Media Comments on 'Performance Persistence in Mutual Funds' by David Blake & Allan Timmermann

FSA U-turn on fund performance data, by Pauline Skypala, Financial Times: Companies & Markets, April 7, 2003

The Financial Services Authority has been forced to rethink plans to restrict the use of fund management performance data by an independent report contradicting some of its key conclusions, and by European Union regulations.

The UK financial regulator, which has consistently refused to include past performance figures in comparative data for consumers, will be embarrassed by the U-turn. It follows a study it commissioned from leading academics to assess earlier research.

It is also consulting on proposals to comply with an EU directive on collective investment schemes by including standardised performance information in the documents provided to consumers by fund managers.

The new research - carried out by professors David Blake of Birkbeck College and Allan Timmermann of the University of California - challenges the FSA's view that statistics on past performance are irrelevant to investors choosing funds.

Their report says there is a case for the FSA to include past performance data in comparative information. But - contrary to arguments by fund managers - this is not because of any evidence that superior performance persists, but rather because poor performance does so.

"The really important message to come out of this is that losers repeat," Professor Blake said. He warned that consumers could be disadvantaged if the FSA does not provide past performance information drawing attention to persistent under-performance.

The report, which will be published on Tuesday, says the FSA should publish performance data with a 'health warning' that "losers generally repeat while winners do not necessarily repeat".

"We believe it is important for investors to have easy access to reliable information on underperforming funds so they can modify their investment strategies accordingly," the report says.

It claims that if investors have such information, poorly performing funds would be closed down or merged more quickly and at a lower cost to investors than if they were to switch to better performers themselves.

The FSA has always maintained that past performance is not a useful indicator of future performance, and has refused to include past performance data in its internet-based comparative tables. Funds are ranked on the basis of their costs alone.

The report supports the FSA's view that charges are very important determinants of fund performance, finding that under- performing funds are those that have no fund manager ability but do have high charges.

But it does not accept the argument that information should be withheld because investors might 'misuse it'. The report concludes: "It is not clear that investors are protected from a failure to expose the performance of poor fund managers." It says that the worst outcome would be to leave the decision on what past performance information to publish in the hands of fund managers, because they are more likely to publish information on the best performing funds.

Despite the negative slant on performance persistency, fund managers welcomed the report's main conclusion.

Richard Saunders, chief executive of the Investment Management Association, said: "If it supports the inclusion of past performance information in the FSA's tables, I would regard that as a welcome endorsement of what we have been saying for some time

U.K. Fund Report Challenges Regulator on Performance Disclaimer, by David Clarke, Bloomberg Edinburgh bureau, 7 April 2003

A report commissioned by the U.K.'s Financial Services Authority said a fund's past performance may be an indication of future returns, challenging the regulator's own rule banning firms from making predictions.

Research demonstrates that poorer-performing funds tend to keep up below-average results, two academies said in a report. The FSA has requires companies to say that past success won't necessarily be repeated in the future.

``Poor performance on a risk-adjusted basis tends to be repeated, which indicates it's the poor skill of the fund manager," David Blake, a professor at Birkbeck College in London, said in an interview. He wrote the report with Allan Timmermann from the University of California in San Diego.

The FSA wants to ensure that customers receive proper information when they buy investment products. It's investigating split capital trusts and some high-income bonds because of allegations that they were sold with promises of certain returns.

The regulator commissioned the study after a report from the U.K.'s Investment Management Association, which represents fund companies, said past results may indicate funds' future returns.

That report didn't take into account fund risk, which was mainly responsible for the performance of the above-average funds, Blake said in an interview.

The Financial Times reported details of Blake's research earlier today. FSA spokeswoman Kate Bristowe declined to comment on the report and said the regulator will publish and comment on the findings tomorrow.

Clients rely on past performance, FT Adviser, 10th April 2003

Research commissioned by the FSA has dealt a blow to its conviction that past performance should not influence consumers.

