

Fund selection: When to hold 'em and when to fold 'em

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Market conditions are subject to constant change, influenced by global economic trends, geopolitical events, investor speculation and unforeseen crises. These factors influence fund performance.

Due to external factors beyond a portfolio manager's control, funds that have outperformed in the past year may not necessarily sustain their success in the following year. Choosing consistently outperforming funds is a formidable challenge due to the dynamic and unpredictable nature of financial markets. Portfolio managers often have to take into account many factors that make identifying and maintaining

a winning investment strategy complex, highlighting the challenge of separating genuine skill from short-term luck.

The vast number of funds available provides allocators with many choices, adding another layer of complexity and room for selection error. With numerous options spanning various asset classes, categories, investment styles and philosophies, selecting the right fund requires in-depth research and a thorough understanding of the fund manager's objectives and definition of risk.

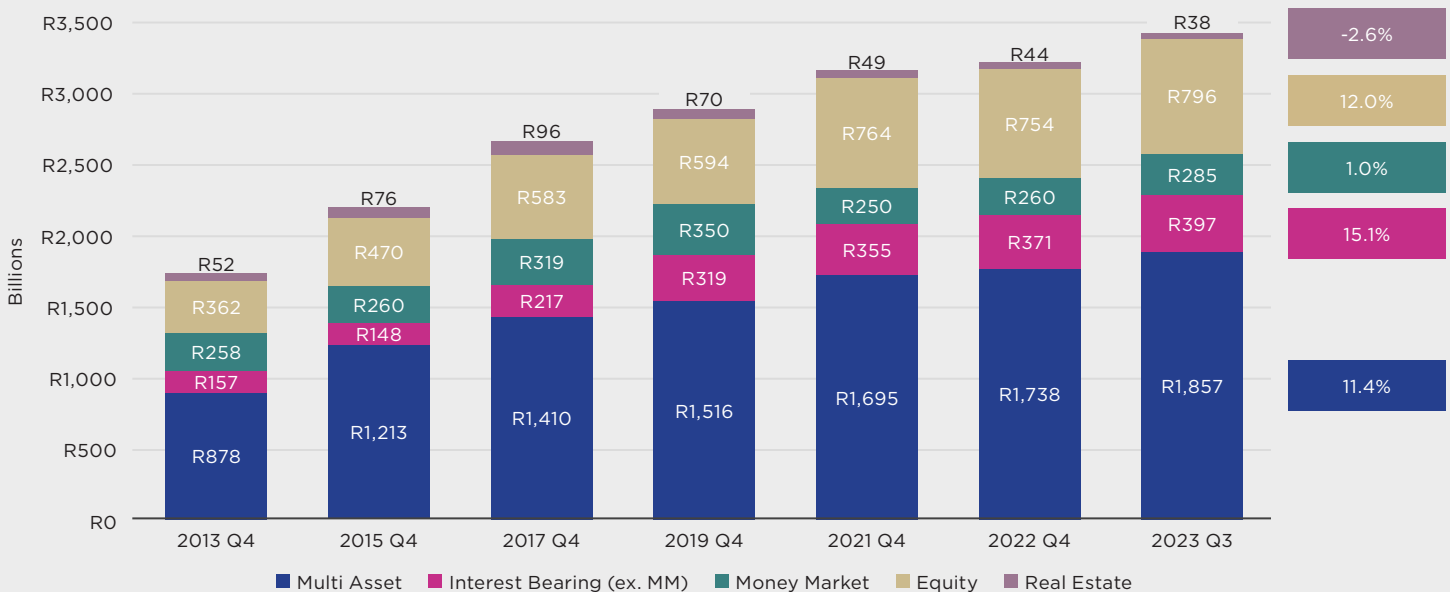
South African Multi-Asset Funds

South African Multi-Asset High Equity (Balanced) funds, characterised by their diversification among multiple asset classes, have played a crucial role in the local investment landscape over the years. Balanced funds typically invest in a blend of asset classes, with risk assets forming the bulk of the allocation over time. They tend to deliver a more stable performance than single-asset-class funds, because of the diversification from investing in multiple asset classes. Research conducted by the Sanlam Investments client research team shows

the dominance of South African Multi-Asset funds from Q4 2013 to Q4 2023 in the chart below. Their total net assets were 48% of the total Collective Investments Scheme (CIS) industry in 2013 and increased to 55% in 2023, with assets under management (AUM) of over R1.8 trillion at the end of Q3 2023. This is an impressive figure compared with the CIS industry total AUM of R3.54 trillion for 2023. Their compounded annual growth rate was 11.4% over this period.

