HYPERION ASSET MANAGEMENT

Why Active Investment Management Businesses Fail

Mark Arnold, Chief Investment Officer, Hyperion Asset Management
Jason Orthman, Deputy Chief Investment Officer, Hyperion Asset Management

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In a capitalist, market-based society, it is extremely valuable to be able to produce attractive and sustained returns on capital that can compound over long periods of time. Compounding and growing capital allows individuals to sustain and enhance their standard of living and reduces the need to rely on personal exertion and government assistance to generate income, particularly in retirement. In a low growth world, the ability to produce alpha (returns above a benchmark) becomes even more valuable because the returns from passive styles of equity investing are likely to produce less attractive returns than they have achieved historically. Active asset management businesses that possess the ability to produce attractive returns over the long term, will continue to provide a valuable service to clients. Few active fund management businesses are successful in achieving positive alpha over long periods of time and many active fund management businesses fail.

Investing is about the future

The problem the market has in correctly assessing the quality of an active fund manager's product is that the strength of its true value proposition is not known at the time the investment decision is made. This is because the value proposition relates to future investment returns over uncertain time periods. A well-executed marketing campaign can result in investors allocating capital to actively managed products that have poor value propositions, because the investment decision is being made under conditions of uncertainty, with the outcome being that these managers are ultimately unable to deliver alpha. There are many actively managed products that have raised money initially by successfully marketing a promise to produce alpha in the future, but which end up failing to deliver that alpha. Hedge funds have been particularly good at marketing primarily through selling complexity and promising low levels of short-term price volatility and future alpha.

An effective proof point for identifying an active investment manager is for that investment manager to be able to show prospective investors a long-term track record of producing alpha after fees. This is evidence that there is some reasonable probability of the asset manager being able to produce alpha in the future by applying the same investment process and philosophy that achieved the historical alpha. However, investors should proceed with caution, as the conditions and factors that enabled and facilitated the historical investment track record needs to remain intact in the future. If there has been a material change in the economic conditions or other factors that facilitated the historical alpha, then the track record becomes less relevant. This has been evidenced by the negative impact a slower economic growth environment has had on traditional value managers' ability to generate alpha.

Reasons why active investment managers fail to produce long-term alpha

Reasons why active fund managers fail to produce alpha include:

1) the economic environment has permanently changed, and the investment philosophy and process no longer work in the new environment; or
2) the philosophy and process were never sound, and the value proposition is weak.

1) The economic environment has permanently changed, and the investment philosophy and process no longer work in the new economic environment

An investment philosophy and process are typically tailored to a specific economic environment. Successful investment approaches can become less effective and even fail if the economic environment permanently changes and historical market inefficiencies disappear.

The economic environment has permanently changed

We believe that there have been several fundamental changes to the economic and business environment over the past two decades that have substantial implications for the success of traditional value styles of investing. The changed environment also has negative implications for passive investment.

In the six-decades leading up to the GFC there were significant economic tailwinds. These economic tailwinds included:
1) young and growing populations;
2) the progressive financialisation of society;
3) a robust and growing middle class;
4) inexpensive energy in the form of fossil fuels that drove powerful machines;
5) a perception that natural resources were abundant and unlimited; and
6) benign levels of competition and limited disruption from new technologies.

Since the GFC the world has experienced lower levels of nominal GDP and corporate profit growth with the emergence of the following headwinds:
1) lower population growth rates and ageing population;
2) high debt levels in most major economies;
3) hollowing out of the middle class and rising wealth and income inequality;
4) increasing awareness of environmental constraints and disruption; and
5) increasing technology-based disruption of old-world business models and human capital markets.

In summary, the following factors have radically changed the economic and business environment:
1) tailwinds have been replaced by structural headwinds for the global economy;
2) aggregate corporate profit growth potential has been weakened overall from increased competition and better and cheaper products and services as result of the internet, smart phones and better software and technology; and
3) the distribution of profits has structurally moved to a few global leaders and away from many old-world and regional businesses.

