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Death, Taxes and Short-Term Underperformance: International Funds

"In this world nothing can be said to be certain, except death and taxes."[1] *—Benjamin Franklin*

Since the Brandes Institute first published its "Death, Taxes and Short-Term Underperformance" pieces more than 10 years ago, they have become a staple among constituents who regularly ask for updates and/or variations on the original theme. While the years have changed since our first study, the overall conclusions from earlier research remain consistent—the best-performing funds had 1- to 3-year stretches when performance was weak relative to their benchmarks and/or peers. But underperformance, even up to three years, had relatively little impact on the best-performing funds' ability to deliver strong gains over a 10-year period. Ultimately, we believe our research shows it may prove shortsighted to fire good managers when they underperform. To put it a slightly different way, we believe our work underscores the importance of having patience and conviction in managers when many investors seem increasingly focused on shorter-term results.

Of course, our work still does not provide the ever-elusive insights on how to identify the top-performing funds now for the next 10 years. At the same time, in our opinion, good, active managers are characterized by proven investment philosophies, consistent processes and smart people who manage with conviction for the long term. We believe with these traits, managers may be more apt to deliver solid long-term returns.

The Sample: 213 Mutual Funds

From the Morningstar database as of 6/30/17

1. Actively managed non-U.S. funds
2. 10 years of performance data available
3. Multiple share classes excluded
4. Global funds, index funds and enhanced index funds excluded

Stepping back, we took Ben Franklin's quote above and added a third inevitability (short-term underperformance among active managers) to his famous quip about life's certainties. The original Death, Taxes and Short-Term Underperformance studies examined a number of asset classes. Here, we revisit our work on international mutual funds. Responding to requests from our constituents, we sought to identify some distinguishing characteristics of top-performing managers, as well as some negative characteristics that distinguish those in the bottom peer ranks. However, our work toward these goals proved inconclusive, as we will describe.

Investigating Short-Term Underperformance Among International Funds

- Identify the top long-term performers
- Reveal their short-term challenges

To investigate actively managed international funds, we applied the same methodology as in previous studies. Using the Morningstar database, we focused on international mutual funds that had at least 10 years of performance data as of June 30, 2017. Global funds, multiple share classes, index funds and enhanced index funds were excluded, yielding a sample size of 213 funds.

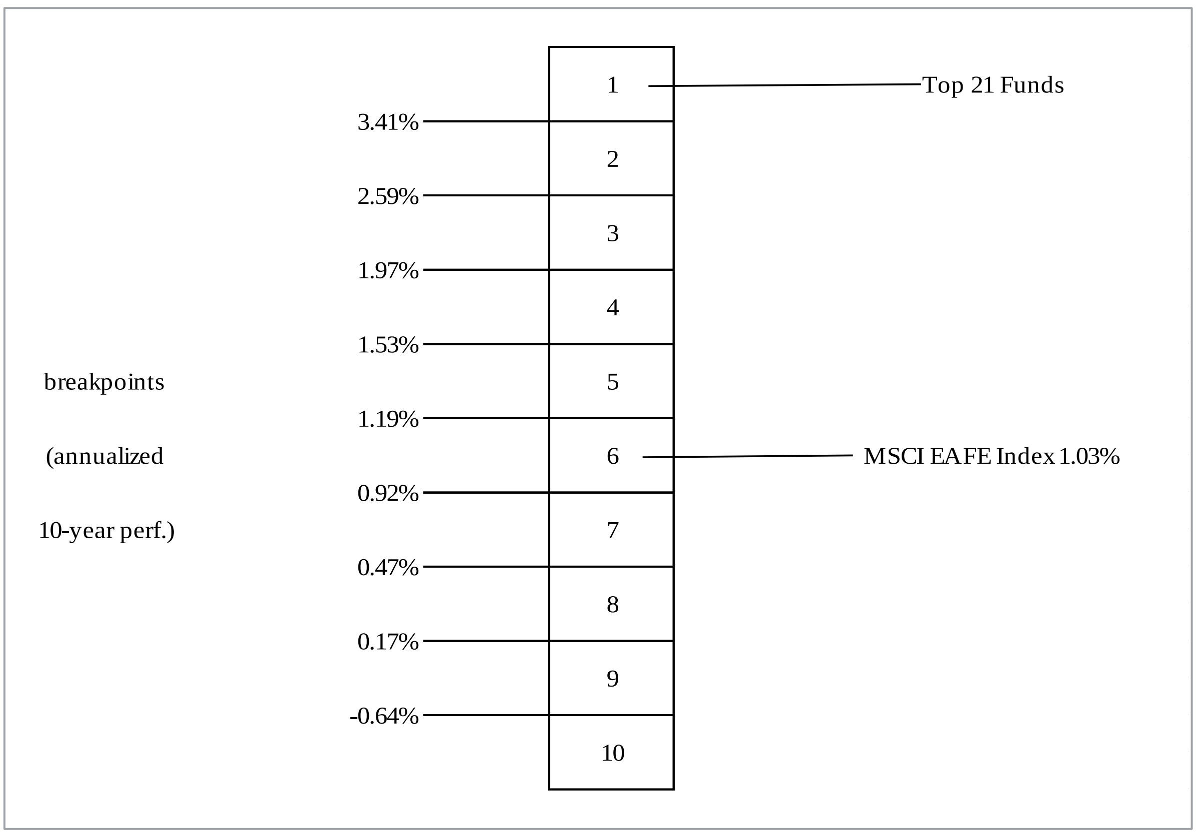
[1] Source: notable-quotes.com, from a letter to Jean Baptiste LeRoy, 11/13/1789.

