The difficult quest for long-term alpha after fees revisited

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Experience and academic research indicate that it is difficult for even the most skillful fund managers to produce net (after fees) alpha over the long term. We have included in the appendix the performance of equity managers over various categories and time periods according to the SPIVA U.S. and Australia Scorecards. It confirms most active fund managers fail to outperform their index. For example, according to the Australian Scorecard, approximately 90% and 93% of international equity managers under-performed over ten and fifteen years to December 2020, respectively.

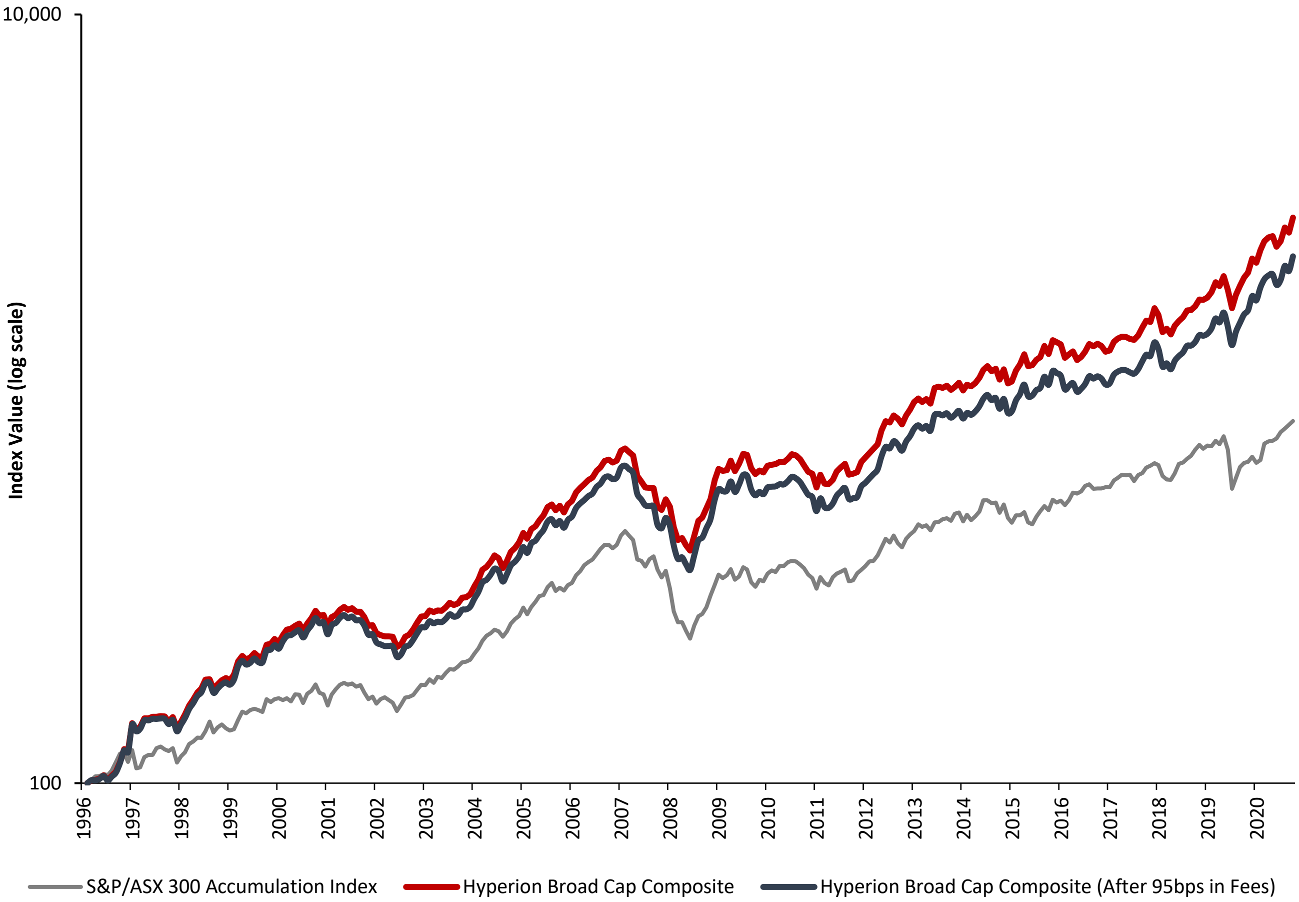
Hyperion has produced net alpha since inception across its three key products. This is rare and valuable. We believe we are well placed to continue to extract long-term alpha after fees across all our products including the Hyperion Global Growth Companies Fund (Managed Fund)[1].

