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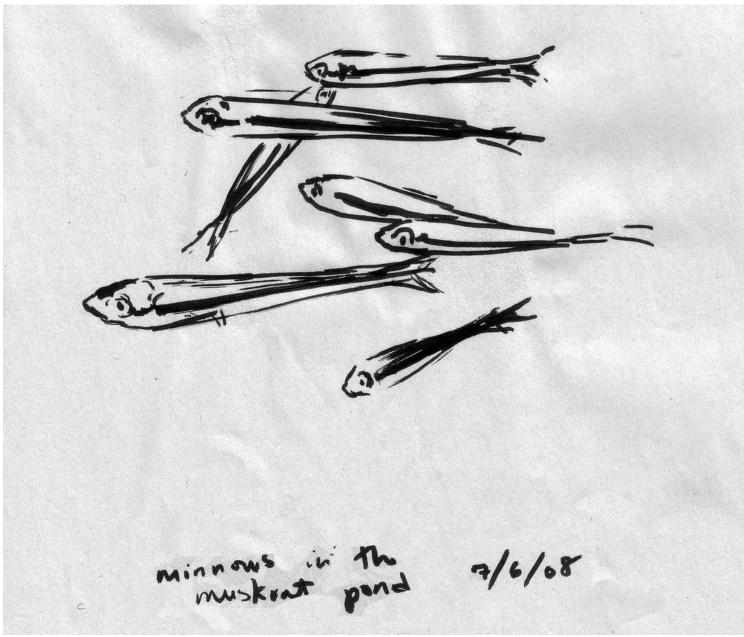
Third Quarter 2015

The Rise of the Minnows



By Daniel R Wessels

A standout feature of the 2015 Rugby World Cup has been the much improved performances by the “minnows” of this four-year event. Typically, the second-tier teams are often filled with amateur rugby players, and in the past lacked perhaps the necessary skill, coaching and gameplay structures to be really competitive against any of the traditional top six rugby playing nations. This year it was clear that the gap is narrowing rapidly, not only did Japan upset the Boks (probably more to do with a lack of preparation and focus, poor discipline and abundance of arrogance by the Boks on the day) and continued with their good form throughout the group stages with three wins in total. Likewise, Tonga and Georgia gained considerable crowd support for their performances. Although not really minnows by any stretch of imagination, Scotland and Argentina played very competitive rugby – in fact, at the time of writing Argentina already qualified for the semi-final by beating Ireland, one of the pre-tournament favourites, while Scotland was extremely unlucky not to upset another bookie favourite, Australia in another quarter-final.

Well, these upsets are possible if teams have first and foremost a fierce commitment, never-say-die attitude, and suitable game plan to succeed on the day. But, essentially, expert coaching can be hired – it is not the “sole propriety” of only the top teams in the professional era any more. Moreover, the requisite skills and gameplay tactics can be trained, and professional players from different parts of the world play together and enhance their respective skills all the time. Thus, all else being equal, the playing field is levelling out.

This phenomenon is a logical consequence of making the game professional across the globe. For those who may think a Japan victory over the Boks was a once-off fluke may have to reconsider their views maybe five to ten years hence! All this makes the game more exciting and fun to watch, and the entertainment value thereof will perhaps soar to new heights. Needless to say, supporters and players of the “establishment” teams will be less self-assured and hopefully a lot less arrogant than before!

