do matter.

Quite simply, a fund that charges higher fees will find it more difficult to add value against a benchmark compared with a cheaper fund. This is best illustrated by comparing the percentage of funds with a positive information ratio between the retail and wholesale product categories.

In all instances, the percentage of wholesale funds with positive information ratios was higher than the corresponding retail categories. The Management Expense Ratios (MERs) of retail funds can be in the order of one percent higher. Retail Australian equities funds have an average MER of 1.88 percent per annum, compared to 0.91 percent per annum for their wholesale counterparts.

In addition, the more difficult it is to add value in an asset class, the greater the impact of fees on the number of funds beating the benchmark. The ratio of wholesale to retail funds with a positive information ratio was 4:1 for listed property funds, and 8:1 for Australian fixed interest funds. The fee discrepancy between retail and wholesale made little or no difference for Australian equities funds, which demonstrated the highest level of excess returns.

Lesson #3: Different asset classes deliver different excess returns.

This study confirmed that the greater the levels of risk in an asset class, the greater the opportunity for excess returns within that asset class. The number of funds beating the index was greatest in Australian equities, less in international equities, and less again in Australian fixed interest. So while the selection of asset classes can deliver very different return levels, the payoff for selecting the best-performing fund also varies between asset classes, and is much less in Australian fixed interest than in Australian equities, for example.

“The study shows clearly that it's more difficult to add value in some asset classes than others,” said Anthony Serhan. “Once again, this highlights the dangers in drawing conclusions from simple return figures. A return figure tells you where the fund finished – it doesn't tell you how the race was run. While a number of funds beat the benchmark, few did it with a level of consistency that would give you confidence about the result.”

About this study

The study looked at retail and wholesale funds in the four main sectors of Australian equities, international equities, Australian listed property, and Australian fixed interest. In total, 316 funds qualified with the minimum five-year performance history. ‘Skill’ was defined as a managed fund which had a positive information ratio and a monthly excess return (over the five or seven years to 30 June 2003) greater than zero at the 95.0 percent confidence level. Fund returns were calculated net of ongoing expenses, and compared to the unadjusted capital market index returns for the relevant sector. Information ratios were calculated as the fund’s excess returns divided by the tracking error over the relevant period.

While quantitative analysis is very useful in understanding the past behaviour of a fund manager, it may not be indicative of future performance. To make an informed opinion about the future requires a fundamental understanding of the fund manager’s investment capabilities today, and the manager's ability to add value in the future.

About Morningstar

Morningstar is the leading global provider of investment research, offering an extensive line of print, software, and web-based products and services. Operating in North America, the United Kingdom, Europe, Asia, and Australasia, Morningstar’s staff of over 800 professionals track, analyse, and publish information on more than 100,000 securities worldwide. By doing this, Morningstar helps intermediaries and institutions provide investors with information to make better decisions to achieve their financial goals.

“Skill versus Luck”

Results to 30 June 2003	5 Years			7 Years		
	Funds	Positive IR ¹	Show Skill ²	Funds	Positive IR ¹	Show Skill ²
<i>Australian Equities</i>						
- Retail	72	61%	4%	61	64%	13%
- Wholesale	58	64%	21%	33	73%	18%
<i>International Equities</i>						
- Retail	35	23%	9%	27	15%	4%
- Wholesale	43	49%	7%	20	25%	10%
<i>Australian Listed Property Trusts</i>						
- Retail	30	13%	3%	22	9%	0%
- Wholesale	23	52%	0%	14	50%	0%
<i>Australian Fixed Interest</i>						
- Retail	28	4%	0%	23	4%	0%
- Wholesale	27	33%	0%	18	33%	0%

1. Positive Information Ratio.

2. Calculated as the percentage of funds with a positive information ratio and a monthly excess return greater than zero at the 95.0 percent confidence level.

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