Independent analysis by Prof David Blake, of Birkbeck College, University of London, and Prof Allan Timmermann, of University of California, backed the inclusion of past performance data for comparative tables. The analysis confirmed that performance tables would highlight a manager's continuous underperformance and concluded that comparative fund performance should use risk-adjusted data.

The FSA had asked the professors to conduct their research on a different set of data, compiled in 2002 by Charles River Associates on behalf of the Investment Management Association, that raised questions over evidence of persistence in mutual fund performance.

However, the academic research supported the case for presenting consumers with past performance. The research stated: "The findings on mutual fund performance have persuaded us that there is a good case for the FSA publishing risk-adjusted past performance data in the comparative tables. [This is] not because we believe that superior risk-adjusted performance can be sustained but because poorly managed funds can be exposed more quickly."

The report revealed that the benefit to investors would be the rapid closure or merger of poorly performing funds with successful funds at a lower cost to investors. The FSA confirmed it "would consider the implications" of the analysis and would "encourage further work" to inform policy decisions.

Learning from the past, by Kevin Brown, FT Your Money; Apr 11, 2003

In the teeth of all the evidence, it has remained an article of faith in the fund management industry that funds that have been successful will continue to do well - in other words, that past performance is a good guide to future performance.

For fund managers, this is a vital issue. In a crowded market - there are about 2,500 competing unit trusts - the idea that investors need look only at past success to see where to put their savings is a powerful marketing tool.

Over the years a number of reviews have concluded that there is little, if any, evidence to back this up. So the industry was understandably heartened by two studies commissioned last year from Charles River Associates by the Investment Management Association.

The Charles River findings suggested that there was strong evidence of persistence over a variety of investment horizons. The report also asserted that these findings remained true even after accounting for charges, survivorship bias (the fact that really poor funds are killed off and so disappear from the calculations) and other variables.

On the basis of the report, the IMA asked the FSA to change its policy of not including performance data in its own comparative tables. This would be an important change, because it would also legitimise the use of past performance figures in advertising.

Sadly for the IMA, however, the Charles River findings have been torpedoed by a report commissioned by the FSA from Professor David Blake of Birkbeck College and Professor Allan Timmermann of the University of California.

Professors Blake and Timmermann point out that Charles River used raw returns, unadjusted for risk, which means that apparent performance persistence reflects funds' risk exposure rather than the skill of the fund managers.

This is because high-risk funds are more likely to be top performers, particularly in the long run, because of the equity risk premium investors demand as the price of buying shares rather than gilts. As the professors point out, if performance persistence merely reflects risk, investors can achieve the same returns at lower cost by using a tracker fund and gearing up.

But the professors also come to a more surprising conclusion. This is that there is indeed "fairly strong" evidence of persistent performance after adjusting for risk, but only in relation to poorly performing funds.

The risk-adjusted evidence of persistent positive performance is "much weaker", they report. In other words, past performance can help you to spot a dog, but not to hitch your wagon to a star - the exact opposite of what the fund management houses like to claim.

This is of crucial importance, because it casts a further shadow over the use of positive performance data to encourage people to invest. "If mutual funds are left to advertise past performance figures on their own, and are free to choose the way in which they do so, this is unlikely to bring as much attention to past underperformance as would seem appropriate given its persistence," the professors note rather drily.

Alan Burton, chairman of the IMA, tells FT Money in an interview on our back page that the industry is winning the battle over performance figures because the FSA is considering a standardised measure of performance for use in advertising.

For the industry, this would be a big prize. But a victory for the industry will not necessarily translate into a good deal for consumers. To ensure that it does - or, at least, that the investing environment does not become even more confused - the FSA must do two things.

First, it must ensure that the standardised benchmark it devises for performance advertising is risk adjusted, set over a lengthy timescale, and reflects variables such as charges, the survivor effect and the tendency of fund managers to move around.

Second, it must swallow its reluctance to include performance figures in its comparative tables. Senior officials' scepticism about performance figures reflects the best of motives. In line with most of the academic literature, they think that past performance is of little value, that retail customers cannot effectively exploit the information and that it is potentially misleading.