Many active fund managers fail to outperform the relevant benchmark over the long term, particularly after fees. In addition, many active managers have high rates of portfolio turnover that can result in higher trading related costs and higher income and capital gains tax expense than would be incurred using more long-term or passive investment styles. High portfolio turnover levels and negative long-term alpha generation are the key reasons for the secular trend towards passive or index-based equity investing. However, by indexing, investors' risk forgoing the benefits of achieving above benchmark returns over the long term.

The magic of growing superior net returns over long time periods is illustrated in the chart below. Since October 1996, the Hyperion Broad-Cap Equities Composite has returned 13.6% p.a. (after assumed fees of 95 bps p.a.). This return from Hyperion compares with the S&P/ASX 300 Accumulation Index return over the same time of 9.2% p.a. As at 30 June 2021, this strong long-term investment performance of the Hyperion Broad-Cap Equities Composite equates to average excess returns above the benchmark of 4.5% p.a. (after fees) over almost 25 years.

[1] The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

Figure 1: Hyperion Broad Cap Composite vs. S&P/ASX 300 Accumulation Index (log scale)



Source: *Hyperion*

Since October 2002, the Hyperion Small Growth Companies Fund has produced average net alpha of 8.3% p.a.

Since inception in May 2014, the Hyperion Global Growth Companies Fund (Managed Fund)[2] has produced net alpha of 9.5% p.a.

The wisdom of crowds makes the market a difficult competitor over long time periods, as history suggests the "average view" is better than that of an individual. Hyperion has historically identified multiple market inefficiencies, and we will strive to continue to exploit these going forward, including in the Hyperion Global Growth Companies Fund (Managed Fund)[2].

Table 1: Hyperion Composite and Fund Performance Since Inception

As at 30th June 2021	**Inception Return (%) p.a.**
From Oct 1996	
Hyperion Broad-Cap Equities Composite (Gross)	14.7
Excess Performance (Gross)	**5.5**
From May 2003	

[2] The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

Hyperion ASX 300 Equities Composite (Gross)	14.8
Excess Performance (Gross)	**5.2**
From June 2014	
Hyperion Global Growth Composite (Gross)	26.8
Excess Performance (Gross)	**12.5**
From Oct 2002	
Hyperion Small Growth Companies Fund (Net)	16.2
Excess Performance (Net)	**8.3**
From Oct 2002	
Hyperion Australian Growth Companies Fund (Net)	13.1
Excess Performance (Net)	**3.6**
From June 2014	
Hyperion Global Growth Companies Fund (Managed Fund) (Net)[2]	23.8
Excess Performance (Net)	**9.5**

Source: *Hyperion. Past performance is not a reliable indicator of future performance. All returns in AUD. All returns presented are annualised. Performance data as at 30th June 2021. [2]The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.*

Research suggests some managers have the skill to produce long-term alpha before fees, but the cost of producing this alpha is too high, resulting in net alpha that is typically negative. The "paradox of skill" is that as the skill and quality of the analysis of investment professionals has risen, the ability to produce strong excess returns of yesteryear is much more difficult. Put simply, competition has intensified. In fact, the world is moving towards a winner-take-all competitive dynamic because of globalisation. The rewards of winning accrue to a few businesses, whilst most industry participants end up producing average quality products and as a result are in various stages of economic failure.

Low fees and trading costs can reduce this alpha hurdle and improve the probability of translating gross alpha into net alpha. It is only net (after fees and costs) alpha that is relevant to clients, because this is the return they receive. Mauboussin suggests that costs are a key factor in separating the best performing from worst performing funds. The Hyperion Global Growth Companies Fund (Managed Fund)[3] has a base management fee of 70bps p.a. We believe this fee is lower than most of our peers. A performance fee in the Hyperion Global Growth Companies Fund (Managed Fund)[3] of 20% of outperformance against its benchmark ensures Hyperion only enjoys higher fees when the unit holders also do well. That is, the performance fee structure helps improve the economic alignment of Hyperion with client investment return outcomes. The performance fee is subject to high water marks and is only payable on positive absolute returns.

