PRUDENTIAL **INSIGHTS**

PRUDENTIAL
INVESTMENT MANAGERS

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Choosing an investment manager: The journey of past performance

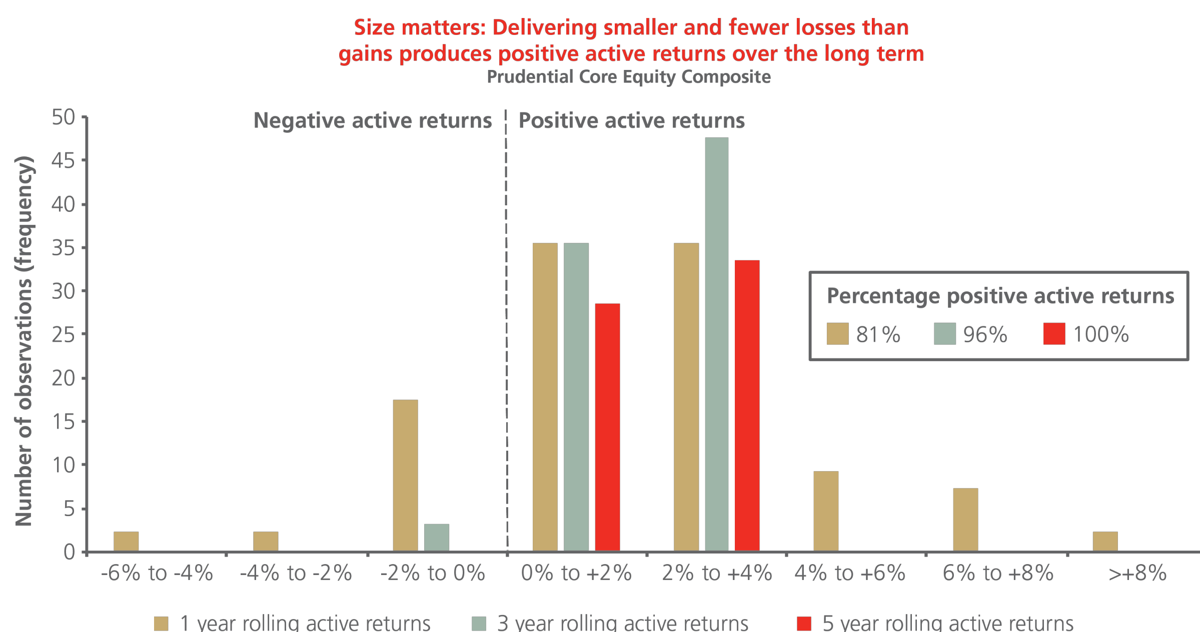
Most investors will know that, when trying to judge the skill of an asset manager, the past investment performance of their funds – especially over the short term - is not a good indicator. However, the reality is that investment flows continue to follow relatively short-term fund performance. Yet an investment return between two specific dates, long-term or not, tells us little about how and when the performance was delivered. We would ask that, in judging a fund's performance and whether the managers have delivered on what they promised, investors look at the performance journey of a fund over many years and through different market conditions, rather than a frozen, point-in-time snapshot.

"Rolling *active* returns...can provide significant insight into the consistency of a manager's outperformance..."

Rolling returns provide an improved measure, allowing investors to see the long term in more detail by using more data points. They break up a performance period into smaller, overlapping periods: for example, a five-year period from 1 January 2014 to 31 December 2018 will contain 49 rolling one-year periods: 1 January 2014 to 31 December 2014; 1 February 2014 to 31 January 2015; 1 March 2014 to 28 February 2015, and so on.

The chronological view that rolling returns provides can reveal important information on how a fund has “behaved” over various market cycles, and ultimately whether investment results have lived up to the manager’s stated investment approach.
Rolling *active* returns, namely the portfolio returns above or below a benchmark, can provide significant insight into the consistency of a manager’s outperformance, an important consideration in assessing investment skill.

Importantly, successful investment is not about being ‘correct’ all the time. What matters ultimately is how much money you make when you are correct versus how much you lose when you are wrong. A frequency distribution is an effective graphical way to distinguish between frequency and magnitude of active returns and observe a manager’s “alpha profile”. In other words, we can see how often an investment manager produces positive and negative active returns, and how large they have been, across various periods.



Source: Prudential Investment Managers

The graph shows the frequency distributions of rolling one-, three- and five-year active returns for Prudential's Core Equity Composite for the 10-year period ending 31 December 2018. The number of observations (frequency) is shown on the vertical axis, while the active return outcomes, grouped into 2% intervals, are shown on the horizontal axis. This bears out the following notable observations:

- Underperformance over rolling one-year periods can and will happen. However, the frequency and magnitude of outperformance (observations to the right of the 0% vertical line) more than offset the instances of underperformance. This is in line with Prudential's approach of compounding relatively small gains over time.
- Underperformance over rolling three-year periods has occurred far less frequently: in only 3 out of 85 observations. Also the combined frequency and magnitude of outperformance significantly offset the relatively small instances of underperformance.
- Over rolling five-year timeframes, all active returns are positive as a result of prudently "winning more than losing" over the shorter time periods.
- Notably, there are more small gains and losses (in the 0%-2% and 2%-4% ranges) over time than larger gains and losses (over 4%). This is also in line with Prudential's investment approach of being mindful of the size of potential losses.
- By compounding relatively consistent performance over time, specifically by delivering greater instances of outperformance relative to underperformance, the Prudential Core Equity Composite has outperformed its benchmark by 1.7% p.a. since inception in 2004 (gross of fees).

So next time you're judging fund manager performance, we encourage investors to look beyond short-term, point-in-time returns measured to the most recent date, and consider the longer journey taken to achieve those returns over time.

For the full article, please see Consider this Q1 2019.

If you need more information please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za