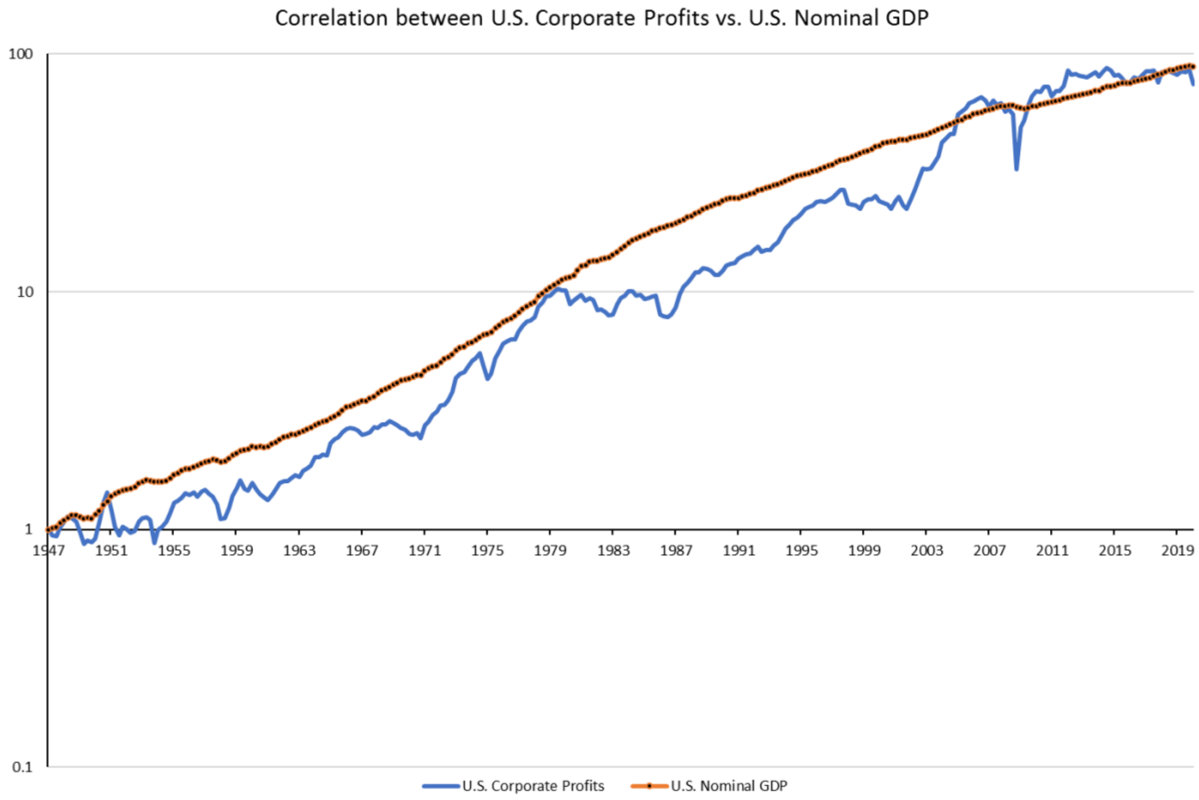
These factors, in combination, have made traditional value investing less effective and will over time reduce the attractiveness of passive investing.

Value investing will struggle in a low growth, internet-enabled and disrupted world

The economic environment has changed permanently since the GFC. We believe this decline in the average rate of nominal GDP growth and associated aggregate corporate profit growth is enduring with long-term risk to the downside. **It is very unlikely that the high economic growth period from 1950 to 2007 will be revisited.** During this almost six-decade period the global economy produced very high average rates of nominal GDP and corporate profit growth. In this high growth environment, average quality companies were able to grow their revenues at attractive rates, in-line with nominal GDP, as they shared in the strong overall growth of the economy.

However, the tailwinds that saw the rapid economic growth of the decades prior to the GFC have dissipated and economic headwinds are strengthening. **The emergence of the COVID-19 pandemic has further reinforced these headwinds and accelerated the disruption occurring in many industries, including in asset management.**

Figure 1: Aggregate corporate profit growth has been weak since the GFC



Note: between 1947-2007 the annualised CAGR of U.S. Corporate Profits and U.S. Nominal GDP was 6.9% and 6.9% respectively. Whilst the annualised CAGR of U.S. Corporate Profits and U.S. Nominal GDP between 2008-2020 was only 2.2% and 3.3% respectively.