Hyperion's stock portfolio turnover is typically in the 20% to 25% p.a. range. This level of portfolio turnover is well below both the market average and the average active fund manager that often approaches 100% p.a. Low portfolio turnover helps improve our clients' after-tax and after transaction cost returns. This is in stark contrast to many active fund managers that have extremely high turnover because they are trying to chase short-term alpha. Chasing short-term alpha is extremely difficult to achieve successfully over long time periods and can be expensive in terms of after-tax and after-cost returns. The avoidance of over-trading is another way to lower the cost hurdles needed to produce net alpha. We believe we do some simple, logical things that

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increase our odds of out-performing. For example, we only change our portfolio weights in response to share price moves that we believe are meaningful and non-fundamentally driven.

Alpha is a zero-sum game where the winners (out-performers) are accruing returns at the expense of the losers (the under-performers). To outperform, the mistakes of others need to be exploited. Historically the "victims" were individuals or some poor performing institutional funds. However, investors that tend to perform poorly eventually give up. According to Larry Swedroe and Andrew Berkin in their book "The Incredible Shrinking Alpha," U.S. households held more than 90% of U.S. corporate equity at the end of WWII. This declined to 48% by 1980 and 20% by 2008. Similarly, institutional funds have struggled to survive, and dollars have flowed to passive managers. Swedroe and Berkin also cite research from John Bogle who found that about 7% of mutual funds "died" each year between 2001 and 2012. This is supported by fund survivorship data from SPIVA (2021) that shows the number of active fund managers in their data sample sets declining by mid-single digits per annum over long time periods. In fact, over 7% of Australian equity general funds were liquidated in 2020, although this rate was higher than typical. In terms of the US Scorecard, between 5% to 10% of funds did not survive in 2020, consistent with recent years.

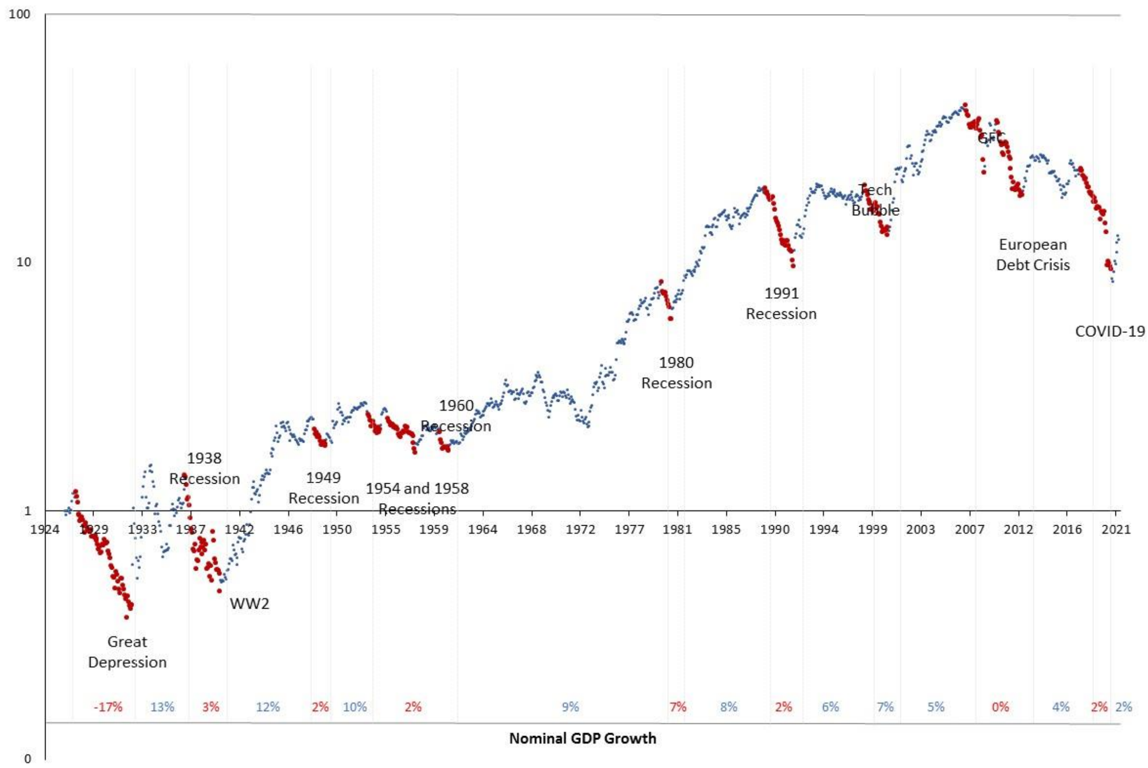
Evidence suggests the proportion of professional investors accruing alpha after fees is shrinking. Swedroe and Berkin referenced academic studies by Mike Sebastian and Eugene Fama that suggest that only the top 1% to 2% of funds showed statistically significant skill (alpha).

