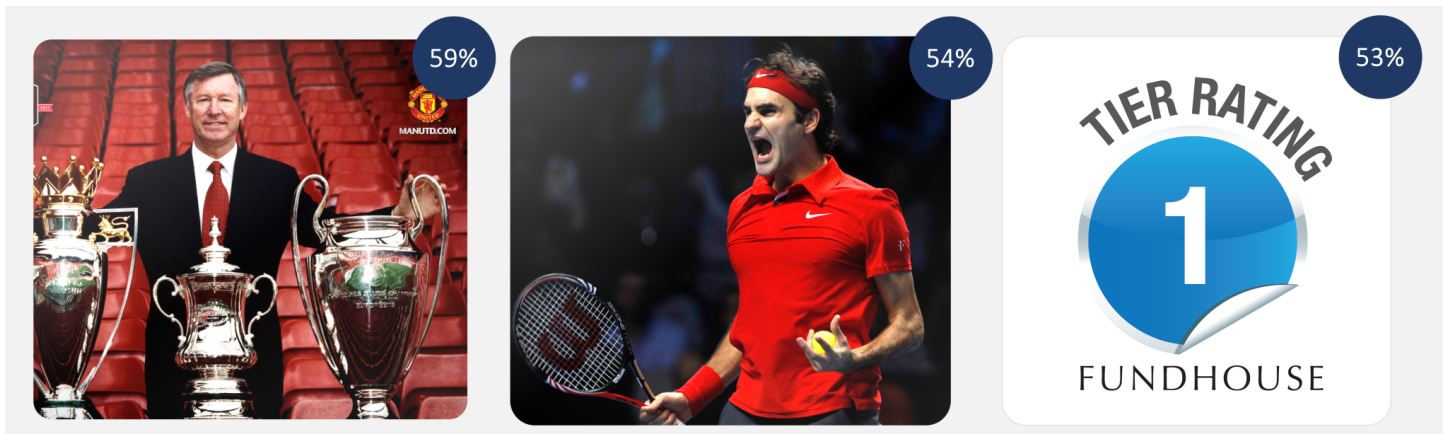


The Importance of Being Wrong

Sir Alex Ferguson is widely regarded as the best football manager off all time. He was the manager of Manchester United from 1986 to 2013 where he won 38 trophies including thirteen Premier League titles, five FA Cups, and two UEFA Champions League titles. One could reasonably expect that he would have won the vast majority of the football matches played over those years. However, the win ratio is only 59% or put differently, he didn't win 41% of the matches he managed.

Another example is Roger Federer. His twenty grand slams are the most by any player in history and he is generally rated as the greatest tennis player ever. Again, one could reasonably expect that he would win the vast majority of the points he has played in his career, but the figure is only 54%. He has lost 46% of the points he has played in his career.

What about the best active fund managers in the world? How many times do they win vs lose? What is their hit rate? An analysis of the global equity fund managers that we rate highly (i.e. Fundhouse Tier 1 rating) shows that only 53% of the stocks selected into their portfolios result in positive alpha or outperformance of the index.



How is this possible? It comes down to winning the big matches, winning the important points and making sure the wins contribute more than the losses.

Investing is a zero-sum game. Even the best fund managers will struggle at times and will lose often. What is important is how they respond to being "wrong" 47% of the time, how they handle these setbacks and whether they learn from their mistakes over time. The mindset of the manager really matters.

Let's consider the example of an active equity fund manager whose fund has underperformed materially for the last 12 months as a result of a number of shares in their portfolio underperforming. These are shares that the manager and their team have analysed in painstaking detail and eventually decided to include in a portfolio. At the time of buying a particular share, the manager is convinced that it would add value to the portfolio over time. A year later and the share price has halved. What now? The portfolio manager effectively has three choices:

- Buy more. At first glance, this would seem the obvious course of action to take. If the manager was convinced before and the share is now 50% cheaper, surely buying more is the best thing to do? But what if the manager was wrong in the first place and is now buying to "prove themselves right"? What if new information has become available that makes the business less attractive to buy?
- Do nothing. The manager could choose to retain the current shareholding if their view is that new data or information means the share is worth less than they initially thought. Or is the manager reacting in fear? Is their conviction in their investment case shaken by the losses made leading to a paralysis to do anything?

- Sell the share. Selling involves admitting that the initial purchase was a mistake. In theory, an easy thing to do but in practice something that many portfolio managers find very difficult. Confidence is a key makeup of a successful fund manager – the trouble is that the shift to over-confidence is not a big one.

All three options could be the correct action to take – the test is whether those actions are followed for sensible, rational reasons or driven by an emotional response to being wrong. It is for this reason that we like to see portfolio managers carrying a few scars, managers who have made mistakes, have gone through periods of underperformance and emerged stronger for it. The portfolio managers that have grown from the errors made and learned valuable lessons are more likely to make the sensible, rational decision the next time around. Fear of failure leads to poor outcomes.

As a result, when we carry out due diligence on a fund manager who has experienced significant short-term under-performance, there are a few questions that we focus on:

- Has anything changed from a business, investment process or team perspective that is having a negative impact on the investment outcome? Is there anything that has happened that should make us question the ability of the manager to manage their fund in the same way going forward? It doesn't mean that any change made is bad, however changes made to try and "fix" the problem are often short-term, emotionally driven calls that end up making things worse.
- Is the business still supportive of the manager and the fund? Are management and shareholders applying pressure following a period of underperformance or is there an understanding of how active asset management works?
- Is there still a culture of debate within the team? The interaction of a team is really tested when things are challenging. The way the decision relating to an individual share is debated following a share price fall is crucial – seeing the lead manager become more autocratic is a clear red flag.
- What actions have they taken within the fund? What have they done with the underperforming shares? We aim to test whether sensible, rational analysis and decision making has been applied at a share level.