Source: U.S. Bureau of Economic Analysis 2020

Lower rates of nominal GDP growth make it more difficult for most businesses to grow their sales and profits. The traditional economic cycles have largely disappeared as the effectiveness of monetary policy has reduced. The virtuous loop of young and growing populations and the productivity boost from low cost fossil fuel-based energy and powerful machines from the second industrial revolution started to fade from the 1970s and 1980s onwards.

Nominal GDP growth is linked to aggregate corporate profit growth. Lower aggregate corporate profits, all other things being equal, results in lower nominal GDP growth. Lower aggregate corporate profit growth has been caused by internet and smart phone related globalization and disruption. Weaker demand growth has also contributed to lower revenue and profit growth. Factors causing weaker demand growth include high debt levels and the loss of middle-income jobs.

The increase in global competition and disruption is placing downward pressure on profit margins for most businesses, particularly “old-world” businesses. Most listed businesses are “old world” in that their business models were created prior to the internet and smart phones.

At the same time, it has become a globalized winner takes all market and a few elite modern businesses have taken significant market share from many old-world businesses that still dominate the global corporate profit pool. These “old world” businesses tend to sell, for obvious reasons, on below average short-term P/E Ratios and thus value investors tend to be attracted to these stocks. The shifting of spending to these “new world” businesses has been given a further boost by the shelter-in-place restrictions of the COVID-19 pandemic. It is expected that this change in consumer habits will be permanent because many “old world” businesses have been forced to closed down or to shift much of their product distribution from bricks and mortar to online and rethink how they communicate, access and provide services to their customers.

Aggressive government spending programs that have been implemented as a result of the COVID-19 crisis have accelerated the trend to higher government debt levels in most countries. Increased unemployment levels will accelerate the trends toward more gig economy jobs, lower paying service jobs and fewer middle-income jobs. We believe many of the middle-income jobs lost during the COVID-19 crisis will permanently disappear. This has significant implications for future rates of economic growth and will result in a completely different and much weaker economic environment compared with the pre-GFC period.

Physical distribution and service models have been migrating to digital formats for many years. These include secular trends towards e-commerce, digital payments, and cloud-based software. The emergence of the internet in the 1990s and the release of the iPhone in 2007 were key enablers of these structural shifts. We believe these ongoing secular trends will help determine which investment styles will remain relevant in the future.

Disruption in the form of a structural trend towards digital products and distribution was emerging prior to the COVID-19 crisis. However, this disruption has been augmented because of the social distancing and shelter in place restrictions adopted globally to fight the pandemic. The resultant acceleration of revenues moving from traditional businesses to modern businesses is placing additional financial pressure on many large, listed companies. At the same time, the disruption is providing a forceful tailwind to modern businesses allowing them to take additional market share. We believe this shift in market leadership will be sustained even once the COVID-19 crisis has ended. This has implications for the long-term economic attractiveness of both passive and traditional value investing.

In a low growth economic environment, most businesses suffer because their profit growth is heavily dependent on the growth in underlying aggregate demand. If that lower level of corporate profit growth is combined with a high level of disruption, then a situation arises where most businesses stagnate or experience declining revenues, profit margins and returns on capital. If these businesses have debt, then financial leverage will magnify declining intrinsic values. **We believe most businesses will lose further market share to a few elite businesses with very strong value propositions under this new economic framework.**

A new economic environment is disrupting the traditional investment models of incumbent asset managers***.*** We believe this trend toward a lower growth, disrupted economic environment is permanent. Traditional value-based investment models that rely on mean reversion or betting against change are no longer valid in a low growth, competitive, internet-enabled world. **Mean reversion of growth rates for businesses has been replaced with dispersion, and betting against change has been replaced with betting on progress.** Investment frameworks that rely on traditional value investing will not work in this new economic environment.

We think this low growth, disrupted economic environment will negatively impact the attractiveness of returns from passive forms of investing over the next decade. Benchmarks are typically dominated by large, average quality, old world businesses. These businesses will be unlikely to produce significant future earnings growth as a collective. This means benchmarks will struggle to produce returns that are as attractive as the returns produced over the past few decades. Active funds management with an investment philosophy tailored to identify those few elite business that will take market share in this new low growth, disrupted world will create long-term alpha going forward.