John Bogle (2018) highlighted the proportion of active managers who underperformed the market has increased over time. Further analysis from Verheyden et al. (2016), who developed a framework to assess whether participants successfully capitalise on market inefficiencies, found that not only are most funds "unable to outperform the market systematically," but only a small sample can generate alpha and gains from inefficient markets. However, successful managers can manage drawdown periods well in market downturns and distress, as well as take advantage of when a market may return to equilibrium stability through what they call "learning effects maximisation." History suggests Hyperion's best alpha capture periods are through a crisis where markets dislocate such as the GFC and COVID-19.

In our first edition of "The difficult quest for long-term alpha after fees" (2018), we referenced Charlie Munger, who has been widely quoted over the years saying, "the top three or four percent of the investment management world will do fine." We believe this now applies to hedge funds, where the performance of the average manager appears to have declined materially over the past decade. This is supported by Bollen et al. (2021) that documents a clear decline in performance since the GFC. Using an equal-weighted hedge fund index, they observe total cumulative returns of just 25% over the eight-year period from 2008 to 2016, a stark contrast from the 225% return for the ten-year period from 1997 to 2007.

It is likely that this decline in returns post the GFC at least partly relates to the fact that many hedge funds have a value style bias. Using Fama French data, Hyperion research indicates that value style managers have significantly underperformed since the GFC (refer Figure 2). Many hedge fund managers have a value style philosophy and investment approach. We believe a key reason why value style investing has performed poorly since the GFC relates to the lower economic growth environment and higher levels of globalised competition because of the internet and smart phones. It appears likely economic growth rates and inflation will remain low over the next decade. This is because of ageing populations, declining population growth rates, high debt levels, the hollowing out of the middle-class, increasing technology-based innovation and higher levels of natural resource constraints and disruption. In addition, the internet, smart phones and ecommerce will ensure continuing high levels of price-based competition. We believe a low growth, highly competitive and disrupted environment is likely to make it difficult for traditional value style investors and, therefore, most hedge funds to produce alpha over the long run.

Figure 2: Fama French HML Index updated for COVID-19 – Value Underperforms in Low Growth, Low Inflation, Low Confidence Environments



Source: *Kenneth R. French U.S. Research Returns Data (2021) Portfolios Formed on Book-to-Market* [*http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Benchmarks*](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Benchmarks)

The proportion of participants achieving net alpha has declined over time. However, we believe the number of winners will be higher in certain markets. For example, "small cap" funds can exploit the fact that many smaller stocks are under-researched or too illiquid for many institutional investors. These small cap funds can employ investment processes that successfully avoid those stocks that are most likely to suffer permanent value destruction from speculative or low-quality business models with unsustainable economics. However, it is extremely difficult to achieve sustained, meaningful alpha in the small cap space because of this lack of liquidity. With limited opportunities, the absolute dollar size of the alpha is highly constrained in the small cap space.

Global funds should be able to exploit specific factors, sectors and stocks in a huge universe of tens of thousands of listed securities. However, it takes skill and insight to filter and analyse such a large universe effectively. You also need to be clear on what inefficiencies your investment process and team can exploit.

Hyperion exploits multiple market inefficiencies and behavioural biases, including short-termism, time arbitrage, recency bias, loss aversion, impatience (driven by a combination of the fund managers themselves and their direct intermediary/institutional and/or retail clients), over-diversification, specialisation biases, herding (including fear of being wrong or being perceived to be wrong by third parties), and the "quality anomaly."