But all these caveats reflect reports that concentrated on above-average performance persistence. As Blake and Timmermann have shown, the real value of performance statistics lies in their ability to identify below-average funds. Since the industry will not give that information to consumers, it is quite clear that the FSA should.

One more thing needs to happen. That is that investors need to ignore the advertising noise and make their own inquiries. The FSA tables at *www.fsa.gov.uk/tables/index.jsp* are already a good source of comprehensive and independent information. Robust performance statistics would make them even more useful, but take a look before you sign your next investment cheque.

Funds in focus: How to gauge returns against the real risks, by Richard Miles, The Times, April 12, 2003

WILL the row over the use of past performance data ever end? The latest salvo in this increasingly bitter debate was fired this week by the Financial Services Authority (FSA), the chief investment watchdog.

It has commissioned a pair of academics to pick apart an earlier study by the Investment Management Association. To no-one's surprise, the IMA's research had concluded that past performance was relevant to investment decisions.

The two professors hired by the FSA, however, argued that the IMA's use of "raw data" meant that its conclusions were less than solid. Instead, they said it is necessary to use "risk-adjusted" performance figures in any comparison of funds. In other words, investors need to understand what risks a fund manager is taking with their money to achieve a return. But this is easier said than done, not least because a fund manager's attitude to risk does not remain constant. Like the odds on a horse, the betting changes along with the conditions of the course.

Many savers know too well the danger of a failure to track the risk-profile of a fund manager. In the late 1990s, funds presented as mainstream investments turned out on closer inspection to be technology-laden portfolios. When the bubble burst, they collapsed.

By a lucky coincidence this week also saw the publication of a league table that does help savers to gauge the risks taken by their fund manager. RiskMetrics, a firm of investment analysts that sprang out of JP Morgan, the US banking giant, issued the update of their best and worst funds measured on a risk-adjusted scale.

RiskMetrics has examined the performance of all UK unit trusts in an attempt to assess whether the returns adequately reflect the level of risk taken by the fund manager. In theory, the higher a risk, the higher the returns. But even in supposedly conservatively-run portfolios, the manager sometimes turns out to be a chancer.

To get a handle on the consistency of the risks undertaken by the manager, RiskMetrics examines the returns over five years, measured on a rolling quarterly basis. It then publishes only the names of the worst and best funds in four categories: conservative, balanced, growth and aggressive portfolios.

It is reassuring to see that some of the public's favourite funds win the top accolades. Fidelity Special Situations, the £2 billion portfolio of Anthony Bolton, ranks as one of the best growth funds. So do Credit Suisse Income, Discretionary, GAM UK Diversified, St James UK & General and two Rathbone trusts.

Far Eastern funds dominate the aggressive league table, a reflection of their ability to hold on to their gains. Again, some of the public's favourites feature strongly: Schroder Tokyo, First State Asia and Aberdeen Asia Pacific, as well as JPMF Natural Resources.

More surprising are the funds that earn the brickbats. No fewer than ten funds have the ignominy of being judged the worst in the conservative field. Four of these are UK funds with some form of capital protection.

They are: Edinburgh Safety First, Gartmore Safeguard, Govett UK Safeguard and Scottish Widows Safety Plus. The last is the biggest, at £242 million, and typifies the group: savers are vouchsafed the return of 95 per cent of their capital in any 12-month period.

The clear implication of their appearance in the "worst" category is that this type of protection is too expensive. All four of these funds show a before-charges loss over five years. The Widows fund has contracted by 5.6 per cent, while Gartmore's takes the biscuit with a loss of 8.2 per cent. A five-year fixed rate cash deposit would have proved to be far better value.

Mike Thompson, risk strategist at the firm, is eager to emphasise that these evaluations are not "predictive": they are no guarantee of future value for money. "They are not an end-all valuation, but a nice complement," he says.

Other important factors are neatly summed up by SEI Investments, a US firm specialising in multi-manager portfol-ios. It says investors need to ask who achieved the returns: was it a team or an individual, and will that team or individual continue to manage your portfolio? Equally, is the firm itself stable? All good questions. But for savers nursing heavy losses after a three-year equity bear market, the dispute over past performance data must seem something of an irrelevance.

