Consistency of global equity funds outperforming the MSCI World Index
If markets are in equilibrium, how can any active investment management strategy outperform a passive strategy? Market efficiency prevails when many investors are willing to depart from maximum diversification in the hopes of realizing above average returns. The competition for such returns ensures that prices will be near their fair value as arbitrage opportunities are sniffed out and snapped up very quickly by superior analysts. Because of this, most investment managers will not beat the passive strategy on a risk-adjusted basis. However, exceptional investment managers might beat the average forecasts built into market prices¹.

There is both economic logic and empirical evidence to indicate that exceptional portfolio managers can beat the average forecast. For the economic logic we assume that if no analyst can beat the passive strategy, investors will divert their funds from expensive active strategies to less expensive passive strategies. In that case, funds under active management will dry up, and prices will no longer reflect sophisticated forecasts and therefore move away from fair value. This opens up profit opportunities which will lure back active investment managers who once again will become successful².

For our empirical evidence GraySwan conducted a study using our database of surveyed global equity funds managed against a benchmark of MSCI World Index or the MSCI All Country World Index (both herein after referred to as MSCI). These funds were filtered to meet at least one of the following criteria: the fund must either be FSB approved, or the Manco (management company) must hold a 13B license or the investment management company must have some form of presence in South Africa. Such screening resulted in a sample of 45 actively managed global equity funds. The aim of the survey was to identify potential actively managed global equity fund offerings available to South African institutional investors. Investors should ensure that they comply to the requirements of the FSB when investing with offshore investment managers. Our survey includes managers, which are currently in the process of complying with such requirements.

The survey brings some interesting results to the table:

1. The **3-year** statistics of the surveyed managers (after fees) indicate the following:
   - Out of the 45 global equity funds surveyed, 44 funds have track records in excess of 3 years.
   - Only 19 of the 44 funds (43% of the funds) have been able to outperform the MSCI over the past 3-years.

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¹ Investments, Sixth Edition, by Zvi Bodie, Alex Kane, and Alan J. Marcus.

² This point is worked out fully in Danford J. Grossman and Joseph E. Stiglitz, “On the Impossibility of Informationally Efficient Markets,” American Economic Review 70 (June 1980).
The top quartile fund outperformed the MSCI by 1.70%, the average fund underperformed the MSCI by -0.26% and the bottom quartile fund underperformed the MSCI by -2.79%.

2. The 5-year statistics of the surveyed managers (after fees) indicate the following:
   - Out of the 45 global equity funds surveyed, 36 funds have track records in excess of 5 years.
   - Only 14 of the 36 funds (39% of the funds) have been able to outperform the MSCI over the past 5-years.
   - The top quartile fund outperformed the MSCI by 1.07%, the average fund underperformed the MSCI by -0.90% and the bottom quartile fund underperformed the MSCI by -2.88%.

3. We then surveyed the selected universe over the past 5 years to ascertain whether the funds are able to consistently outperform the MSCI over 3-year rolling periods within the past 5 years. The 5-year period was selected as the impact of the recent financial crises in 2008 needed to be incorporated into such an analysis.
   - The analysis indicates that only 7 funds have been able to consistently outperform the MSCI over all 3-year rolling periods during the past 5 years.
   - Furthermore, 21 funds have underperformed the MSCI more than 50% of the time over the 3-year rolling performance periods over the past 5 years. This means that 21 funds (58% of the universe with track records in excess of 5 years) have a probability (based on past performance) of 50% and less of outperforming the MSCI.
   - 11 out of 36 funds (31%) have never been able to outperform the MSCI over any 3-year rolling period over the past 5 years.

4. The 8-year statistics of the surveyed managers (after fees) indicate the following:
   - Out of the 45 global equity funds surveyed, 27 funds have track records of 8 years or longer.
   - Only 13 of the 27 funds (48% of the funds) have been able to outperform the MSCI over the past 8 years.
   - The top quartile fund outperformed the MSCI by 1.79%, the average fund underperformed the MSCI by -0.04% and the bottom quartile fund underperformed the MSCI by -1.87%.

5. We next surveyed the selected universe over the past 8 years to ascertain whether the funds are able to consistently outperform the MSCI over 3-year rolling periods within the past 8 years.
   - Only 1 fund of 27 funds (4%) has been able to outperform the MSCI over each 3-year rolling period during the past 8 years.
   - Furthermore, 15 of the 27 funds (56%) underperformed the MSCI more than 50% of the time over the 3-year rolling performance periods over the past 8 years. This means that 15 funds (56% of the universe with track records in excess of 8 years) have a probability (based on past performance) of 50% and less of outperforming the MSCI over 3-year rolling periods.

The results indicate that the longer the fund's track record, the higher the probability of outperforming the MSCI consistently. It is clear that outperforming the MSCI after fees consistently is not an easy task but it is possible and had been achieved historically. The analysis indicates that a top quartile global equity manager can outperform the MSCI by approximately 1.8% (after fees), and that a bottom quartile manager will typically underperform the benchmark by 1.9% (after fees) over the long term.
Global equity and bond markets are more efficient than the South African market. Such efficiency makes it harder for offshore active investment managers to outperform passive investment strategies. However, this plays right into the hands of competent South African investment consultants. A large portion of the global equity universe can be quantitatively screened out of a potential global equity shortlist for potential investment due to historical low probabilities of outperforming the MSCI. This technique allows GraySwan to identify truly exceptional investment managers relatively easily and effectively for potential offshore strategy and investment manager selection.

Once a shortlist has been defined via our quantitative screening methodologies we set out to conduct our on-site due diligences and qualitative views. We’re off to London in May for a week of manager due diligences and thereafter we will link up with the CFA conference in Chicago.

For more information please feel free to contact our Research team on +27 21 852 9092.