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Emerging market active managers: Skilled or stubborn?

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ABSTRACT

This paper examines the impact of active management – intended as an investment policy focusing on specific assets/styles – on portfolios' risk–return profiles, at country level and at whole market level, with respect to the BRIC area. Active management is often coupled with overconfidence in stock-picking exhibited by those fund managers who overweight the portfolio with securities for which they have a strong belief and perhaps an emotional commitment. To this end, the main question this study wishes to answer concerns whether the lack of portfolio diversification is the consequence of fund managerial skills, generating a positive alpha, or it is determined by their attitude to overestimate private (local) information and their self-ability to beat the market. The study does not find evidences of focused portfolios overperformance, which suggests behavioural biases prevail over a disciplined asset allocation approach.

1. Introduction

A recent branch of the literature on asset pricing focuses on the role of active investment policies. To this end a number of studies are proposing methodological approaches to quantify the level of "managerial activism" and the impact on performance. A parallel issue is the overconfidence in stock-picking exhibited by those fund managers who overweight the portfolio with securities for which they have a strong conviction and perhaps an emotional commitment. Whether the active policies are the outcome of their actual managerial skills or their stubbornness in a biased active stock-picking is a matter of interest both for the behavioural finance investigations and the asset allocation practice.

While academics have called upon diversification and market efficient hypothesis, practitioners have often showed to focus their (active) investment policies on specific asset classes or risk factors, somehow disregarding standard portfolio models (see Karoui and Meier, 2009).

Despite the increasing interest towards behavioural portfolio theories (cf. Shefrin and Statman, 2000) and investor's sentiment research (cf. Baker and Wurgler, 2006, Kumar and Lee, 2006), explicit behavioural interpretations of active management are still scantily investigated.

Among notable exceptions is Gort (2009), who conducts an empirical study across Swiss pension plans, investigating the relationship between overconfidence and active management. By means of a survey analysis, he finds the diffusion of active management style, across Swiss pension fund managers, can be the consequence of subjective perceptions of their own skill. Similarly, through a questionnaire Frijns et al. (2008), collect data concerning

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the respondents' degree of risk aversion and their self-assessment of knowledge about investments, finding, through behavioural experiments, that the perception of financial expertise, coupled with other individual's characteristics, is a determining factor of portfolio investment decisions. Other authors analyse the lack of diversification in portfolios as a form of possible managerial overconfidence, who overestimate their self-ability to beat the market.

Busse et al. (2007) identify this phenomenon by measuring the impact of portfolio concentration on performance. By means of Herfindahl based indices they measure the dispersion of portfolio loadings relative to the overall mean and find that focused portfolios outperform those more broadly diversified and suggest that investors might improve their performance by diversifying across focused managers rather than portfolio securities. Chen and Lai (2015) achieve similar findings, this time with respect to risk-adjusted performance and using an analogue set of concentration ratios. Specifically they find that concentration levels are highly related to fund returns in stable market periods; conversely they are negatively related during turmoil market periods.

The link between the diversification level of individual investors' portfolio and overconfidence is also analysed by Fuertes et al. (2014). They introduce a set of proxies to measure the managers' informational advantage. Their findings support the hypothesis of overconfidence bias by suggesting a negative relationship between investors' information set and diversification. Ho (2011) partly confirms this trend reporting that overconfident traders tend to hold loser stocks too long.

2. Empirical analysis

We obtain return data on BRIC mutual equity funds from the Bloomberg database. The database covers monthly returns for the period from June 2007 to December 2013. We have two data sets: one deals with generic BRIC markets, meaning that a fund manager can invest its assets under management on all BRIC markets without distinguishing a specific geographical focus; a second data set involves local BRIC markets, namely Brazil, Russia, India and China markets. On the whole our sample holds 1665 equity funds.

In order to build risk measures at BRIC country level, the following market indices are used: Brasil Sao Paulo Stock Exchange Index, Russian Trading System Index, India National Stock Exchange CNX Index, Shanghai Shenzhen CSI 300 Index. We use the S&P500 index as a proxy for non-BRIC (global) investment returns.

In as far as an active manager is most likely to concentrate his or her portfolio on specific market segments, it is possible to discriminate active from passive funds by means of style indicators, whose weight in the managed portfolios emphasise managers' attitude to actively focus their allocation in asset bundles bearing specific (style) characteristics.

To investigate this notion of active management, we apply a factor model where we aim to analyse the relationship between a fund performance and the breadth of the underlying strategies (see Chincarini and Kim, 2006).

Table 1
Relation between style concentration and performance. Gr. 1/Gr. 2 refers resp. to fund cluster with better adjusted R-squared in the Style/Model market. The R^2 is referred to Market model.

# Funds		Z_Alpha			Z_Alpha -Adj			R^2
		Coef	t-stat	p-value	Coef	t-stat	p-value	
Gr. A	58	−0.05	−0.32	0.38	−0.06	−0.27	0.35	0.77
Gr. B	13	0.24	0.86	0.35	0.23	0.83	0.35	0.69

Based on Aliano et al. (2014), in our style model in Eq. (1), we to take into account market capitalisation and valuation multiples as follows:

$$r_{i,t} = \alpha_i + \beta_{1,i} RMRF_t + \beta_{2,i} SMB_t + \beta_{3,i} HML_t + \epsilon_{i,t} \quad (1)$$

where: $r_{i,t}$ is the excess return of fund i at month t, $RMRF_t$ is the excess market return at month t; SMB_t is the difference in return between the MSCI BRIC Small Cap index and the MSCI BRIC Market index at month t; HML_t is the difference in return between the MSCI BRIC Market Value index and the MSCI BRIC Market Growth index at month t. The risk free rate to compute excess returns is proxied with the 10 year T-note rate from Bloomberg.

The multifactor model from (1) is to be compared with standard single market model from CAPM as follows:

$$r_{i,t} = \alpha_i + \beta_i RMRF_t + \epsilon_{i,t}. \quad (2)$$

Comparing (2) and (1) is useful to test whether the relation between portfolio concentration and performance is driven by fund managers' willingness to take a chance for big bets on single styles.

By examining the relationship between the number of factors to which the funds are exposed and their performance, we built two groups as follows: Group 1 consisting of funds whose adjusted R-squared from the multifactor model (1) is lower than the one obtained by the market model (2); Group 2 consisting of funds where the multifactor model produces higher adjusted R-squared values. Group 1 can be thought as consisting of those funds targeting the minimisation of the track error from the fund's benchmark, while Group 2 consists of funds adopting on average a larger number of distinctive concentrated strategies, that is those with stronger breadth of underlying strategies.

The performance differentials between the two clusters are shown in Table 1. Results show that funds with higher number of distinctive strategies perform better than indexing funds, despite p-values. Country breakdown (except for Brazil counting only 14 funds) is presented in Table 2, which confirms previous results.

3. Local vs. global risk factor

In this section, we focus the analysis on portfolios' risk–return profile: by adjusting performance results with the taken risks at regional and global level, in order to understand how model results are driven by local risk factors.

According to Olga and Burger-Helmchen (2012), an asymmetric downside risk approach relying on Behavioural Portfolio Theory (see Shefrin and Statman, 2000) is more