A star burns out

Troubles at the Woodford investment group point to a wider trend

Even the most promising active investor cannot beat the market in the long term

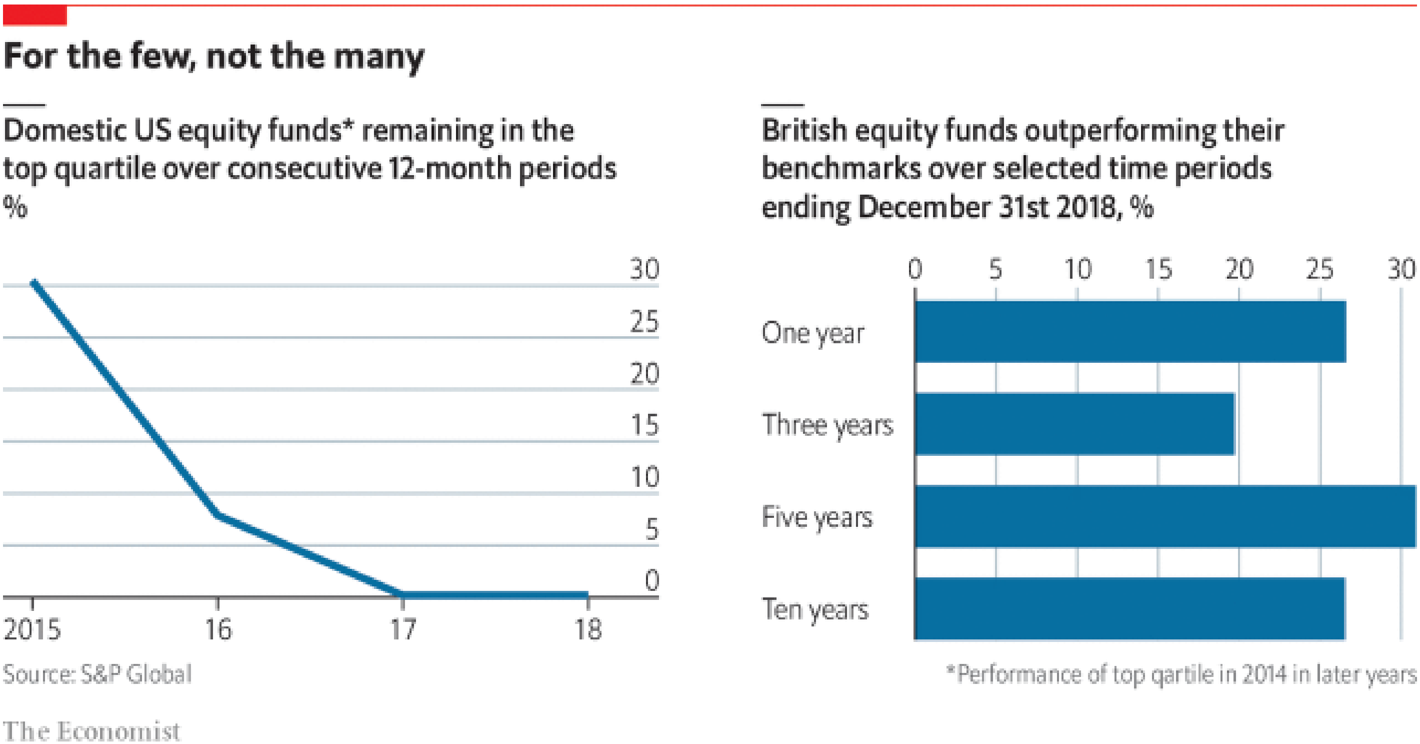
Business
Jun 6th 2019

THE STOCKMARKET is a risky and complicated place. For more than a century many investors have trusted financial experts to pick the best shares for them, in return for a hefty fee. But even the experts can get it badly wrong.