2) The philosophy and process were never sound, and the value proposition is weak.

Most active investment management firms never raise enough funds under management ("FUM") to create an economically sustainable business because they do not possess the investment process necessary to deliver alpha. However, sometimes clever marketing will enable an active fund manager to achieve scale despite the investment process and philosophy being fundamentally weak and unlikely to produce long-term alpha. There appears to be a growing belief in the industry that performance is not as important as good distribution, good messaging, and a suite of product offerings to suit every occasion. We believe this industry trend is based on a false narrative.

No sustainable business can have two masters. A marketing culture is radically different to a research driven, alpha focused culture. The two cannot co-exist in an active asset management business over the long term. If the marketing culture defeats the alpha driven culture, then the active asset management business will fail in the long run. In a competitive market, the most important factor that determines whether a business is a success or failure is the quality of the product and the strength of its value proposition. A business with a weak value proposition will still ultimately fail even if the marketing is brilliant. On the other hand, a high-quality product with a highly disruptive value proposition will normally succeed even in the absence of a large salesforce and sophisticated marketing. Great marketing spin does not turn a poor product into a great one. Selling a poor-quality product ultimately results in unhappy clients, no matter how good the marketing message. Active asset management businesses only exist because clients believe that they can generate future excess investment returns over the long term. ***Sophisticated marketing such as complicated presentations or clever messaging will not fool clients indefinitely***. ***Ultimately, results and track records matter in funds management.***

An active asset management business can only be sustained over the long-term if it has a strong alpha driven proposition. This starts with an investment framework that exploits identifiable market inefficiencies. Consequently, we believe funds management businesses need to be led by experienced members of the investment team. Further, the key investment professionals should own equity. These members understand that the core inherent value in a fund management business is sourcing alpha and not in marketing, distribution, or product development.

Hyperion has traditionally focused on developing and maintaining a strong investment philosophy that is embedded in high quality research and has eschewed excessive marketing**.** The impact of this approach is reflected in the breakdown of the source of its funds under management as shown in Table 1. **Hyperion's total FUM has predominately been generated from investment performance, not client flows.** The table below shows that alpha generation and market returns contribute $6.62 billion (85% of total FUM). This compares to $1.19 billion (15% of total FUM) from net client contributions.

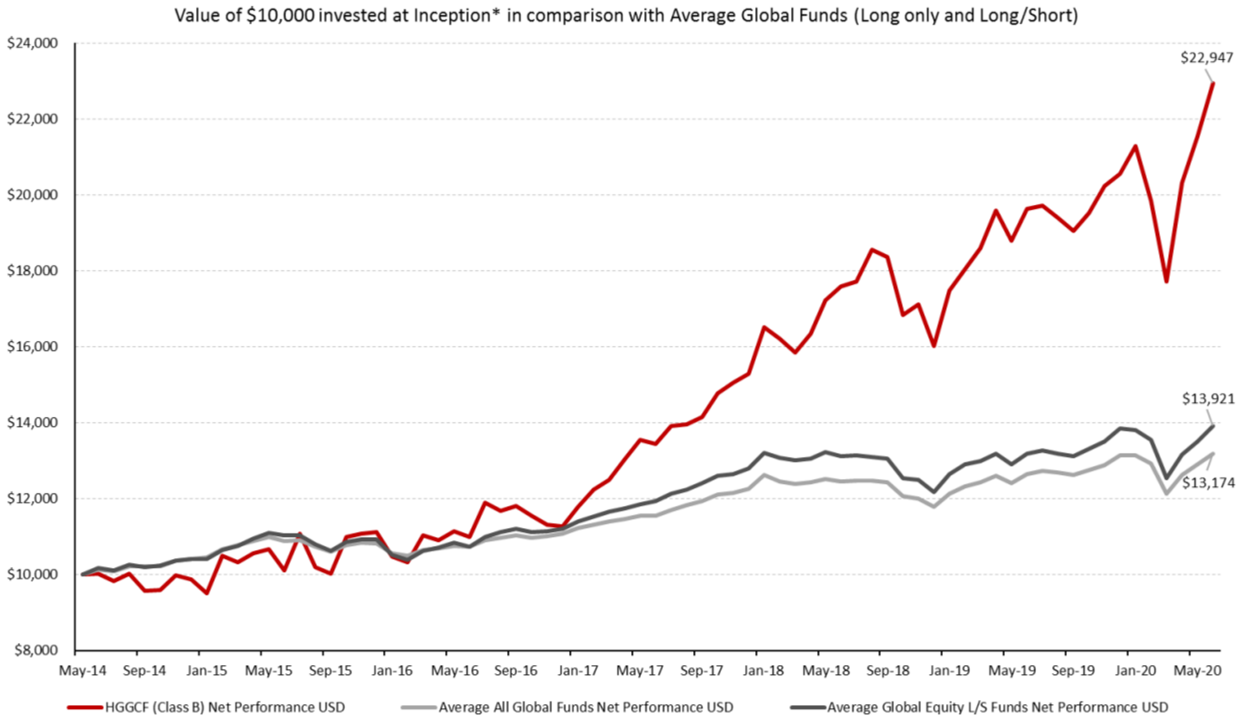
Table 1: Hyperion's funds under management profile