We don't have any issues with mistakes – in fact, we believe being wrong is part of the job of managing a portfolio. It is how the business and the team react which gives real insight.

Morgan Housel wrote an article for the Collaborative Fund on 4 June 2019 entitled "Financial Advice For My New Daughter". The piece of advice that struck a chord with me was the following:

'It's OK to change your mind. *Almost no one has their life figured out by age 18, so it's fine if you pick a major you end up not enjoying, or even get a degree in a field that isn't your passion. It's fine if you work in a career and then decide you want to do something else, and it's fine to admit that your values and goals have evolved. Forgiving yourself for changing your mind is a superpower.'*

A personality that allows one to evolve and change as circumstances change or as new information comes to light is crucial. In an ideal world, we are looking for a fund manager who possesses this 'superpower' and uses past mistakes to make better decisions in future.

data provided by Reuters and Datastream

31 May 2019

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	7.1%	2.4%	4.2%	5.4%	12.6%	11.1%	12.2%
FTSE/JSE SA Listed Property	ZAR	0.8%	3.8%	-4.8%	-2.6%	5.9%	12.6%	13.8%	13.4%
SA All Bond Index (ALBI)	ZAR	2.7%	5.3%	7.7%	10.5%	8.3%	8.8%	7.7%	6.9%
SA Cash Index (SteFI)	ZAR	1.8%	3.0%	7.3%	7.4%	7.1%	6.6%	0.2%	0.3%
Balanced Benchmark	ZAR	1.8%	6.8%	6.4%	5.2%	7.4%	12.2%	7.4%	7.8%
SA Inflation (1 month lag)	ZAR	2.3%	2.1%	4.4%	4.7%	5.0%	5.2%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	-0.9%	10.1%	0.3%	9.6%	6.2%	10.6%	11.4%	13.2%
Emerging Markets Equity (Datastream EM)	USD	-4.4%	4.2%	-8.3%	10.3%	2.2%	5.4%	15.6%	17.4%
Global Bonds (Barclays Global Bond Index)	USD	2.5%	3.0%	2.8%	1.5%	0.5%	2.0%	5.3%	5.6%
Global Cash	USD	0.6%	1.1%	2.6%	1.7%	1.2%	0.8%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	7.1%	2.4%	4.2%	5.4%	12.6%	11.1%	12.2%
Global Equity (Datastream World)	ZAR	2.6%	11.4%	15.3%	6.8%	13.2%	17.3%	15.5%	14.3%
Emerging Markets Equity (Datastream EM)	ZAR	-1.1%	5.4%	5.4%	7.5%	8.9%	11.8%	13.7%	13.5%
SA All Bond Index (ALBI)	ZAR	2.7%	5.3%	7.7%	10.5%	8.3%	8.8%	7.7%	6.9%
Global Bonds (Citigroup)	ZAR	6.1%	4.2%	18.1%	-1.1%	7.2%	8.2%	14.3%	13.8%
COMMODITIES									
Gold (US Dollars)	USD	-1.2%	1.5%	-0.3%	2.3%	0.9%	3.1%	12.7%	16.1%
Gold (Rands)	ZAR	2.3%	2.7%	14.6%	-0.3%	7.5%	9.4%		
CURRENCIES									
Rand / Dollar	ZAR	-3.5%	-1.2%	-14.9%	2.5%	-6.6%	-6.1%	15.6%	15.1%
Rand / GBP Pound	ZAR	1.9%	-0.2%	-8.9%	7.1%	-0.7%	-3.5%	16.4%	14.7%
Rand / Euro	ZAR	-1.3%	1.4%	-9.7%	2.5%	-2.4%	-3.6%	14.6%	13.5%

Spot Rates		31-May-19	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	14.56	14.42	12.67	10.58	8.04	6.21
Rand/GBP	Rand	18.34	18.80	16.86	17.76	12.98	9.95
Rand/EUR	Rand	16.22	16.19	14.78	14.44	11.38	6.47
RATES							
Libor 6m \$	US\$	2.52	2.66	2.47	0.32	1.24	5.25
Repo Rate	Rand	6.75	6.75	6.50	5.50	7.50	15.46
Prime	Rand	10.25	10.25	10.00	9.00	12.00	19.00
All Bond Index Yield	Rand	9.46	9.44	9.18	8.54	10.28	NA
COMMODITIES							
Gold (\$/oz)	US\$	1,300.11	1,295.72	1,304.08	1,244.66	959.80	269.95
Platinum	US\$	791.00	850.00	907.00	1,464.00	1,175.00	364.00
Oil (Brent Crude) \$	US\$	64.93	68.55	77.65	110.53	64.87	14.90
INFLATION							
SA Inflation	%	4.4	4.5	4.4	6.6	7.8	NA

Fundhouse is a leading investment adviser specialising in fund research, ratings and portfolio construction services. We help clients manage investments on behalf of the end investor. Our experienced team understands the complexities of the fund management world. We apply this knowledge alongside a client first mindset to improve the outcome for the end investor.

Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.