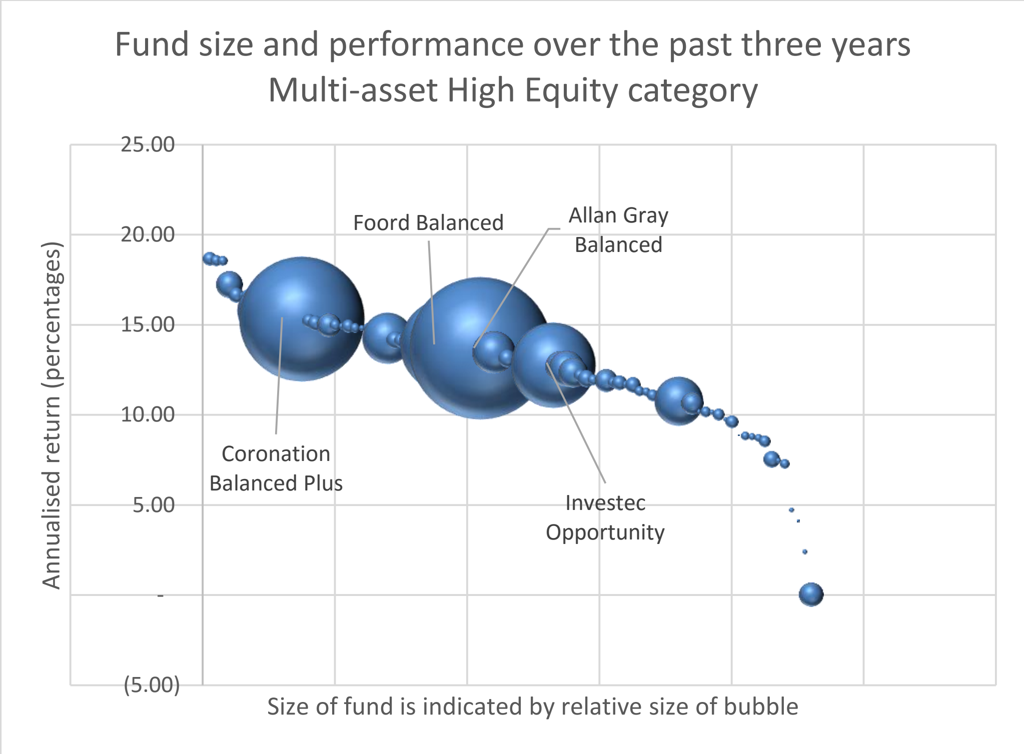
In a previous newsletter (Third Quarter 2014) I wrote about the paradox of skill – how the convergence of skill in competitive domains makes the actual winners less predictable and pure luck often starts to play an important role in the outcome of events. This time I extend on the same topic highlighting the fund performance of lesser-known fund management firms (the "minnows") relatively to their established, well-known counterparts.

The "establishment" manages the bulk of investors' assets across the asset class spectrum – the largest asset management firms (like Allan Gray, Coronation, Investec, Nedgroup) manage more than 50% of all assets in the collective fund (unit trust) industry. These managers typically manage large-sized funds relatively to their lesser-known managers.

Large-sized equity funds, despite the general perception among investors of having comfort in "safety in numbers (size)", often inhibit the manager's ability to deliver top performances relatively to smaller-sized funds. Specific fund rules prohibit managers to assume large, out-sized positions in specific stock beyond specific liquidity constraints and market-capitalisation issues. The net implication thereof is that large-sized fund managers cannot easily make meaningful, performance-enhancing investments in stocks that are regarded as "mid-cap" or "small-cap" stocks – those stocks that often outperform towards the latter parts of a bullish stock market.

The "fund size" issue is somewhat negated by multi-asset class and offshore investment mandates, i.e. the managers have a larger investment breadth than narrowly-defined investment mandates.

For the purpose of my discussion I considered how fund managers fared in one of the most popular investment fund categories, namely the multi-asset high equity category.



Source: Morningstar, DRW Investment Research

This category is dominated by a few mega-large funds, a characteristic that is also shared in other popular investment categories. The largest fund, *Allan Gray Balanced*, holds 24.5% of all assets invested in this category (total assets invested in this category as at the end of September 2015 = R432 billion), *Coronation Balanced Plus* 18.8%, *Foord Balanced* 10.5% and *Investec Opportunity* with 8.6%. These four funds, out of a total of 125 funds listed in this category, manage more than 60% of all assets!

