Credit Where Credit is Due

I always dread talking about summer holidays with other members of my profession. What do you say to someone who tells you their poolside reading this year was The Theory Of Value Investing? My first instinct is to marvel at how that is possible in the two hours a day between getting up and opening the first bottle of rosé. But the better side of me gives credit where credit is due, whilst making vague (and, I assume, barely credible) references to how I must get round to reading that myself next year.

In fact, as a consequence of an ill-advisedly early summer holiday this year, I have spent much of the summer pondering how to communicate to our clients how we give fund managers "credit where credit is due": for outperformance that is due to skill. If we cannot distinguish luck from skill we cannot hope to identify in advance fund managers who will outperform. And if we cannot distinguish simple outperforming attributes from skill then we may be paying an active manager a fee for outperformance we can find more cheaply elsewhere.

One of the biggest areas where this challenge is prevalent within the U.K. Equity sector is mid cap investing. About 80% of the value of the FTSE All Share is in the biggest 100 companies, the FTSE 100. About 15% of the value is in the next 250 companies and just about 5% in the remaining, smaller still companies. The vast majority of funds in the U.K. equity sector are heavily overweight middle sized (FTSE 250) companies compared with their FTSE All Share benchmark. Over time, this typically leads to strong outperformance as these mid cap companies typically outperform large cap companies. This gives funds overweight these companies a strong performance tailwind.

The cynics' argument is that having an overweight to mid-caps isn't skill. Most investors in this space know that mid-caps have outperformed large caps for two years out of every three since 1955 thanks to their earlier lifecycle stage and ability to challenge (large cap) incumbents with disruptive growth. Indeed since 1994 UK mid cap companies have grown earnings on average by 8.4% p.a. vs 3.2% for the average FTSE 100 company. Thus a fund manager with a large overweight to mid-caps will, all other things being equal, outperform a manager without over a market cycle, without any difference in manager skill. Given mid-caps are also on average more risky than large caps, why should we judge the outperforming fund "better" or more likely to outperform in the future? After all, if a fund manager sold 50% of their large cap stocks to buy a FTSE 250 ETF, that fund would probably outperform, but few of us would think this outperformance was due to manager skill!

Mid cap exposure may provide additional benefits. Companies in this market segment are more diversified by sector and income than the FTSE 100 and the vast majority of company research is focused on the larger companies, leaving an opportunity for more mis-pricing and stock selection skills in the mid cap space. After all, the best performing FTSE 100 stock over the last year has returned +86% whilst the worst has lost you 40%. In the mid cap space the numbers are +352% and -77% respectively.

We therefore spend a lot of time trying to adjust a fund's track record for structural overweights to mid-caps (and other structural differences for that matter, such as a yield focus, or a style or a geographical bias) that might account for outperformance that is therefore either not due to skill or is not necessarily repeatable in the future.

We tend to give more credit to managers who vary the market cap mix of their funds rather than keeping it static, the latter perhaps being a sign of a manager looking to "ride" mid caps' long term outperformance. After all over time there have been long periods where large caps have been cheaper than mid-caps. There are times when the UK's large cap companies offer better prospects in aggregate than its mid-caps. A poorly performing U.K. economy with further sterling weakness might well help the U.K.'s larger companies with their more international revenue streams. A good fund manager may know to be overweight mid-caps over the cycle, but not overweight mid-caps throughout the cycle.

On most risk-adjusted measures over the long term mid-caps are superior to large caps; they are riskier but you are more than compensated for that with higher returns. Mid-caps provide diversification and more opportunity to add value through stock selection skill. For these reasons alone we understand the value of being overweight mid-caps. But the crucial analysis for us to undertake is to assess the fund manager's willingness and ability to invest and to add value in stock selection across the market cap spectrum. Finally not only can sheep recognise up to 50 other sheep faces and remember them for 2 years, but they can also recognise human faces. This week on this day in 1893, which country became the first to introduce registration for motor vehicles?

In other words: credit where credit is due.
Andrew Summers
Head of Collectives

FTSE 100 Weekly Winners

Coca-Cola HBC AG	10.4%
Worldpay Group	9.8%
Fresnillo	6.5%
Randgold Resources	5.3%
Persimmon	1.5%
Associated British Foods	1.5%
Barratt Developments	1.1%

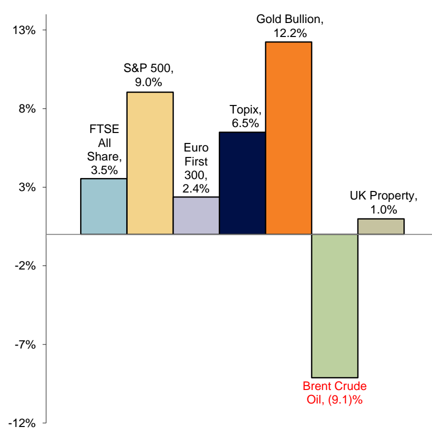
Source: FactSet

FTSE 100 Weekly Losers

G4S	-10.1%
InterContinental Hotels Group	-8.5%
Paddy Power Betfair	-8.4%
Standard Life	-8.1%
BT Group	-7.1%
Pearson	-6.1%
Standard Chartered	-6.1%

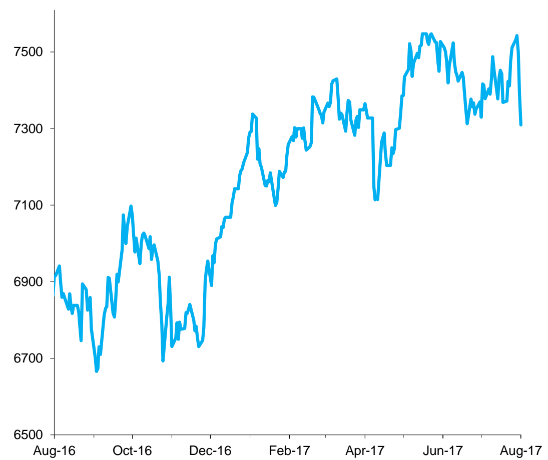
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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