In Search of Success

A Contrarian View

Dr Adrian Saville
Chief Investment Officer

Cannon Asset Managers
adrian@cannonassets.co.za · www.cannonassets.co.za

2007

“Where we have strong emotions, we’re liable to fool ourselves.”

Carl Sagan, *Astronomer*, 1934-1996

“Just because so many accept something as true without further thought on the subject will cause some to feel that any questioning is out of place. To those, I would point out that history has shown that, in every age and in every field of human knowledge, many of the views which almost everyone accepted as true and never bothered to think about further were in time proven completely wrong. It took centuries of civilization before it was realized that the earth went round the sun and not the other way around ... Because something is generally taken for granted and even though respected leaders in places of power tailor their policies accordingly, this does not of itself make it correct.”

Philip A. Fisher, *Paths to Wealth through Common Stocks* (1960, 12)

If you are looking for an equity fund manager that is capable of producing sustained, market-beating portfolio performance, you might be wasting your time. The roots of this argument can be traced back to Eugene Fama's efficient market hypothesis published in 1965. Fama asserted that financial markets are informationally efficient, which simply means that prices on traded assets – including equities, bonds and property – always reflect all known information and therefore are unbiased or efficient. Further, because information that affects future prices is unknowable and arrives in the market in a random fashion, the future movement of share prices is unpredictable. Gathering up these arguments, modern portfolio theory reaches the conclusion that if markets are efficient it is impossible for investors to consistently beat the market, except through luck. Thus, modern portfolio theory concludes that passive investors who own a market index are likely to beat almost all active managers – except for that small handful of active managers who possess luck (not skill).

As one would expect, the efficient market hypothesis has promoted fierce debate between advocates of active investing and those who believe in passive investing. For this reason, a rich body of evidence has emerged since the early 1970s that provides insight into the validity of the efficient market hypothesis. For instance, John Bogle, founder of The Vanguard Group, established that, between 1970 and 1991, the S&P 500 index outperformed more than half of all fund managers in the United States in all but six years. In a similar vein, academics Zvi Bodie, Alex Kane and Alan Marcus (2002) produce more recent evidence which shows that the Wilshire 5000 index outperformed the average fund in the United States by 1.6 percent per annum over a thirty-year period. Further to this, in one of the most comprehensive studies done to date, Mark Cahart of the University of Chicago studied 1 892 funds that existed between 1961 and 1993 and found that actively managed funds underperformed the index by 1.8 percent per year.

The evidence drawn from elsewhere in the world is much the same, and South Africa is no exception. For instance, over the two decades to end 2004, more than 80 percent

[1] This note was originally published in *Funds on Friday* by Sanlamøs Glacier (September 2007).

of active domestic equity managers were beaten by the market. Over five years and ten years the level of underperformance is similar, ranging between 70 percent and 80 percent of funds. In short, beating the market is no average task.

These studies, along with others, provide a clear message from a fifty-year history of professional investment management: in any asset class, the only consistently superior performer is the market itself. In *The Little Book that Beats the Market*, Joel Greenblatt (2006) puts the point bluntly: “If you really want to beat the market, most professionals … can't help you.“ In sympathy, legendary investor Warren Buffett wrote in the 1996 annual report of Berkshire Hathaway: "Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals."

Despite Buffet’s advice, his action of actively investing via Berkshire Hathaway demonstrates that he does not subscribe to the efficient market hypothesis. Rather, Buffet believes – and has demonstrated over forty years – that the market can be beaten; and he is not alone. Buffet belongs to a small group of highly successful active investors, which includes managers such as John Neff, Anthony Bolton, Paul Sonkin and David Dreman, to name a few, who have demonstrated an ability to consistently beat the market. Critically, the success of these managers has little to do with luck. Instead, in a recent paper *Modern Portfolio Practice: A View from the Ivory Tower*, James Montier (2007) points out that successful active managers can be identified through their display of common characteristics in their investment process. Below, six of the most important factors are identified and briefly discussed.

Six Pillars

First, focused funds do better than diversified funds. In an insightful paper entitled *Fund Managers Who Take Big Bets: Skilled or Overconfident?*, Baks, Busse and Green (2006) show that in the United States over the period 1979-2003, the average fund held 128 counters; but top performing funds held less than half that number. Intuitively, many people feel that running a more concentrated portfolio should increase the

riskiness of a portfolio. Yet the opposite is true. The trick in building concentrated portfolios is to add a small number of uncorrelated shares that diversify away company-specific risk and not so many that the portfolio starts to hug the market. Paradoxically, active managers who hope to reduce risk by running portfolios with a large population of shares increase the risk that their fund will underperform the benchmark after fees, trading expenses and other frictional costs, such as the bid-offer spread.

Second, Sir John Templeton once observed: "It is impossible to produce a superior performance unless you do something different from the majority". In other words, following the herd is dangerous. Dasgupta, Prat and Verardo (2006) cast useful light on this argument. In their study entitled *The Price of Conformism*, the authors show that equities that institutions are most aggressively selling outperform equities that institutions are most eagerly buying. The difference is as much as nine percentage points a year. Related to this, in their paper *Fund Manager Use of Public Information*, Kacperczyk and Seru (2007) show that the more a manager follows analysts' recommendations the more performance lags the market. Successful active managers avoid the herd.