Top ten funds by asset size in multi-asset class high equity category

Fund name and class	Fund size (rands) as at 30 September 2015
Allan Gray Balanced A	105,743,894,014
Coronation Balanced Plus A	81,431,739,404
Foord Balanced R	45,497,082,542
Investec Opportunity R	37,255,169,362
PSG Wealth Moderate FoF D	13,294,593,370
Discovery Balanced	12,590,660,911
Prudential Balanced A	12,324,612,271
Old Mutual SYmmETRY Balanced FoF A	12,234,315,877
SIM Balanced R	11,896,488,018
Old Mutual Balanced R	9,411,945,319

Source: Morningstar

Why are these funds so popular among investors? Well, first and foremost, they have had very good long-term performance records, generally have a very good distribution network (agency force), and over the years they established a good reputation, brand awareness and trust among the general public.

It does not mean, however, these mega-large funds are always the best performers, in fact, studying the table below reveals that only a few of the largest ten funds delivered top performances over reasonable investment periods, especially considering the most recent short-term investment periods. Likewise, most of the time they have not been among the worst performers either, thus it seems one would have received at least more or less "middle-of-the-range" type of returns if one invested in any of these large funds.

Performance of the largest ten multi-asset high equity funds:

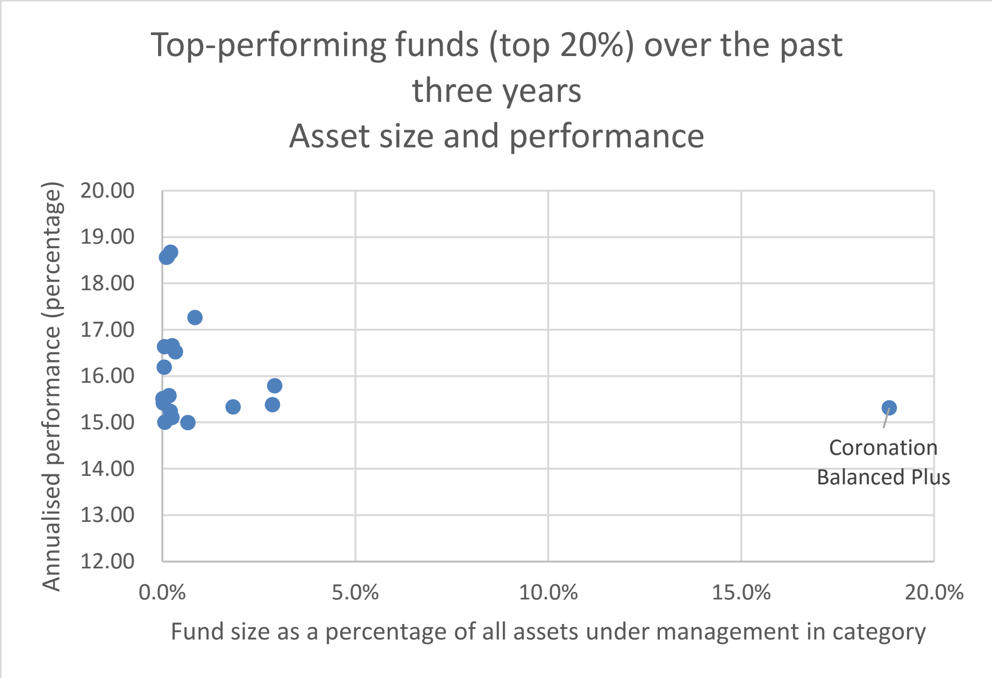
Fund name and class	**One-year**	**Two-years**	**Three-years**	**Five-years**	**Seven-years**	**Ten-years**
Allan Gray Balanced A	3.74	9.42	13.68	13.13	12.75	13.24
Coronation Balanced Plus A	5.93	9.68	15.31	14.11	14.01	14.30
Foord Balanced R	6.59	9.19	13.85	14.34	13.49	13.82
Investec Opportunity R	9.71	10.01	12.76	13.58	12.78	13.51
PSG Wealth Moderate FoF D	6.99	9.81	14.24	13.75		
Discovery Balanced	12.87	13.41	15.79	14.17	13.82	
Prudential Balanced A	7.76	11.25	15.39	14.19	13.39	13.29
Old Mutual SYmmETRY Balanced FoF A	2.96	6.56	10.75	11.03	11.57	11.65
SIM Balanced R	4.32	8.75	12.89	12.44	12.13	12.59
Old Mutual Balanced R	7.34	9.92	13.50	12.85	11.97	12.11
Top 20% of all funds' performance	9.11	11.14	15.00	13.99	13.17	12.64
Median of all funds' performance	6.63	9.41	13.12	12.10	11.57	11.30
Worst 20% of all funds' performance	3.98	7.30	10.68	10.01	10.08	10.10

