INREV Persistent Performance Among Core Open End Funds **2016**

Snapshot Research

Top half performers demonstrate greater persistency than top quartile performers

> Performance stickiness is greater in bottom quartile funds than top quartile funds
> Top half performers can maintain performance for longer than bottom quartile funds
> Patterns of persistence vary across fund characteristics and with market cycles

It is said that the past does not predict the future; however, a good track record is often one of the criteria for fund manager selection. So does past performance provide information about future returns?

What is being described here is the phenomenon of persistent performance, where a fund may sustain out/underperformance for a period of time. If persistent performance does indeed exist then this implies that recent track record could be a good predictor for future short- and medium-term movements in performance.

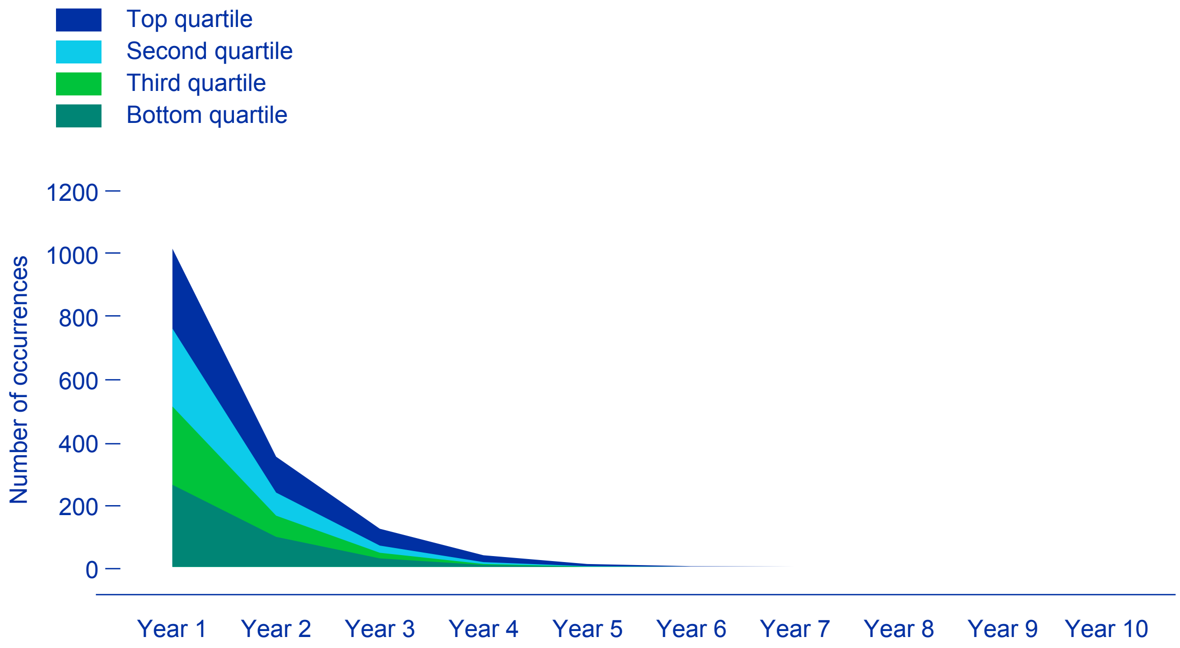
There are several reasons why this may be the case. For example, if a fund manager is performing relatively well compared to its peers, it is likely to attract more inflows. Such inflows are to the detriment of underperformers. Therefore, the manager's probability of survival and success increases. Nevertheless, the performance of such persistence holds only for a limited period of time, and competition dictates that over time rival managers will mimic the strategy followed by the outperformer. In time, the excess return will dissipate.

The findings from this research demonstrate that persistent performance does indeed exist. While widespread, it is not consistent across core open end European real estate funds.

It is not limited to a particular sector or style. It exists among funds of all sizes and for all levels of gearing, and it is applicable across various countries.