The sample was divided into deciles based on the funds' performance for the entire 10-year period. For example, decile 1 consisted of the 21 funds with the highest 10-year returns, while the 22 funds with the next-highest returns formed decile 2, and so on.[2] All mutual fund performance figures assume the reinvestment of interest and capital gains, include the impact of the funds' fees and expenses, and do not include the impact of taxes.

> "…the best-performing funds had 1- to 3-year stretches when performance was weak relative to their benchmarks and/or peers."

Exhibit 1 shows the top 21 mutual funds in the sample posted an annualized gain of at least 3.41% over the 10-year period. All of these "decile 1" funds outperformed the MSCI EAFE Index (the Index or the benchmark), which returned 1.03% during the decade. There have been numerous studies recently questioning the ability of active managers to outperform respective indices, particularly in the more efficient, large-capitalization segment. However, each of the decile 1 funds delivered at least 238 basis points of outperformance vs. the benchmark on an annualized basis. In addition, all of the funds in deciles 1 through 5 outperformed the MSCI EAFE benchmark, which was ranked in decile 6. For our universe and study period, the median manager was better than the benchmark.

Exhibit 1: The Top Funds Outperformed the Benchmark by More Than 238 Basis Points, Annualized
International Funds Ranked by 10-Yr. Annualized Performance, 2007–2017



Source: Morningstar, Brandes Institute; as of 06/30/17. Past performance is not a guarantee of future results. One cannot invest directly in an index.

[2] Per statistical convention, all deciles contained 21 or 22 funds, except decile 10 which contained 20.

Short-Term Snapshots Reveal Dramatic Underperformance vs. Benchmark

While more than 50% of active international managers beat the benchmark for the 10-year period as a whole, this changes significantly over shorter periods. For the 21 funds in decile 1, many underperformed the Index by wide margins—with active returns ranging from 2.54% to -21.56% during their worst 1-year rolling periods, as illustrated in Exhibit 2. (On average, these funds trailed the Index by -7.64% in their worst 1-year rolling period.) For most of the funds, the worst 3-year rolling period underperformance versus the Index was also substantial.

Exhibit 2: The Top Funds Underperformed by 764 Basis Points, on Average
Top 21 Funds: Relative Performance vs. MSCI EAFE Index, 2007-2017 (Annualized)

	Worst 1-Year Rolling Period	Worst 3-Year Rolling Period
Range	2.54% to -21.56%	1.17% to -10.30%
Average	-7.64%	-3.77%

Source: Morningstar, Brandes Institute; as of 06/30/17. Past performance is not a guarantee of future results. One cannot invest directly in an index.

The poor relative returns illustrated in Exhibit 2 may have been deemed “unrecoverable” by a frustrated investor, prompting them to select another manager. However, abandoning one of these top-performing funds during a streak of poor returns probably would have been a mistake. Our research shows significant short-term underperformance among international equity funds was not unusual, even for those funds that outperformed over the long term. In fact, poor short-term relative returns were common among each of the funds exhibiting the best long-term results. These findings illustrate the importance of looking past short-term performance and focusing on longer-term return potential.

Underperformance vs. Peers

In addition to investigating performance relative to the Index, we studied these funds’ performance relative to peers over the decade, ranking them over rolling quarterly, 1-year and 3-year periods. Similar to the pattern exhibited for benchmark-relative returns, the top-performing funds each found themselves in lower deciles when compared with their peers over shorter periods.

In fact, in terms of quarterly performance, all 21 of the top funds (100%) made at least one below-median appearance (at or below decile 6) during the decade—and 19 (90%) of them showed up in the worst decile (decile 10) for at least one quarter. When it came to 1-year and 3-year periods, the top 21 funds also experienced underperformance vs. peers, as shown in Exhibit 3. For example, 100% of the funds made at least one appearance in deciles 6 or 7 for 1-year returns. Looking at 3-year returns, for example, 86% were below median at least once and a third of the top decile funds landed in the bottom decile over a 3-year period.

