

Myth of Eternal Alpha

A look at trend of out/underperformance of Active Fund Managers in India

In many classic active versus passive debates in Indian media and private interaction, proponents of active fund management have always claimed that Indian markets are different and Indian fund managers will always be able to outperform the benchmark or generate Alpha.

The arguments given are manifold. The most common one is that Indian markets are inefficient and the fund managers are privy to information or their level of intellect is much higher than the market (of which they themselves are part).

This argument is in direct contrast with the reality of developed markets, where, over the long-term nearly 80% of actively managed funds under perform the indices. Hence indexing is a core strategy for both institutional and other sophisticated retail investors. In fact a majority of fee based financial planners in the US make use of index funds only for financial / investment planning.

We commissioned a small study to examine the truth and the trend. The results are similar to the prognosis of decoupling of markets. It falls flat on its face.

Methodology

It has often been argued that individual active fund managers are consistently able to exploit anomalies & aberrations

that may exist in the market and while considering out performance/ under performance one should look at longer periods.

Argument accepted and therefore we looked at three year periods for rolling return analysis in order to avoid any aberrations. The schemes have been selected by applying two filters. Firstly the scheme should have been in existence for the past five calendar years as on December 2008. Secondly the scheme should have as its Benchmark one of the broader indices (S&P CNX Nifty or BSE Sensex or BSE 100 or CNX 100). We have compared these funds with Nifty BeES because (1). Nifty BeES Captures dividends unlike pure nifty index and (2) Nifty BeES also has management expenses like other mutual funds.

After applying these filters, we were left with 60 schemes for further analysis. We took simple average of returns of the schemes selected. For simplicity we have taken only growth plans or dividend reinvestment plans assuming no pay out.

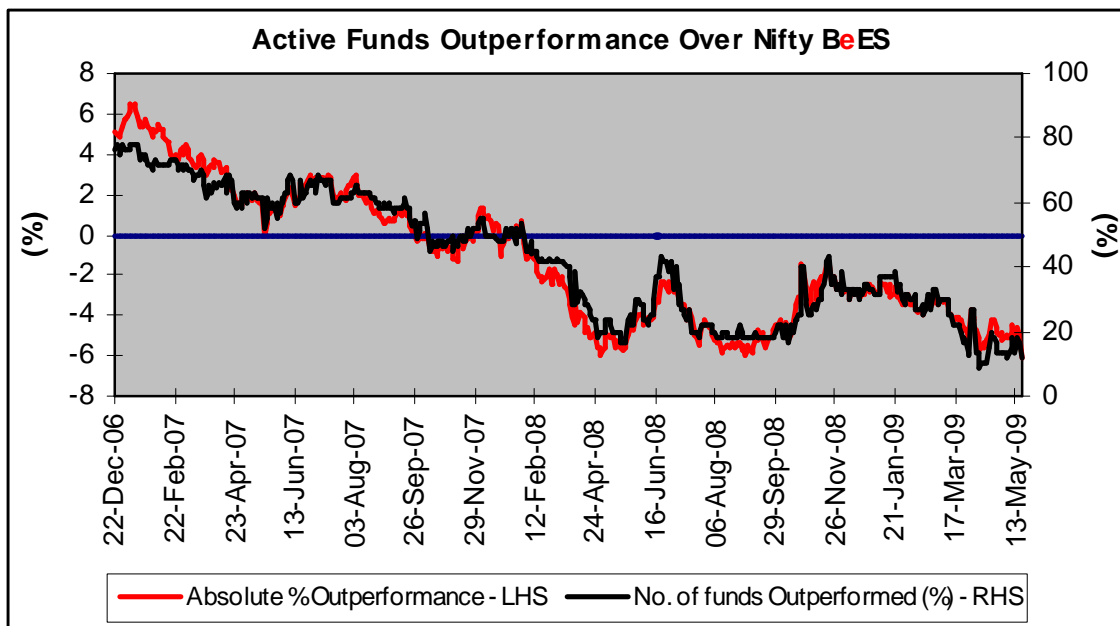
The period of investment commences daily from December 2003 and ends on May 2006. The last observation date is 19th May 2009. Thus over 500 data points have been considered for analysis.

Results

The graph below depicts, that the average out performance of large cap diversified active funds is consistently declining over last few years and has now gone into underperformance zone touching more than 6% per annum under performance. **Please note that this is three year CAGR % and hence in absolute term it is around 18% underperformance excluding load and if we included load then it results in 20.25% underperformance over three**

years.

Also if we compare each of the 60 scheme's performance vis-a-vis Nifty BeES, we can see from the below graph that the no. of funds outperforming (in % terms) Nifty BeES has been continuously declining and has reached the rock bottom of around 8% to 12% recently i.e out of the 60 schemes considered for analysis only 5 to 7 schemes were able to outperform NiftyBeES.



Source: MFI explorer & Internal

Analysis

Is it an aberration or a paradigm shift? How does one explain this phenomenon? We believe that this trend is here to stay and our reasoning is based on same factors which are responsible for indexing doing relatively better elsewhere.