Source: Morningstar, DRW Investment Research

Note, however, the asset size of a fund can dwindle dramatically as investors will withdraw their funds following a period of severe underperformance against their peers. For example, relatively large funds in the past, like the *Nedgroup Managed Fund* (managed by RECM) and *Investec Value Fund* have experienced heavy investment outflows after protracted periods of dismal performances. Thus, it is not absolutely true that "large" funds always will protect investors against severe underperformance, it is rather that a large fund will remain a large fund as long as its relative performances do not unnerve its investors!

So, who were the top performers of recent investment periods? And does any chance exist that some of these performers will become perhaps the new “large” fund somewhere in the future, i.e. toppling some of the current funds that carry this label?

The three graphs below depict the top quintile (top 20%) performers over three-year, five-year, and seven-year periods for the quarter ended 30 September 2015, given their fund size at the end of this period. Each graph shows the fund size (as percentage of total assets invested in category) on the horizontal axis and annualised return on the vertical axis.

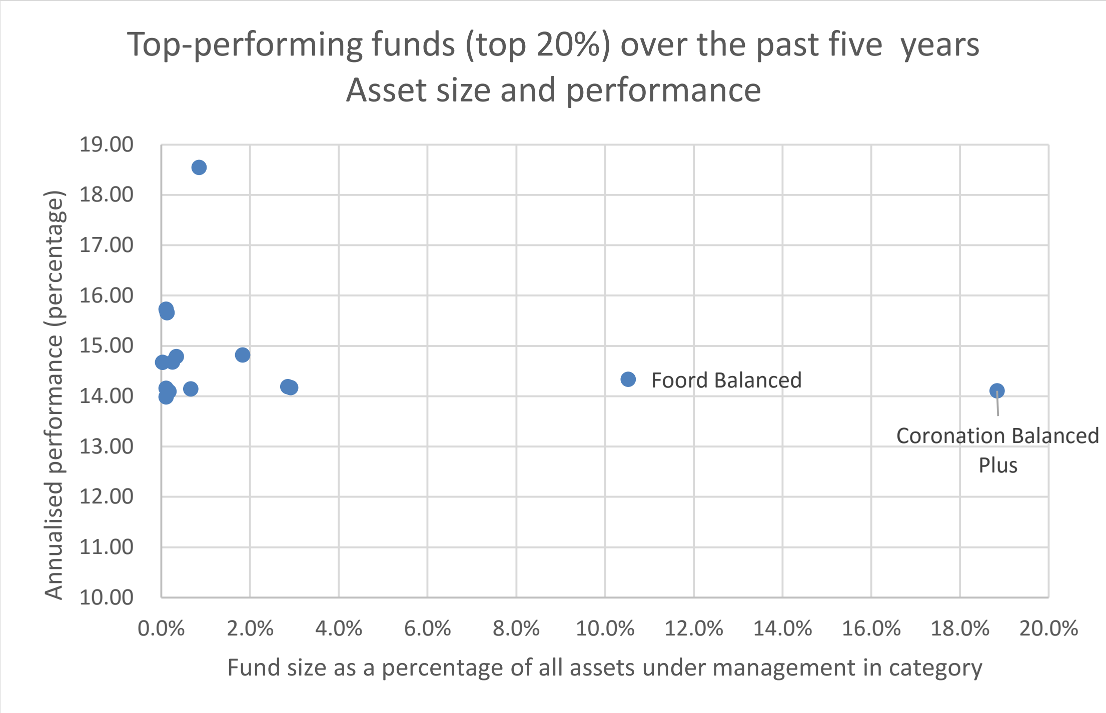


Source: Morningstar, DRW Investment Research

Top-quintile performances over the past three years

Fund name and class	Fund size (rands)	Fund inception date	Annualised return
Truffle Balanced A	937,288,001	2011/10/11	18.67
Rezco Managed Plus A	567,359,959	2010/08/02	18.58
Autus BCI Balanced A	450,296,525	2006/01/03	18.56
Rezco Value Trend A	3,661,939,970	2004/09/30	17.26
Personal Trust Managed	1,088,417,539	2007/08/01	16.66
Grindrod Balanced	236,047,091	2012/03/01	16.64
Momentum Best Blend Balanced FoF B1	1,453,579,235	2007/11/01	16.53
Plexus Wealth BCI Balanced A	191,999,288	2009/06/25	16.19
Discovery Balanced	12,590,660,911	2007/11/06	15.79
SIM Mgd Aggressive FoF A1	735,019,164	2006/08/18	15.58
Contego B3 MET Protected Balanced A	52,351,179	2006/02/01	15.51
MET Odyssey Balanced FoF A	112,700,406	2006/01/03	15.42
Prudential Balanced A	12,324,612,271	1999/08/02	15.39
Investec Managed R	7,906,353,736	1994/02/09	15.34
Coronation Balanced Plus A	81,431,739,404	1996/04/15	15.31
Momentum Factor 7 FoF A	890,498,235	2004/07/01	15.24
Sygnia CPI + 6% B	1,066,617,725	2012/08/15	15.11
Quantum BCI Balanced FoF	290,170,629	2007/03/01	15.00

