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Rosefinch Research | You can't win all the time, but you can win over a long time

In fairy tales, we love to read about the winning champions – they conquer whatever stands in the way and always emerge the winners. Similarly in investing: investors favor those funds who successfully navigate both bull and bear markets. However, when it comes to actual practice, investor is often faced with the inconvenient truth: even for the long-term successful funds, why does it always fall behind peers when I get in? Or is it just my "luck"?

How hard can it be to find the fund that at least beats the median performance every year? We took that question and did the following analysis. First, we reset the clock to 2010. In the next five years, we looked at the cumulative performance and took top 10% of active equity mutual funds in China. These 30 funds are therefore our "picks" for the next five years. We asked the following question: how many of these 30 funds had annual returns in the top half every years? The answer: ZERO!

Here's the distribution of the top 10 funds' annual ranking over that five-year period:

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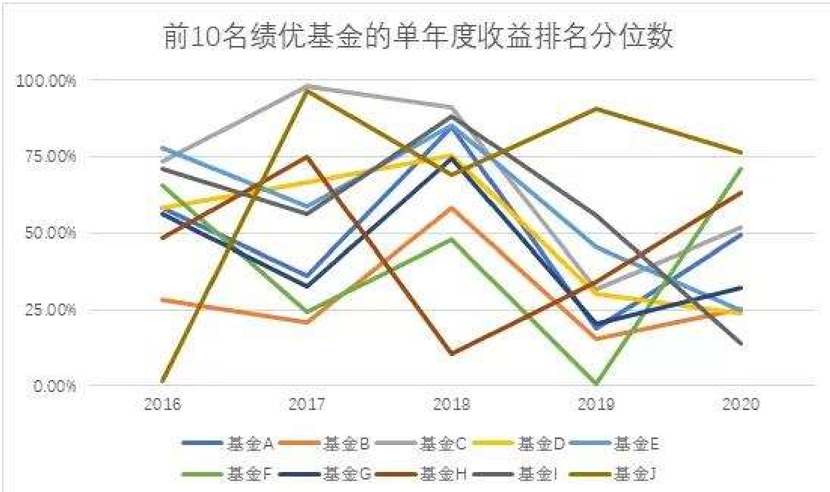

Source: Wind, Rosefinch.

In fact, there is very little correlation between the consecutive two years' rankings. To pick next year's winner based on this year's winner is a bit of a random walk. The question then comes: if your fund is under-performing in the short-term, should you redeem right away? What if we rebalance away from the under-performers each year? We did backtesting on our initial portfolio of 30 top performing funds. Starting from 2016, whenever any fund's return is below industry average, we'll redeem it at end of year and reallocate equally amongst the remaining funds. After repeating this until 2020 and ignore any transaction cost, the cumulative return of the portfolio is +158%. And what if you did nothing and kept the 30 funds throughout the period? The return is +162%. The annual rebalancing did not bring the expected excess return. In fact, if you add in the usual redemption or purchasing fees, the net return of the rebalancing portfolio will be considerably lower.

Source: Wind, Rosefinch. Orange bar has annual rebalancing; Blue bar is static portfolio.

While the starting point is the historical long-term 5-year performance, if investment decisions are based in short-term 1-year return, then there's a contradiction in the logic. Furthermore, as we saw from the results, even if we start with top performing funds, if the investors can't withstand the short-term return volatility, they may underperform over the 5-year period.

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In fact, this irrational behavior of over-focusing on short-term and missing long-term value is an example of "narrow framing", the concept made famous by Nobel Laureate Richard Thaler. To use an analogy: when we take a photograph, what we see depends on how we frame it. We can only see the framed part of the environment, therefore missing the whole picture. In the case of fund investing, many investors have similar problems: they may habitually check the fund valuations on daily basis, which inadvertently impact their long-term investment returns.

An US investment firm *Betterment* did a research project that showed the more frequently an investor checks its trading account performance, the higher the chance of seeing negative returns. If an investor checks the account once a day, then there's about 50% chance of seeing losses, and about 25% chance of seeing large losses of worse than -2%. We tried to replicate this result using Wind index on Chinese equity mutual funds. Since 2003, this index has gained over 12 times in the 18 years, with an annualized return of +16%, a truly exceptional performance. But if we zoom in on the daily returns, we noticed that in the last 5 years, 561 out of 1217 trading days had negative returns, or about 46%. This is almost an even chance of seeing negative return daily, or just a coin toss. And when investor sees loss in the account, his/her emotion will be impacted by the market volatility. The more the index goes up, the more risk-seeking he/she is and the more the index goes down, the more risk-averse or emotional he/she becomes. It's in these moments of emotional volatility that regrettable decisions are made.

How to be successful then? Well recently, there's a story of a very successful Chinese equity investor making the rounds in the market. The key factor in the investor's success? The investor is visually impaired and therefore do not monitor the short-term performance. He became a long-term investor both in name and in deed. Keeping a "safe" distance from the market may be the key to be more successful in the market. If the investor gets too close in the market, he forgets the long-term goals and loses himself in chasing small profits in short-term trading. Focusing on the daily valuation fluctuations or using short-term returns to judge fund managers is a classic example of "narrow framing."

When it comes to fund investment, there's no one that always wins. There's no magic potion that guarantees victory each and every time. The good thing is, even through stormy markets, we can still see hints of long-term champions. Behind their success is the consistent and disciplined investment approach that continuously build on expertise and chases after long-term returns.

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