That has been the case this week with Woodford Investment Management, which has suffered two devastating blows. The first occurred when the firm suspended trading in its flagsh' ıity Income fund, locking in investors' money. The second

The Woodford crisis illustrates a much broader trend. Investors have steadily been realising that the experts can struggle to outperform the market. Instead they have been pouring money into funds that simply seek to mimic the market, but charge low fees. Assets in exchange-traded funds (ETFs) rose from $716bn in 2008 to almost $4.7trn at the end of last year, according to Statista, an information group. The two biggest fund management groups in the world, BlackRock and Vanguard, specialise in index-tracking or passive funds. Active funds (those that try to beat the market) have struggled to perform over periods from one to 10 years. The right-hand chart shows that only a tiny proportion of funds investing in UK equities (like the Woodford fund) have beaten the market over periods from one to 10 years.

During the long period when he was a fund manager at Invesco Perpetual, Neil Woodford seemed to be an exception to this rule. He picked unfashionable stocks in areas like tobacco and avoided the dotcom boom. His success prompted many clients to follow him when he set up his own firm in 2014. Woodford Investment Management was managing more than £10bn at its peak.



But this belief in “star” fund managers is not supported by the data. The left-hand chart shows the percentage of US managers in the top quartile (best performing 25%) of 2014 that repeated the feat in succeeding years. If the results were just random, then 25% of managers should repeat the feat in the first year, 12.5% in the second, 6.25% in the third and so on. As you can see, the figures become much worse than random a e goes on. Picking managers on the basis of past

For a while, they might try to invest in the same shares as before. But if they are not careful, they will end up owning 20-30% of such companies. So the temptation will be to spread the portfolio over a broader range of groups. The danger is that their 50th favourite stock might not be as good a bet as their top ten.

The resulting pattern can be strong performance in the early years, but a more mediocre result later on. The long-term return numbers can still look good. But most clients will have invested their money after the stellar years; the return earned by the average client will not be that great. A classic example of this phenomenon was Fidelity Magellan. When Peter Lynch took over the fund in 1977, it had just $22m in assets. He achieved a return of 29% a year on average until 1990, by which stage the fund had $14bn under management. Assets continued to pour in under his immediate successors and the fund reached more than $100bn, making it by far the biggest mutual fund in 2000. But the fund lagged the market for years afterwards; the latecomers (who invested the bulk of the money) lost out.

Mr Woodford tried to escape the rut by investing in smaller stocks, some of which were unquoted and some of which were listed on the tiny Guernsey exchange. This meant that his fund did not resemble the conventional market, and thus had the chance to outperform. But it created three problems. The first was that Mr Woodford was running an equity income fund, which meant that he needed to find companies that paid regular dividends; small, unquoted companies tend not to do this. The second problem was some of Mr Woodford's bets went badly wrong: the fund has returned 11% since its launch, compared with the UK market's 34%. The third problem was the greatest. Woodford Equity Income is an "open-ended" fund. When investors buy into the fund, its assets rise, and the manager must buy more shares; when they sell, the assets fall, and the manager must sell. There was thus a mismatch between Mr Woodford's clients, who could demand instant liquidity, and his assets, a proportion of which was difficult to sell. Poor performance has been causing money to head out of the fund, with £560m flowing out in May, according to Morningstar, an investment research firm. When one big client, Kent County Council, demanded its money back, trading was suspended to give Woodford time to realise the money.

All of this was a big shock for Mr Woodford's prominent backers, including Hargreaves Lansdown, a leading financial adviser. The Woodford fund was on its "Wealth 50" list of favourite funds. And Hargreaves also runs its own funds, one of which, the Multi-Manager Income & Growth Trust, had £405m (13.7% of its assets) in the Woodford fund. So it is not just the experts who can get it wrong; so can the experts who pick the experts.

For years, those arguing that UK investors should stick to passive tracking funds have faced the comeback "What about Neil Woodford?" They won't get that comeback any more.

Business
Jun 6th 2019

Weapons of mass disruption

America is deploying a new economic arsenal to assert its power

That is counterproductive and dangerous

The Economist asks

Who can lead Britain through Brexit?

PODCASTS

Braking bad

A merger of Fiat Chrysler Automobiles and Renault is no more power