Source: Morningstar

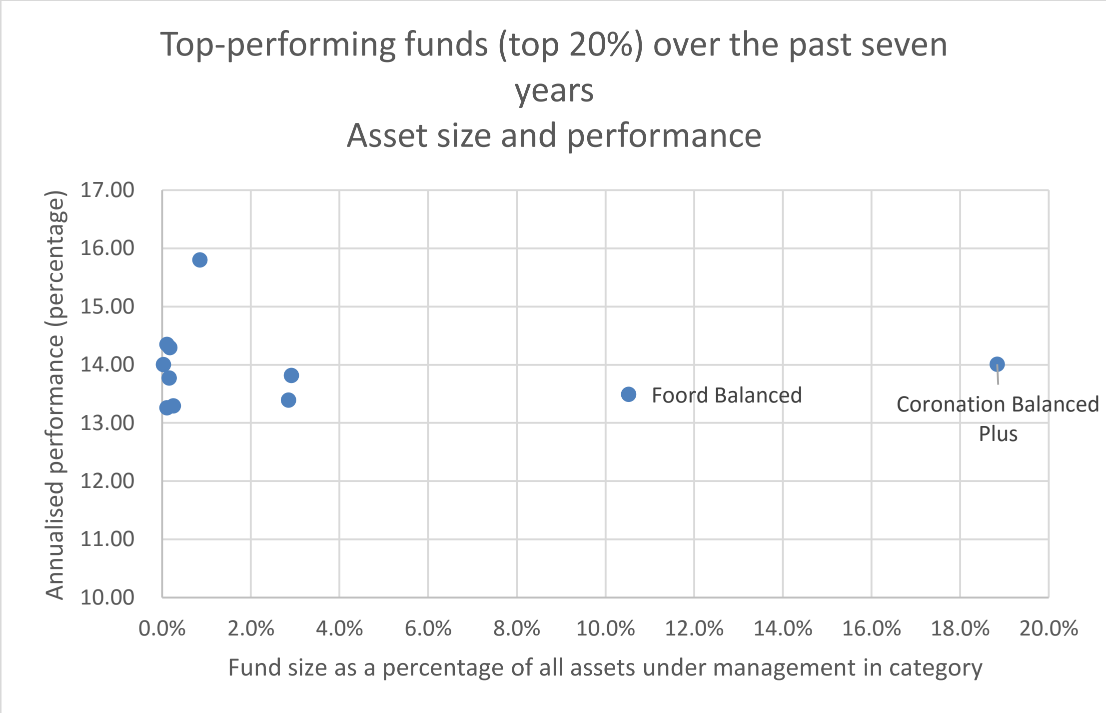


Source: Morningstar, DRW Investment Research

Top-quintile performances over the past five years

Fund name and class	Fund size (rands)	Fund inception date	Annualised return
Rezco Value Trend A	3,661,939,970	2004/09/30	18.55
Autus BCI Balanced A	450,296,525	2006/01/03	15.73
Rezco Managed Plus A	567,359,959	2010/08/02	15.66
Investec Managed R	7,906,353,736	1994/02/09	14.82
Momentum Best Blend Balanced FoF B1	1,453,579,235	2007/11/01	14.79
Personal Trust Managed	1,088,417,539	2007/08/01	14.68
MET Odyssey Balanced FoF A	112,700,406	2006/01/03	14.67
Foord Balanced R	45,497,082,542	2002/08/30	14.34
Prudential Balanced A	12,324,612,271	1999/08/02	14.19
Discovery Balanced	12,590,660,911	2007/11/06	14.17
AS Forum BCI Aggressive FoF	449,927,828	2006/11/02	14.16
Nedgroup Inv Core Diversified B	2,847,201,375	2009/09/01	14.15
Coronation Balanced Plus A	81,431,739,404	1996/04/15	14.11
SIM Mgd Aggressive FoF A1	735,019,164	2006/08/18	14.10

Source: Morningstar



Source: Morningstar, DRW Investment Research

Top-quintile-performances over the past seven years

Fund name and class	Fund size (rands)	Fund inception date	Annualised return
Rezco Value Trend A	3,661,939,970	2004/09/30	15.80
Autus BCI Balanced A	450,296,525	2006/01/03	14.35
SIM Mgd Aggressive FoF A1	735,019,164	2006/08/18	14.29
Coronation Balanced Plus A	81,431,739,404	1996/04/15	14.01
MET Odyssey Balanced FoF A	112,700,406	2006/01/03	14.00
Discovery Balanced	12,590,660,911	2007/11/06	13.82
Southern Charter BCI Growth FoF	691,583,234	2007/10/26	13.77
Foord Balanced R	45,497,082,542	2002/08/30	13.49
Prudential Balanced A	12,324,612,271	1999/08/02	13.39
Personal Trust Managed	1,088,417,539	2007/08/01	13.30
AS Forum BCI Aggressive FoF	449,927,828	2006/11/02	13.26

Source: Morningstar

The *Coronation Balanced Plus* fund is the only one of the "Big Four" funds that yielded exceptional performances over all the above reported periods, the *Foord Balanced* fund achieved a similar feat over the past five- and seven-year periods.

