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Are star fund managers a dying breed?

By Jeremy Hazlehurst

Warren Buffett

Everyone agrees that Warren Buffett is a stockpicking genius. But is he better than an algorithm? A study published in late 2013 by researchers at Connecticut-based AQR Capital Management and Copenhagen Business School claims to have discovered Buffett's secret: he picks cheap, low-volatility stocks that are profitable and pay dividends. Over time, this strategy is very effective.

The study said that Buffett had a Sharpe ratio – a measure of risk-adjusted performance – of 0.76 between 1976 and 2012. That is double the median ratio of 0.37 for the 196 US mutual funds that have existed for more than 30 years. This intrigued the researchers. By using a computer to pick the sorts of stocks in which Buffett's investment company, Berkshire Hathaway, invests, they created a Buffett-style portfolio – indeed one that would have outperformed the man himself.

When even the world's best stock picker can be beaten at his own game by a mere formula, should we call time on the idea of the star fund manager?

The mutual fund industry is keen on individual managers, which it markets as rock stars and rocket scientists rolled into one. And why not? If you had invested £1,000 with Neil Woodford's Invesco Perpetual fund in 1988, you would have £23,000 today. In the 11 and a half years he ran his fund at Schroders, Richard Buxton's annualised total return was 10.8 per cent. When both left their funds last year many loyal fans went with them, moving billions to the managers' new employers.

But the academic consensus is that these followers are misguided. Copious research shows that very few active managers outperform their benchmark, and those who do cannot manage it for long. Markets are very efficient these days, goes the argument, and it is almost impossible to find undervalued stocks. Outperformance is luck, say the academics. There is no such thing as a star manager. A cautionary tale is that of Anthony Bolton, who was arguably the brightest of stars when he managed the special situations fund at Fidelity. However, he failed to repeat his success when he changed focus to China and has since announced he is to retire from fund management.

But is it possible to reconcile the research with the fact that some managers consistently outperform? Perhaps, because being a star could be about more than great stock picking. Richard Watts, a fund manager at Buxton's new employer, Old Mutual, says good managers have "a conviction-style, repeatable investment process" that they "can communicate to both retail and institutional investors on their terms".

Perhaps a star is a good salesperson, then. Imagine someone who made money early in their career and was eloquent enough to convince people that they had a system – money would flow in. It is not impossible that their employer would then ensure they had the best team and resources. If anyone could outperform over time, it would be that person.

If star quality was really a myth, then surely computers would be better than people at running funds. But they are not, as Robert Kosowski, director of the risk management lab at Imperial College London, says: "It is hard for a computer to work out whether a merger will stall for regulatory reasons."

Indeed, most of us like to have a person in charge. "You can fly jumbo jets to New York with no pilot," says Andrew Clare, professor of asset management at Cass Business School in London, "but I feel more comfortable with someone in the cockpit."

But is it simply a mixture of luck, sales patter and a good knowledge of financial news? Perhaps, but even if stars do exist, they have several problems. First, as Clare says, "to stand out, they have to be brilliant: the Usain Bolt of fund management". All managers are looking at the same information and they are all clever, so even a super-genius is only going to get a sliver of outperformance over the rest. Given the difficulty of what they are trying to do, that is likely to only be a little better than the benchmark.

Second, success means inflows and the sheer size of a fund can hamper a star. The bigger your fund, the fewer trades are open to you. Kosowski is working on unpublished research that suggests the current size of a fund is inversely proportional to its future performance.

Third, once a star has become a star, it is too late to get in on the action. If stars are just lucky and revert back to the benchmark, there is little point investing, because once you have spotted outperformance it is likely to be over. If managers really can outperform, their fees will be astronomical. In short, you have to invest in the nascent stars. As the authors of the Buffett research put it, somewhat unhelpfully: "If you travel back in time and pick one stock in 1976, Berkshire Hathaway would be your pick."

The frustrating conclusion is that even if stars exist and you know who they are, unless you have a time machine you cannot profit from that knowledge. But there may be a solution. A few years back Kosowski co-authored a study with Juha Joenväärä and Pekka Tolonen from the University of Oulu in Finland that claimed to identify genuine outperformance in hedge funds.

The implication is that if you can identify new funds with the same investment strategy as successful old funds – clones of those funds, if you like – then you should be able to predict future stars. They studied hedge funds, but assuming the conclusion also holds for mutual funds, and that you are an expert at the fearsomely complicated maths involved in applying "seemingly unrelated regression techniques", then you might have just found the Holy Grail for finding star managers.

Otherwise you could just do what most people who have studied the investment industry do: buy a tracker.