Stock market investment is not a zero sum game i.e. when markets are up, every one wins and when markets are down every one loses (Except shorts). However outperformance is zero sum game i.e for some investors to outperform the average others by default have to underperform. In other words, as investors, all of us as a group earn the

stock market's return-hence in the aggregate we are 'average' (fund managers included). This is before deduction of costs. Each extra return that one of us earns (including the individual active manager) will mean that the other member (s) of the group (managers included) has to suffer a return shortfall of the same proportion. This is the zero sum equation i.e. beating the market before costs are a zero sum equation and net of costs it is a loser's game.

This iron clad and a fundamental mathematical law that governs the stock market, has been aptly put by William F. Sharpe, Nobel Laureate in Economics, 1990, "*Properly measured, the average actively managed dollar must under perform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.*"

The above explains the gradual under performance of many individual active managers and also as a group-provided the correct comparison and measurement is done.

However the absolute skills of fund managers remain the same but their skills relative to markets are diminishing. In an increasingly institutionalized market dominated by professional managers all of them as a group are becoming a larger and larger portion of the market. The direct consequence of this is the emergence of an efficient market where price discoveries are faster. Also fund corpuses

have grown bigger and it has become difficult to add zing to consistently out perform by discovering 'ten baggers'.

Implications for Investors

One of the risk factors highlighted in mutual fund documents is "Past performance is no guarantee of future performance". This is true for out performance as well. The most common method by which the majority of investors invest into a fund is based on past performance or past out performance. The results from study show that this method is highly unreliable.

An investor seeking long-term exposure in equity is likely to get disappointed by remaining under an illusion that Alpha or out performance is easy and that every fund manager will deliver it-consistently.

Of course, at any given point in time-some funds out of the many available will out perform-however this is random. Sadly, a typical fund investor will not be able to identify the individual 'alpha' -in advance-except by luck. A deeper analysis of such funds may force us to come to conclusion that such outperformance is largely due to luck rather than skill.

If this is the harsh reality then how does one select the fund which will outperform for next five years i.e. in advance? Indeed it is difficult to decide and hence internationally large investors like pension funds, insurance companies etc. eliminate this guesswork by making

indexing as one of their core long-term equity strategies.

Only thing which can be controlled – Cost

One cannot time the market nor can you predict future out performance or underperformance. The only predictable factor in investments which can be controlled are the various annual costs,

e.g. index funds at 0.5% per annum or active fund at 2.5% per annum.

This difference of 2% per annum can balloon into huge difference over number of years because of compounding. In the moderate return environment it becomes a significant portion of your returns.

Statutory Details:

Investment Objective: Nifty Benchmark Exchange Traded Scheme (Nifty BeES): The investment objective of Nifty Benchmark Exchange Traded Scheme (Nifty BeES) is to provide investment returns that, before expenses, closely correspond to the total returns of the securities as represented by the S&P CNX Nifty Index. However, the performance of Scheme may differ from that of the underlying index due to tracking error. There can be no assurance or guarantee that the investment objective of Nifty BeES will be achieved.

Statutory Details: Constitution: Benchmark Mutual Fund has been set up as a Trust under the Indian Trust Act, 1882. **Trustee:** Benchmark Trustee Company Pvt. Ltd. **Investment Manager:** Benchmark Asset Management Company Pvt. Ltd. **Sponsor:** Niche Financial Services Pvt. Ltd.

RISK FACTORS

General

1. Mutual funds and Securities investments are subject to market risks and there can be no assurance or guarantee that the objective of the Scheme will be achieved. 2. As with any investment in securities, the Net Asset Value (NAV) of the units issued under the Scheme can go up or down depending on the factors and forces affecting the capital market. 3. Past performance of the Sponsors/Investment Manager/Mutual Fund and its affiliates does not indicate the future performance of the schemes of the Mutual Fund. 4. Nifty BeES is the name of the Scheme and does not in any manner indicate either the quality of the Schemes or its future prospects and the returns. Investors are therefore urged to study the terms of offer carefully and consult their Investment Advisor before they invest in the Scheme. 5. The Sponsor is not responsible or liable for any loss or shortfall resulting from the operation of the Fund beyond the initial contribution made by it of an amount of Rs. 1 Lac towards setting up of the Mutual Fund. 6. Investors in the Schemes are not being offered any guaranteed or assured returns. 7. The Schemes' NAV will react to the stock market movements. The Investor could lose money over short periods due to fluctuation in the Scheme's NAV in response to factors such as economic and political developments, changes in interest rates and perceived trends in stock prices market movements, and over longer periods during market downturns. 8. The returns are not necessarily indicative of future results and may not necessarily provide a basis for comparison with other investments. 9. Past returns may or may not be sustained.

Benchmark Asset Management Company Pvt Ltd.

405, Raheja Chambers, 213, Nariman Point, Mumbai – 400 021

Tel: +91 22 66512727 FAX : +91 22 22003412

Email: webmaster@benchmarkfunds.com Website www.benchmarkfunds.com