Note that some of the top-performing funds, and relatively small-sized funds, like *Truffle*, *Rezco*, and *Grindrod* have been in existence for only a relatively short period of time, but by no means are these funds managed by managers who may lack any investment experience. Thus, not too much can be read into the *fund inception date*, it is rather a question of who are managing the funds.

Will some of these funds continue to attract investors' monies and become large-sized funds? Yes, it is certainly possible – institutions like *Discovery*, *Sanlam Investment Management* (SIM) and *Nedgroup Investments* have well-established distribution networks and adequate marketing budgets to promote their fund performances. While becoming a large-size fund is a fantastic money-spinning achievement for the fund management firm, investors are not necessarily equally well compensated in the process. Remember, investors mostly make their fund choices based on past performances, and as the fund grows in size it becomes difficult, but not impossible for these managers to identify ongoing opportunities that will make a significant contribution to future fund performances.

The only exception to this rule may be a fund like Nedgroup's *Core Diversified Fund* which follows a low-cost passive investment strategy where fund size growth in all likelihood will lead to lower investment charges, but not affecting the investment opportunity set as the fund seek only to replicate specific market benchmarks.

All in all, it is very likely we will see some changes in the fund size pegging order over the next, say, five to seven years – some funds may lose their mass appeal while others will gain as investors' favourites. That always has been the historical precedent of fund management – that much we know, but not much more!