Exhibit 3: Over 10 Years, All of the Top-Performing Funds Fell Behind At Some Point
Percentage of Top 21 Funds With at Least One Appearance at or Below

Based on . . .	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
	← Underperforming Funds				Worst-Performing Funds →
Quarterly Performance	100%	100%	100%	100%	90%
Ann. 1-Year Performance	100%	100%	90%	81%	71%
Ann. 3-Year Performance	86%	57%	43%	38%	33%

Source: Morningstar, Brandes Institute; as of 06/30/17. Past performance is not a guarantee of future results.

Again, these findings suggest that short-term underperformance relative to peers is to be expected, even for international equity funds that performed well over the long term.

Characteristics Shared by Outperformers vs. Underperformers?

This study suggests that short-term underperformance, while frustrating, may not necessarily be a cause for alarm over a longer-term horizon. At the request of some of our constituents, we looked for common traits among the best and worst performers. However, based on our analysis, there do not appear to be definitive traits associated with either strong or weak performers. Here are the characteristics we investigated:

- Assets under management
- Manager tenure
- Standard deviation (volatility)
- Expense ratio
- Number of holdings (concentration)
- Tracking error
- Annualized turnover

The results are shown in Exhibit 4. Note, for the top and bottom decile funds, we show not only the median fund in each decile, but the range across each decile for each trait:

Exhibit 4: Top, Bottom and Median Decile Manager Characteristics (2007-2017)

	Assets ($M)	Concentration (# of names)	Manager Tenure (Years)	Tracking Error	Standard Deviation (Volatility)	Annualized Turnover %	Expense Ratio (I Shares)
Median Top Decile Manager	$5,561	92	8.33	5.33	18.01	26	1.13
Range (Low to High)	$5 to $34,647	30 to 1,238	1.83 to 16.33	3.63 to 14.06	7.99 to 21.70	3 to 95	0.45 to 1.40
Median Manager	$647	92	6.13	4.43	18.97	37	1.04
Median Bottom Decile Manager	$203	103	4.32	4.48	19.35	64	1.34
Range (Low to High)	$5 to $3869	51 to 656	0.33 to 20.92	2.98 to 10.68	18.43 to 24.97	15 to 198	0.58 to 2.90

Source: Morningstar, Brandes Institute; as of 06/30/17. Past performance is not a guarantee of future results.

For all of these traits, the results were inconclusive, revealing no meaningful relationships. We also wonder about the important distinction between correlation and causation. For example, having more assets under management generally was associated with top performers, but not always. And we ask whether a large asset base was the *cause* of those funds' outperformance or a result of strong returns that attracted new assets. Conversely, lower relative returns may have triggered a decline in assets under management—not vice versa. One could have the same debate about manage tenure. There were other traits where lower figures tended to be better such as turnover, standard deviation and expenses, but again, there were meaningful exceptions (noted in the ranges in Exhibit 4) and we would not draw any meaningful conclusions.

One comment about tracking error: lower tracking error for poor performers, as well as the median fund, may suggest that a number of these funds were closet indexers. But before drawing strong conclusions, we suggest a closer investigation of these funds, including a thorough holdings-based analysis.

Short-Term Underperformance as Normal as Death and Taxes

Overall, whether relative to a benchmark or peers, short-term performance can be frustrating. However, this updated study again illustrated that it may not necessarily be a cause for alarm. Poor results may be an inherent byproduct of the investment process that is behind a successful longer-term record. Unfortunately, we were unable to pinpoint specific traits that were consistent across the best (or worst) performing funds during our study period.

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Ultimately, we believe this brief study's key point remains: underperformance in shorter periods—such as one quarter, one year, and perhaps even a few years—can be a normal part of the investment experience, even for funds that perform well over longer periods. In our opinion, investors who keep this in mind may be better positioned for long-term success.

Disclosures

Mutual fund investing involves risk. Principal loss is possible. Past performance is not a guarantee of future results. No investment strategy can assure a profit or protect against loss. The information provided in this material should not be considered a recommendation to purchase or sell any particular security. The performance discussed occurred under conditions which may not be repeated. Please note that all indices are unmanaged and are not available for direct investment. International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility.

Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth.

Morningstar, Inc. is an independent mutual fund research and rating service.

Basis point: 1/100 of 1%.

Standard deviation: Dispersion of a data set from its mean.

Tracking error: Standard deviation of the difference between a portfolio's return and its benchmark's return.

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