Irrespective of how funds are grouped or ranked, there is one commonality across all of them. Performance persistence does not last forever. It tends to fall away over time. Top quartile funds have a tendency to 'drop out' quite quickly, indicating that stellar returns produced in a short-time period (maximum of four years) can occur but sustaining that performance for a long period of time is more difficult.

Figure 1: Persistence in quartiles among core open end funds



On the other hand, bottom quartile funds maintain their position for longer (up to seven years).

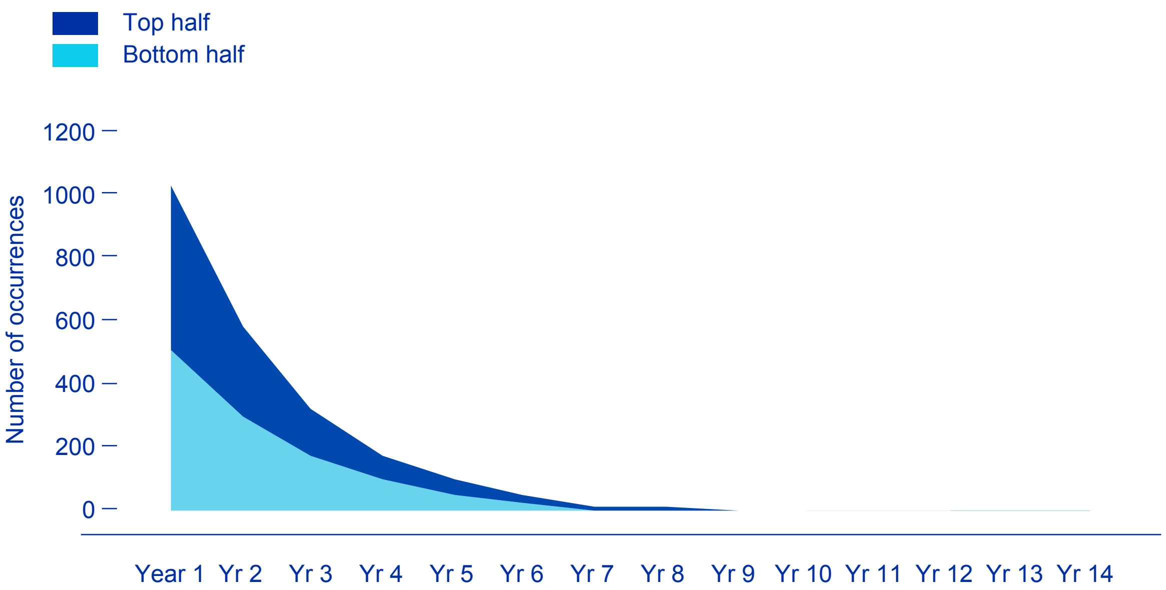
As funds transition from one ‘state’ to another over time, they eventually drop out of any category, and as they do so the ‘neither’ category, neither pure top nor pure bottom, expands. Eventually, all persistence reduces to a very low number, and can potentially reduce to zero. The path to get there varies, and there are some pathways that are a lot more travelled than others, and some not travelled at all. Travelling through the bottom quartile is the most common path taken - even though it is the ranking that all participants try to avoid.

Therefore focusing on quartile performance can be distracting and may be counterproductive in the longer term. A safer bet might be to focus on funds in the top half of the group, where greater performance stability is observed. In fact, top half performers can maintain their position for up to 11 years on average, which can also be stretched to 12 years within some categories. In contrast, the bottom half performers can hold on to their position for an average of nine years.

Persistency in performance would be of little interest to investors if the excess returns available were very small, but that is not the case. Investors in funds that were ‘pure top half performers’ earned excess returns of up to 2.3% per annum, depending on which category they are in.

It may be possible to exploit persistent performance by using a momentum trading strategy, but the implementation challenges are daunting. The most significant one is likely to be liquidity. Given the non-listed nature of the funds analysed, liquidity may remain difficult even in the case of open end funds. In particular, trading of bottom performing funds may pose a considerable challenge.

Figure 2: Persistence in halves among core open end funds



The findings, in relation to the duration of performance and the fact that performance persistence exists, may help guide manager selection and expectations regarding performance.

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