Past performance doesn't equal future returns, past skill might

Investor Strategy News

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Historical investment skill means managers might have better odds of outperforming in the future, according to new research from Essentia Analytics that chips away at the conventional wisdom of manager selection.

Asset allocators no longer need to go with their gut. There is a way to tell whether a manager is more likely than other managers to deliver outperformance in the foreseeable future, according to a new study from research house Essentia Analytics.

The study examined the anonymised daily holdings data of 123 long-only equity portfolios from 2014-2023 and found that an active equity fund manager who demonstrated decision-making skill over the last year was more likely to outperform their benchmark over the next 12 months than a manager who didn't.

"It makes intuitive sense," said Essentia founder and CEO Clare Flynn Levy. "An investor who consistently makes good investment decisions should outperform one who doesn't, and we now have sound evidence. These findings uncover a powerful new way to quantitatively compare and contrast equity managers and their relative probability of outperformance."

To get its result, Essentia investigated seven different decision types (stock picking, sizing, entry timing, scaling in, size adjusting, scaling out and exit timing) and the value added or destroyed (as measured by the impact on returns relative to the portfolio's benchmark) by each of them. That data was then transposed into a Behavioural Alpha score – Essentia's proprietary measure of demonstrated investment skill. A score greater than 50 meant a manager was creating value, while a score less than 50 meant exactly the opposite.

And while having a good score wasn't a prediction of future performance, managers with a score above 50 were 1.5 times more likely to outperform than managers with a score of less than 50.

"I appreciate the magnitude of that statement, and don't make it lightly," Flynn Levy said. "And as I said at the top of this piece, it is intuitive: if we measure skill based on relative P&L added or destroyed through decision-making, then it stands to reason that the skilled manager should perform better — particularly given our recent finding that investment skill itself tends to persist into the future."

Essentia has previously said it doesn't think its Behavioural Alpha score should form the sole basis for making manager selection decisions, but that it does provide "a powerful additional lens" through which to analyse managers once due diligence has been done.

"Focusing on decision-making (which is, after all, what the fund manager actually does day-to-day) — rather than on portfolio performance (which is often heavily influenced by exogenous forces the manager cannot control) — we are able to provide both the manager and the investor with previously unavailable insight into whether that manager is likely to make good, value-additive decisions (which, over time, can be expected to lead to good performance."

Essentia was established in 2013, with Northern Trust taking an equity stake in the business in 2021 as part of its "Whole Office" strategy to provide clients access to new technologies, services and solutions from across the investment lifecycle.

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