FSA report: History can be guide to the future, by Alistair McArthur, The Scotsman, Apr 12, 2003

A REPORT for the Financial Services Authority (FSA) has concluded that past performance can be used as a guide for the future.

The watchdog currently insists financial products carry a warning that past performance is no guide to the future.

But there are provisos. The authors, Professor David Blake of Birkbeck College, University of London and Professor Allan Timmermann of the University of

California, San Diego, analysed past performance of investment funds and concluded: "There is a reasonable case for arguing that risk-adjusted past performance data should be included in the FSA's comparative tables."

They added that if past performance was used, it should be adjusted to reflect how much risk fund managers took, as high risk funds generally had higher returns.

"It is far better for the FSA to publish past performance data on a risk-adjusted basis for all funds and to give a health warning," they said.

The FSA welcomed the analysis for its contribution to the past performance debate and said it will carefully consider the implications.

Investment commentators point out that past performance cannot be ignored, but equally that it should not be relied upon.

Past performance back in the reckoning? A new report suggests that the history of a unit trust does have a bearing on its future. But the FSA is unmoved, writes Paul Farrow, Sunday Telegraph, 13 April 2003

The Financial Services Authority is to resist calls to include past performance in its unit trust league tables, despite the findings of a report that it commissioned.

Michael Schumacher won often in 2002, but has yet to win a race in 2003

The report, by David Blake of Birkbeck College and Allan Timmermann of the University of California, suggests there is an argument for including past performance in the FSA's comparative league tables.

But the FSA has poured cold water on speculation that these latest findings would force it to reverse its original, controversial decision to ignore past performance when assessing the relative merits of unit trusts, investment trusts and Isas.

The FSA tables were introduced a couple of years ago to help consumers pinpoint the best unit trusts, mortgages and stakeholder pensions, judged by price and flexibility.

The exclusion of information about past performance angered fund managers, but the regulator argued that no one had ever been able to demonstrate a meaningful correlation between past and future performance.

This assertion was like a red rag to a bull to the Investment Management Association, which promptly enlisted the help of Charles River Associates, the economic consultancy, to find the evidence.

Last November, CRA published research purporting to show that previous top-performers had a better-than-average chance of repeating their success. But the FSA was sceptical and asked Blake and Timmermann to subject the report to a thorough examination.

Blake and Timmermann decided there was a reasonable case for the inclusion of past performance data in the FSA's comparative tables but, crucially, that this should be done on a "risk-adjusted basis". This meant taking into account the relative risks associated with the underlying investment strategy of each fund.

They did not consider the conclusions of the CRA report to be very helpful because they were based purely on straight past performance. By ignoring risk, investors could be steered unwittingly into higher-risk funds, they said.

"On average, the funds that take the greatest risks deliver the best returns over the long term, while lower-risk funds tend to produce lower returns," says Blake. "But that doesn't make higher-risk funds better funds."

Using "raw" performance figures would encourage investors to hold more funds with higher-risk profiles. "You might as well say 'invest in high-risk funds and hope for the best' since, if you hold them for long enough, it generally works out," he says.

Where past performance can help is in identifying the underachievers. "There is fairly strong evidence of persistence of negative performance, but much weaker evidence of persistence in positive performance. Past performance won't help you pick out the winners, but it could certainly help you avoid the losers."

The FSA is unmoved by the new findings. It says risk-adjusted performance using a mathematical formula would be of no real use because the consumer is likely to be even more confused. An FSA spokesman says: "How would you explain the formula used to demonstrate risk in 50 simple words on a website? The report will serve as another piece of information to be taken into account, but I don't think we're minded to include past performance in the league tables. We're still to be convinced."

Members of the financial services industry admit that past performance is no guarantee of future success, but reckon it should still be used as an indicator when picking a fund.

Most investment professionals consider performance, although looking at separate figures over a series of discrete years is generally considered more meaningful than a single figure covering several years. The top-selling Fidelity Special Situations fund, for example, has grown by 26 per cent over the past five years, but produced negative returns in two of the five.