AUM by asset class

CAGR = 9.8%



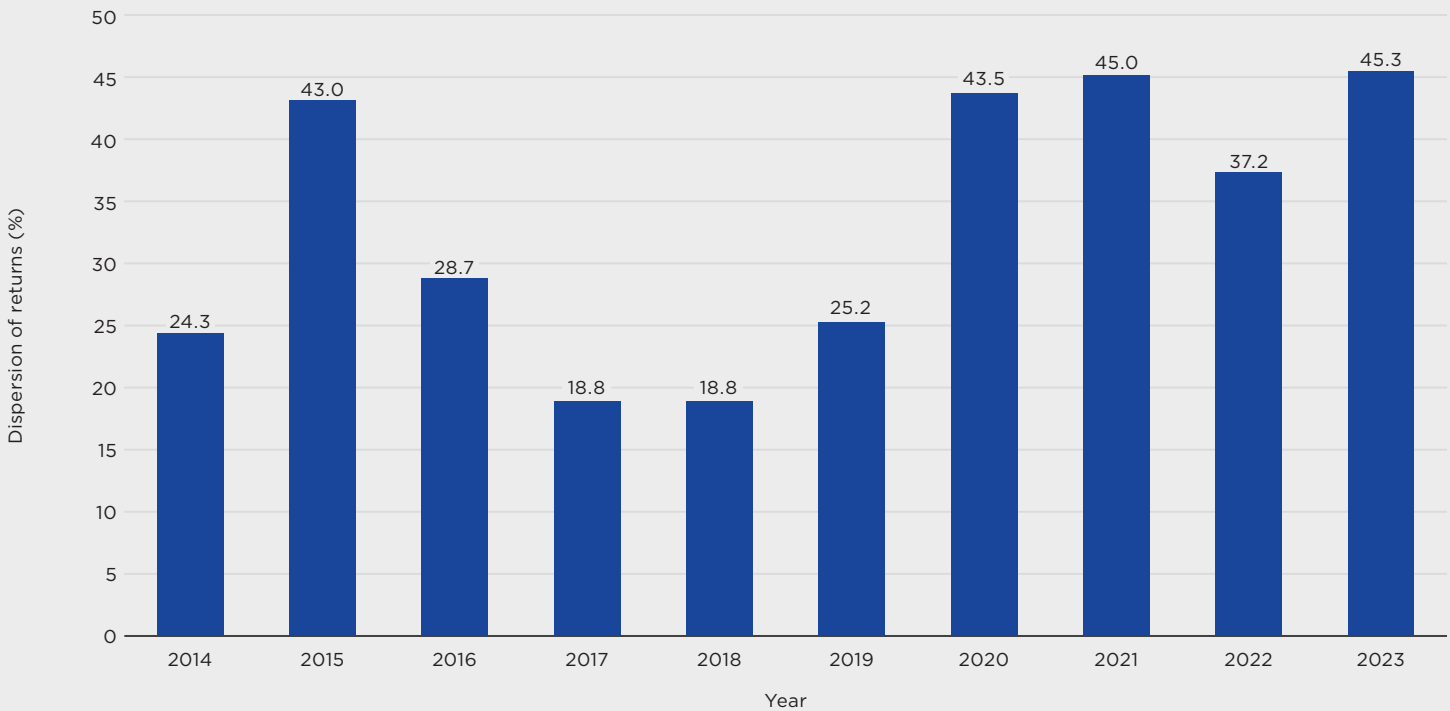
Source: ASISA, Sanlam Investments Multi-Manager, 31 December 2023

Dispersion of returns in the Multi-Asset High Equity category

Although there were positive net inflows into the Multi-Asset High Equity category in 2023, the data shows that there has been an increase in the dispersion of returns among these funds over the past decade. This is clearly depicted in the chart below. The dispersion was vast within each calendar year, as illustrated below: It ranged between 18.8%

in 2017 and 2018, and 45.3% in 2023. 2023's high dispersion could be attributed to the 2022 changes to Regulation 28, specifically the increase in the offshore maximum limit to 45%. This is despite the asset class selection, geographic exposure, position sizing, and style differences within the offshore component of these funds as well.

