Lucky bets and hot hands - Is your fund manager really performing?

by Joop Huij and Dirk Brounen

Congratulations! You are a lucky winner! All too often we receive email messages like these in our inbox and they invariably turn out to be nothing but a scam. But why be lucky? For the manager, the financial equivalent of winning is in outperforming benchmarks or the markets, preferably through the application of skill, insight and experience, not pure luck.

Outperformance, the reputationally enhanced promise of fund managers worldwide, is evaluated empirically at the end of a term. Nowadays, sophisticated asset pricing models are used to disentangle historic relative returns and provide data that enhances our luck and skill. At least, that is what they are designed to do.

Performance evaluation is clearly important since it allows clients to objectively assess the results of their agents. At the same time, these evaluations also generate crucially important lessons for managers about past decisions and thereby yield valuable insights for the future. However, this is only so if the evaluation tools are adequate for such tasks. Even evaluation tools need evaluating from time to time, and this is a challenge that academics are lining up to do.

Recently, in a comparison study of the financial performance of US Real Estate Investment Trust (REITs) mutual funds, we found that conventional performance evaluation does not appear to work[1]. Although real estate used to be an exclusive alternative for a relatively small group of investors, doing so through REITs, real estate mutual funds and private offerings, is now easier than ever.

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Managers of such investments are compensated for the returns they produce relative to a benchmark portfolio. The difference between the return earned by the manager of the mutual fund and the return on the benchmark - known as abnormal return, or alpha - is typically attributed to managerial skill.

Interestingly, our analysis shows that outperforming – creating alpha – is easy in this market; little skill is needed. In fact, to not outperform is a much harder task, at least when applying the standard evaluation tools. Rather than through expertise alone, the source of the success of the real estate fund manager can be attributed to the principle of momentum.

Real estate performance is typically very stable over time, and our analysis shows that this year's winners are very likely going to outperform next year as well. This momentum offers a simple formula for achieving success since it only requires managers to select investments that have done well in the past.

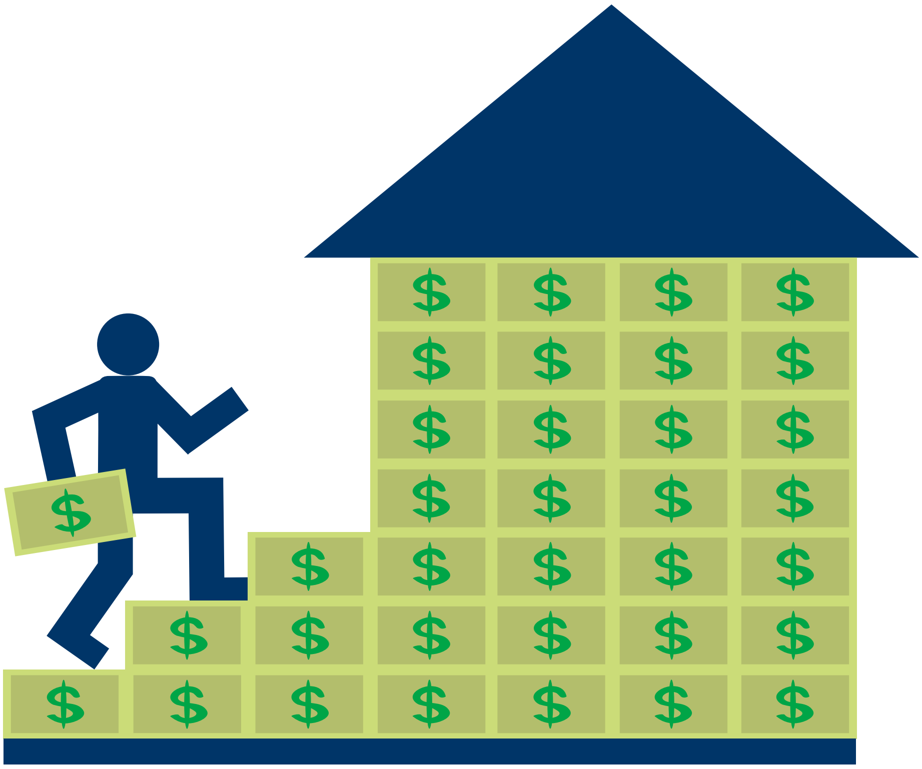
In some business sectors recurring outperformance can of course occur, and managers on such winning streaks are referred to as having 'hot hands'. In financial markets however, genuine recurring outperformance tends to be rare, since simple trends are usually anticipated and accounted for in the evaluation model.

Making handsome returns from momentum alone does not require skill and an old newspaper will provide you with all the inside data you need. By merely chasing the triumphs of last year, and avoiding past failures, real estate fund managers are able to claim the success of outperformance. Through such basic insights and actions fund performance will appear higher than average. However, it is simply the result of buying into existing, but slow moving trends.

We are not the first to document the persistence of returns. In fact, the momentum factor has been incorporated into modern finance ever since research analyst and fund manager Mark Carhart introduced the concept in 1997. The most striking result from our analysis of real estate mutual funds is that this common stock momentum factor, which was explicitly designed by Carhart to capture these trend-following strategies, does not suffice to capture the REIT momentum anomaly.

Genuine outperformance in real estate fund management only occurs when momentum is considered. Our findings show, when given in this context, that only half of fund managers actually outperform, while the rest achieve lower than average results.

Hence, we must categorically state that for the proper evaluation of performance, and to meaningfully differentiate luck from skill, it is essential to re-assess the measurement tools.



Finance literature has a lot to offer on the risks and returns of our investments, but in many markets the dynamics are more specific than the accepted textbook tools tell us.

The specifics of industry performance need to be acknowledged before being incorporated into any evaluation tool, and only then can real winners can be identified. Winning in markets where not everyone wins all the time has nothing to do with luck, or 'hot hands', but really does rest on the quality of your evaluation models. ■

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[1] This study was published in the Financial Analyst Journal, Volume 65 (5), pp. 24-35.