"Both reports miss the point," says Simon Ewan, managing director of SEI, a portfolio manager. "Performance, whether in terms of raw returns or risk-adjusted, should only ever be one of the criteria of an informed decision about managing your money. It should never be considered alone."

Investors should ask themselves a couple of key questions before choosing a fund, he says. Check how the performance was achieved and, on that basis, decide how much it was due to luck, and whether it is sustainable. Second, find out whether the returns were achieved by a team or an individual - and, most importantly, whether those responsible are still in situ.

Top-performing managers are often poached by rivals - more than 100 fund managers jumped ship in the past 12 months - so you should always keep a close eye on who's running the fund.

HSBC, for instance, is running advertisements trumpeting the success of its European Growth and UK Income & Growth funds over the past five years. What the adverts fail to tell investors is that the principal fund managers, Chris Rice and Tim Russell, moved to Cazenove less than six months ago, along with several members of their teams.

The FSA will shortly publish new rules governing financial advertising aimed at reducing the danger of misleading investors.

In the past, investment companies tended to emblazon billboards and marketing literature with mouthwatering figures, typically showing how well the funds had done between carefully-chosen dates. Ironically, falling stock markets over the past three years have clobbered performance, forcing companies to abandon the practice for the time being.

The FSA has proposed banning companies from using performance figures as the principal message in adverts. It also wants them presented in a standardised format.

Although the rules have yet to be finalised, the FSA has already made it clear that it will not tolerate misleading adverts. Only last month, it fined DBS Financial Management network £100,000 for making false claims in an ad for a "protected Isa".

The adverts were found to have misled potential investors about the level of capital protection. They also promised there was no initial charge when, in reality, there was an initial charge of up to 6 per cent and an annual fee of up to 1.25 per cent.

The FSA is keen for investors to tell them about companies they consider to be running misleading adverts, either via its internet site (www.fsa.gov.uk/consumer) or by calling 0845 606 1234.

Risk-adjusted figures a good guide, by Simoney Girard & Sam Dunn, FT Adviser, 14th April 2003

New research backing the relevance of past performance figures has upped the ante for the fund management industry.

Analysis commissioned by the FSA proposed that the City regulator should include past fund performance data in comparative tables for marketing – a move backed by investment houses – but recommended that it be adjusted for each fund’s level of risk.

The report conducted by Professor David Blake, of Birkbeck College, University of London, and Professor Allan Timmermann, of University of California, said that risk-adjusted information would reveal persistent underperformance and force through change, closure or even fund mergers. Consequently, the research said, this would be in investors' interest since underperforming funds offered comparatively high costs and charges in the face of poor returns.

Retail fund managers could find themselves open to greater scrutiny. The report said such a case had been made "not because we believe that superior risk-adjusted performance can be sustained over long periods, but because poorly managed funds can be exposed more quickly".

Significantly, the research warned that earlier research commissioned by the Investment Management Association focusing on what the FSA called raw, or absolute, returns that did not take fund risk into account, had been flawed and any implementation of such proposals would mislead investors. It said: "High-risk funds are more likely to be top performers (particularly in the long run) while low-risk funds are more likely to be among the worst performers. Performance figures based on raw returns are likely to induce investors to hold more mutual funds with high risk and fewer mutual funds with low risk, regardless of whether returns generated by these funds are justified by their level of risk exposure."

However, Richard Saunders, chairman of the IMA, suggested risk-adjusted returns would pose more questions than it answered. He said: "It is beyond most advisers and clients to decide the best way to calculate a risk-adjusted returns relative to the absolute returns, as how one measures that is open to question."

Investment: Come on FSA, join the real world - Performance tables really do matter, says a report to watchdog from its own academics, by Jonathan Davis, The Independent, Apr 19, 2003

No serious person I have met in the investment business thinks the Financial Services Authority (FSA) has covered itself in glory with its high-minded and frankly nonsensical opposition to the use of past- performance figures in the promotion and analysis of investment funds, a policy with which John Tiner, managing director of the FSA's consumer, investment and insurance directorate, has unavoidably been associated.