Calendar year dispersion between best and worst SA MA High Equity Funds



Source: Morningstar, Glacier Invest, March 2024

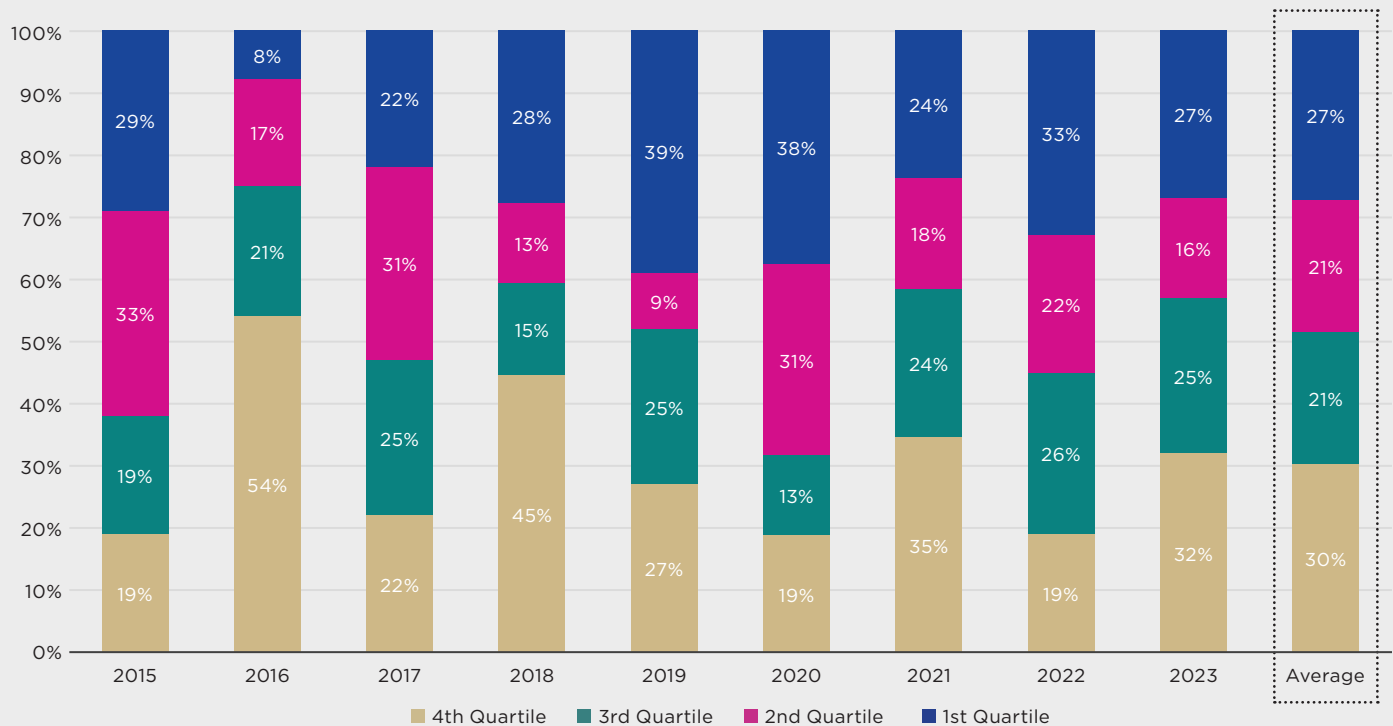


What happened to the top quartile SA Multi-Asset High Equity funds of the previous year?

After observing some cyclicalities among the performance of the managers on our buy list, we undertook an exercise to establish whether being a top quartile performer in one year helps to predict

performance in the following year. The graph below examines which quartile funds moved to the calendar year following top quartile performance in the prior calendar year.

Where did last year's top quartile go?



Source: Morningstar Direct, Dec 2023; ASISA SA Multi Asset High Equity; Primary share class. Calendar year returns

Source: Morningstar, Glacier Invest, January 2024

For example, if we examine the return series for 2023, of the funds which had a top quartile year in 2022, only 27% managed to stay in the top quartile in 2023, while 32% ended in the bottom quartile. Another more extreme example emerged in 2016, when more than half (54%) of funds which were

in the top quartile in 2015 ended up the bottom quartile in 2016. On average, over the past 10 years, there is approximately a 50/50 likelihood that funds will stay in the 1st and 2nd quartiles or move to the 3rd and 4th quartiles in the following calendar year. A coin flip!



Reasons for Multi-Asset fund performance variability over time

A possible explanation for fund performance variability between calendar years, apart from outright error, could be how each fund manager defines risk and towards which investing style they are biased. Each style and strategy bias could generate diverging outcomes at different points of the economic cycle, even within the same fund category. Another reason for performance variability could be changes in key members of investment teams. The cyclical and unpredictable nature of financial markets can also impact fund performance, depending on the asset allocation and definition of risk. Some strategies are focused on tracking error, while others may be more focused on capital protection and absolute returns. Each of these strategies may perform well in different environments

It's all about making informed, rational decisions

The task of consistently picking and sticking to superior funds is further complicated by the influence of behavioural biases, particularly the tendency of investors to succumb to performance chasing. This psychological phenomenon, driven by the fear of missing out (FOMO) and the desire to ride the wave of recent successes, can

persuade investors to make sub-optimal decisions. Performance chasing is fueled by a recency bias, where investors give undue weight to the recent positive performance of a fund, assuming it will persist in the future. The relationship between behavioural biases and the already challenging task of picking funds introduces an additional layer of complexity for individuals.

Allocators who carefully select and blend different strategies with distinct investment styles, each of which is anticipated to outperform over the economic cycle, provide an effective way of addressing these challenges. This approach introduces diversification at the style level, enabling performance to be generated from complementary return sources, with potentially reduced volatility across the economic cycle.

In the end, investors should be able to navigate the emotional pitfalls associated with FOMO and overconfidence to make informed, rational decisions that align with their long-term financial goals. Successful navigation of both market dynamics and behavioural biases is essential for achieving sustained investment success in the ever-evolving fund landscape. While the task of selecting funds and constructing them into a robust portfolio remains a challenge, partnering with the right Discretionary Fund Manager (DFM) could help to create consistent and robust investment portfolios.

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