FUM Generation		$B (AUD)
Net Flows from Clients	15%	1.19
Market Return	49%	3.80
Alpha	36%	2.82
Total FUM*	100%	7.81

Source: Hyperion, *as of 30th June 2020

On the other hand, hedge funds have been notorious for over promising through aggressive marketing, aggressive trading strategies, employing shorting and other forms of leverage, as well as using complexity as a marketing tool. Hedge funds provide a good example of funds that have a questionable value proposition and a business model that relies on marketing and complexity to entice client investment. We believe a lot of these techniques are without merit and are no more than marketing gimmicks. Hedge fund returns overall have been underwhelming in recent years. Unfortunately, for many hedge fund products it has been more hype than substance.

Figure 2: Hyperion's relative performance profile compared to traditional and hedged offerings

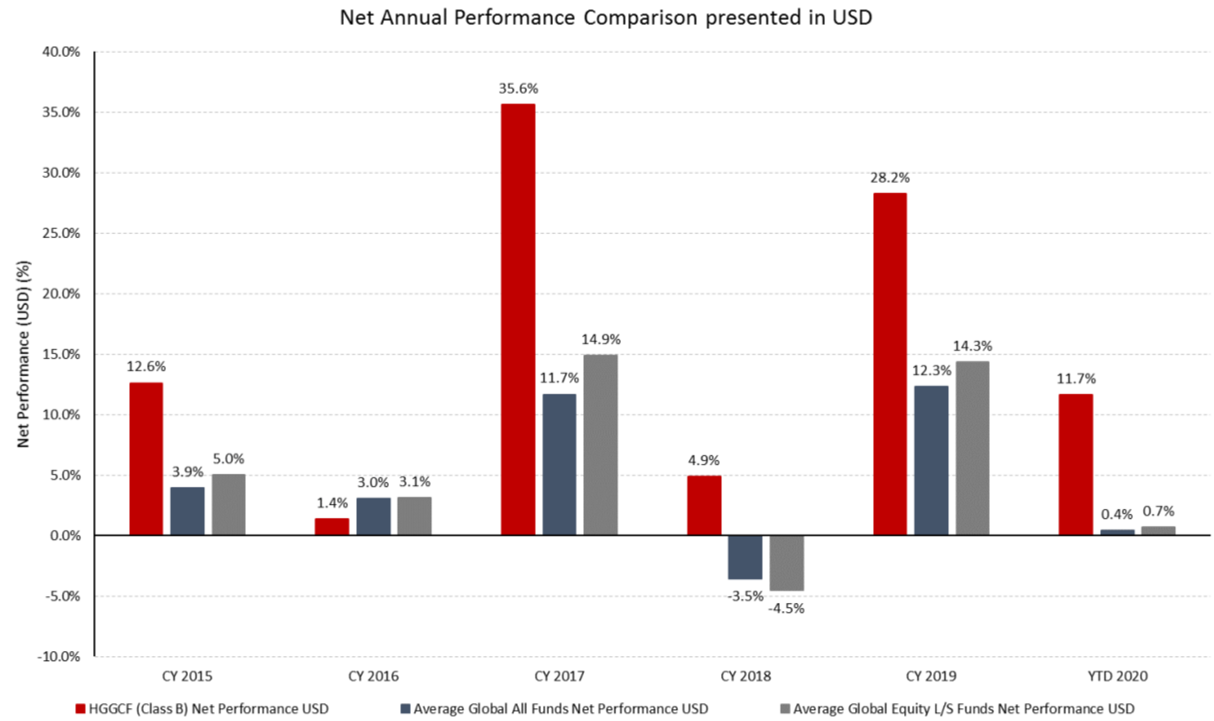


*Inception Date: 31st May 2014

Note: All performance figures are expressed in Net (%) and in U.S. Dollars. The Hyperion Global Growth Companies Fund (Class B) Benchmark is the MSCI World Net (USD) Index. As of 30th June 2020, the Hyperion Global Growth Companies Fund (Class B) has a Management fee of 0.70% p.a. and a Performance fee of 20% p.a.

Source: Hyperion and Morgan Stanley 2020

Figure 3: Hyperion's annual performance profile relative to traditional value and hedged offerings



Note: All performance figures are expressed in Net (%) and in U.S. Dollars. The Hyperion Global Growth Companies Fund (Class B) Benchmark is the MSCI World Net (USD) Index. The Inception Date of the HGGCF (Class B) Fund is the 31st May 2014. As of 30th June 2020, the Hyperion Global Growth Companies Fund (Class B) has a Management fee of 0.70% p.a. and a Performance fee of 20% per annum. CY2014 Performance figures have been excluded due to the Inception date of the fund not providing a full year of data.

Source: Hyperion and Morgan Stanley 2020

One of the common investment tools used by Hedge Funds is short selling. We believe that **short selling incorporates the worst aspects of the financialisation of society** in that it encourages short-termism and uses financial leverage to facilitate speculation on near term share price movements. Shorting also limits and reduces the benefits of the compounding effects of investing in successful businesses that can grow their revenues and EPS significantly over time. Shorting stocks is primarily a marketing gimmick used by hedge funds to play on clients' fears of short-term market-based declines and associated return volatility.