By refusing to include any past-performance figures in its own comparative tables on funds, the FSA has made itself look stupid, albeit (as so often with well-intentioned regulation) for the best of motives.

Two things that can be said with certainty about past-performance figures for unit trusts and other managed funds are (a) that there is precious little predictive value in them; and (b) that many investors buy funds on the assumption that past records are a sensible guide to how well they will do in the future.

In this latter behaviour, they are aided and abetted by the fund management industry, which has long used performance figures as a key part of its promotional and marketing material because, whatever academics may say, they do seem to work in influencing investors, and especially IFAs/advisers, on the funds they should be buying.

The trouble with the FSA's approach is that, in its manifest desire to protect consumers from themselves, it has boxed itself into the position of saying that because the information about past performance has no predictive value for future performance, it has no value when consumers come to buy a fund. Sadly, the second position does not follow logically. In pretending it does, the FSA looks grossly out of touch with the real world.

Now, after a painstakingly long time in which the industry and FSA have traded research papers criticising each other's position, the argument seems to be edging forward. The latest report by the FSA was published last week.

The authors, Professor David Blake, of University of London, and Professor Allan Timmermann, from the University of California, make useful and constructive points, despite having been hired, one suspects, to do a hatchet job on a consultants' report commissioned last year by the Investment Management Association.

To nobody's surprise, the academics do find the Charles River Associates report is full of logical and evidential holes, as you would expect given the evidence for persistence in fund performance is almost all against the idea that performance does persist in a consistent or predictable way. But the new report also concedes points to the industry's arguments.

For example, one of the authors confesses to having been won over by the evidence that, while better-performing funds tend not to remain superior performers over time, the same may not be true with poorly performing funds.

Funds that act like dogs have an above average chance of being dogs again, information which the academics concede may well be of genuine value to investors, if only so they can know what to avoid. They say the comparative tables published by the FSA should contain data on performance figures.

But their argument is that the data which should be included is not "raw returns", but risk-adjusted performance figures, those that adjust the returns achieved for the level of risk the fund manager has adopted. There are well-established formulae for calculating this, and the information is widely available and widely used in the data services favoured by most professional advisers.

Professors Blake and Timmermann conclude, tellingly: "We are not persuaded that important information should not be published just because it might be misused. It is not clear that investors are protected from a failure to expose poorly performing managers." It will be interesting to see whether the FSA rises to the challenge of being told they have got it wrong.

What ordinary investors would make of risk-adjusted returns in another matter. Risk has always been the missing ingredient in most fund promotion.

Statistical analysis, the academics say, can be used to provide a range of possible outcomes a fund is likely to achieve, assuming it continues to be run in the same way. (On a somewhat similar basis, this is how the Bank of England presents its range of forecasts for future inflation in its regular inflation reports.)

The final point that the report makes is a more subtle argument for tracker funds. The authors say that, rather than putting, say, pounds 1,000 into a high- risk and high-cost actively managed fund, investors can often achieve the same risk-return exposure more cheaply by borrowing a little money (say pounds 150) and investing the original cash and the borrowed money (pounds 1,150 in this case) in a tracker fund.

This is true, though one has to say it is a strategy that few financial advisers in my experience show any wish or capacity to understand, since it requires a knowledge of financial theory that few possess.

IT IS not clear whether the stock market is going to end this year higher or lower than last year, though my hunch is that it will be the former. Ken Fisher, the American money manager, told me that when the market does recover from a secular phase like the recent bear market, it tends to do so sharply. His figures show that markets often make what he calls big moves (up more than 20 per cent or down more than 20 per cent).

The dull, flat years are the exception, not the norm. Since 1926, the UK market has risen by more than 20 per cent in a year more than one year out of three. Only 40 per cent of the time does it produce a return of between zero and 20 per cent, and my guess is that this year is not going to be one of them, regardless of whether we are still in a secular bear market or not.

If the market does fall sharply from here once more, which is also possible, then the rebound when it comes will be bigger still.