Third, portfolio turnover – which is driven by managers' overconfidence – pushes fund costs up at the expense of performance. High portfolio turnover is equivalent to wheel spinning: it is (possibly) impressive and catches the attention of onlookers. Ultimately, however, it is expensive: burning rubber raises costs and, unfortunately for high turnover managers, high turnover is correlated with underperformance. Edelen, Evans and Kadlec (2007) report on this phenomenon in their study *Scale Effects in Mutual Fund Performance*. Funds with the highest turnover have the lowest risk-adjusted returns. The message is simple: keep turnover and costs low. It is telling that the average active equity fund in South Africa is turned over more than once a year.

Fourth, size counts. In many cases fund managers – or fund management companies – obsess about asset gathering: larger asset bases produce larger profits for owners of asset management companies. However, as Chen, Hong, Huang and Kubic (2004) demonstrate in *Does Fund Size Erode Mutual Fund Performance*, size comes at the

expense of investment results. The authors find that over the period 1962-1999 small funds display risk-adjusted outperformance over large funds of 1.7 percent per year.

Sometimes investment styles fall out of favour – as was the case with value during the technology boom of the late 1990s. The fifth pillar of successful active management requires managers to stay true to their investment principles. In a paper entitled *Staying the Course*, Brown and Harlow (2002) show that managers that stick to their style have portfolios with lower turnover and higher returns than managers that exhibit style drift, with consistency adding as much as 2 percent to annual returns. Style drift converts managers into return chasers; sticking to the knitting pays off.

Finally, industry experience reveals that having skin in the game bolsters a manager's performance. As evidence of this, in their study *Portfolio Manager Ownership and Fund Performance*, Khorana, Servaes and Wedge (2006) find that funds with manager ownership produce annual outperformance of 1.4 percentage points over funds where the manager has no ownership. James Montier (2007) makes the point neatly: "Those managers who are prepared to eat what they kill show markedly better performance than those who prefer to dine out."

The Contrarian Conclusion

As the above evidence demonstrates, whilst beating the market is no average task, it is not an impossible dream. David Dreman, founder of the highly successful Dreman Value Management, once quiped: "Nobody beats the market, they say … Except for those of us who do." More importantly, producing consistent, market-beating results has little to do with luck. To the contrary, the roots of successful active management reside in the disciplined application of well-crafted investment processes that embrace portfolio focus, a willingness to step away from the herd, patience, knowing how much is enough, adherence to a clearly defined investment philosophy, especially when times are difficult, and the practice of eating your own cooking. In short, to be successful, the active manager must be contrarian. Thus, rather than being fruitless, the search for successful active managers should begin with a search for the contrarian.

End Note: A Contrarian View

Readers may be interested to know that Cannon Asset Managers' portfolios are highly concentrated. The Core Companies Fund, for example, has never held more than 20 counters since inception. The active stance of their investment process is evidenced by the fact that the Cannon Equity Fund and Cannon Core Companies Fund have less than 40 percent overlap with their benchmarks. Portfolio turnover is low – it took the investment team seven years to turn over the segregated Cannon All Equities portfolio once. The investment process benefits from the fact that the size of the assets under management allows exposure to a wide universe of 250 stocks in the case of general equity mandates. Cannon Asset Managers has demonstrated dedication to the deep-value philosophy through time, underscored by the launch of the value business in the late 1990s which was a time when the growth philosophy was strident and value was distinctly out of favour. Finally, the team eats its own cooking. The Chief Investment Officer's personal South African investment portfolio only holds two positions: the Cannon Equity Fund and the Cannon Core Companies Fund.

This report has been prepared by the author identified on the front page of this document. However, contributions to this report may have been made by employees of Cannon Asset Managers (Pty) Ltd other than the author identified. Each contributor has not and will not receive any compensation for providing a specific recommendation or view in this report. Conflicts of interest may exist with any one or more of the securities recommended in this report. These conflicts include situations where Cannon Asset Managers or an associate makes a market in securities of a company mentioned in the report; the author/s of the report or a member of his/her household own a direct position in securities issued by a company mentioned or derivatives thereof; an employee of Cannon Asset Managers acts as a director of a company mentioned in the report; Cannon Asset Managers owns securities or derivatives thereof in a company mentioned in the report; or Cannon Asset Managers receives compensation for providing financial services to a company mentioned in the report.

The publication is based on information believed to be reliable, but is not guaranteed as to accuracy and completeness. Cannon Asset Managers accepts no liability for any loss arising from the use of the contents of this report, or from any acts or omissions based on such contents. Views expressed are those of Cannon Asset Managers' research team only, and are subject to change without notice. Neither this report nor any opinion expressed herein should be construed as an offer or solicitation of an offer to sell or acquire any securities mentioned. This publication is confidential, and is for the information of the addressee only and may not be reproduced in whole or in part, copied, circulated, or disclosed to another party, without the written prior consent of Cannon Asset Managers. Please cite source when quoting.

Cannon Asset Managers (Pty) Ltd is a Financial Services Board licensed asset management company. For further information or correspondence, the company's contact details are set out below.

Cannon Asset Managers (Pty) Ltd
Unit 6 Rydall Vale Crescent
Rydall Vale Park La Lucia Ridge 4019
PO Box 5200 Rydall Vale Park
La Lucia Ridge 4019
South Africa

+27-31-566-6633
info@cannonassets.co.za

Cannon Asset Managers (Pty) Ltd
First Floor, Building B
Bryanston Corner
Ealing Crescent, Bryanston, 2194
South Africa

+27-11-463-3140
adrian@cannonassets.co.za

Directors: A Cann*, RC van Vliet* (Chairman), AD Saville, JL Liackman, CB Simpkins, MWG Voges
* Non-Executive