Hedge funds can use financial leverage to boost returns. This financial leverage increases the fundamental risk of the product and can potentially lead to disastrous end results. A classic example from the 1990s was the funds management business, Long-term Capital Management that was ultimately liquidated in 2000 after its earlier bail out. The firm employed significant leverage and used lots of data to identify small mispricing alpha opportunities. Marketing spin involving complexity and extreme leverage resulted in economic disaster for the firm and their clients in the end.

Hiding behind complexity

Competition has intensified and the world is moving towards a winner takes all competitive dynamic, whether it is in business, music, sport or investing. Winnings accrue to a few from the many losers. This is also true for the funds management industry where only a small fraction of participants will accrue alpha over the long term. Unless the market inefficiencies exploited by the active asset manager are very clear and the investment process is structured and repeatable the business will not generate alpha and will not survive in the long run. **Complexity of the product, relentless marketing,**

product proliferation, large investment teams nor the persistence of the distribution team will replace the need to generate alpha long term.

Of course, all managers will periodically under-perform, and clients should be educated that this is normal and acceptable. This contrasts with the overemphasis given to short-term movements in the market and media which puts intense pressure on fund managers to perform in the short term and to market products with a short-term focus. It is the long-term alpha that is valuable and should be the pursuit of active managers. Good active managers should be able to explain the inefficiencies they exploit as well as the market conditions in which they expected to out-perform and under-perform. This moves the conversation with clients from a litany of excuses to education.

Conclusion

The creation of excess long-term returns by active fund managers is valuable for clients. However, not all active funds managers are able to produce long-term alpha. In this paper we discussed two common reasons why investment frameworks fail to produce alpha. The first is that the economic environment has permanently changed, and the investment philosophy and process no longer work in the new environment. We have shown that an active investment style based on traditional value investing is not suited to the current low growth, disrupted world. The second reason that active fund management businesses fail is that the investment philosophy and process were never sound, and the value proposition is weak. We believe that there has been a trend in the industry for managers to focus on distribution and excessive product offerings to the detriment of alpha production. We argue that there is no value for clients in this approach. Over the long term, funds under management will be driven by sustained outperformance, not astute marketing.

- Mark Arnold (CIO) and Jason Orthman (Deputy CIO)

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