Achieving alpha has become difficult, but there are some reasons to be optimistic as to why accruing alpha could become easier over time. The ever-increasing focus on short-term results, catalysts and share price movements help ensure those that take a longer-term view tend to be competing in a much less crowded space. Growing data availability, accountability, measurement, transparency and specialisation are perversely increasing short-termism and decreasing conviction in the market. The trend towards indexing and passive investing means the proportion of “dumb” money is rising. Eventually, the level of analysis and insight on individual stocks is likely to decline and lead to increased mispricing of stocks. It is likely that a new source of “victims” will eventually emerge.

In conclusion, Hyperion has a track record of being able to produce long-term alpha after fees. This contrasts with most fund managers that struggle to produce positive alpha over long time periods. The evidence that this statement is true is provided by industry league tables (after adjusting for fees and survivorship biases) and many academic studies. Long-term alpha generating track records are valuable and meaningful.

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HYPERION ASSET MANAGEMENT

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Appendix Tables

SPIVA AUSTRALIA SCORECARD

Table 2: Percentage of Funds Outperformed by the Index (Based on Absolute Return)

	15 Year (%)	10 Year (%)	5 Year (%)
International Equity General	93.4	90.3	81.8
Australian Equity General	86.3	79.3	81.7
Australian Equity Mid- and Small-Cap	48.8	50.5	75.2

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2020. All returns in AUD. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. The fund returns used are net of fees, excluding loads.

Table 3: Average Fund Performance (Equal-Weighted)

	15 Year Annualised (%)	10 Year Annualised (%)	5 Year Annualised (%)
International Equity General			
Average Fund	6.1	11.6	10.1
First Quartile	*7.0*	*12.9*	*11.5*
Hyperion Global Growth Companies Fund (Managed Fund) (Net) ^	**N/A**	**N/A**	**22.8**
Australian Equity General			
Average Fund	6.1	7.2	7.2
First Quartile	*6.7*	*8.2*	*8.7*
Hyperion Australian Growth Companies Fund	**11.4**	**13.2**	**13.8**
Australian Equity Mid- and Small-Cap			
Average Fund	9.4	9.9	11.6
First Quartile	*9.8*	*11.0*	*12.5*
Hyperion Small Growth Companies Fund	**14.3**	**15.9**	**12.8**

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2020. All returns in AUD. Returns shown are annualized. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. The fund returns used are net of fees, excluding loads. Equal-weighted returns for a particular style category are determined by calculating a simple average return of all active funds in that category in a particular month. The p^{th} percentile for a set of data is the value that is greater than or equal to p% of the data, but is less than or equal to (100-p) % of the data. In other words, it is a value that divides the data into two parts: the lower p% of the values and the upper (100-p)% of the values. The first quartile is the 75th percentile, the value separating the elements of a population into the lower 75% and the upper 25%. The second quartile is the 50th percentile and the third quartile is the 25th percentile. For fund category quartiles in a particular time horizon, the data used is the return of the largest share class of the fund net of fees, excluding loads. ^The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

SPIVA Disclaimer

In this scorecard, SPIVA evaluated returns of over 897 Australian equity funds (large, mid, and small cap, as well as A-REIT), 475 international equity funds, and 112 Australian bond funds.

Survivorship Bias Correction

Many funds might be liquidated or merged during a period of study. However, for someone making an investment decision at the beginning of the period, these funds are part of the opportunity set. Unlike other commonly available comparison reports, SPIVA Scorecards account for the entire opportunity set—not just the survivors—thereby eliminating survivorship bias.

Morningstar Classification

Data from Morningstar is obtained for all managed funds domiciled in Australia for which month-end data is available during the performance period. The data include the most comprehensive Australian fund data on active and finalized (merged or liquidated) funds over the chosen period. Funds are classified based on the Morningstar fund classification system, and the SPIVA Australia Scorecard covers the Australian Equity General (large-cap equity), Australian Equity Mid- and Small-Cap, International Equity General, Australian Bonds, and Australian Equity A-REIT categories. The Morningstar classification system produces narrow, style-based classifications for Australian equity funds. S&P Dow Jones Indices has consolidated the style-based categories in order to generate a larger sample size and develop a broad-market comparison to market-based benchmarks. A narrow, style-based comparison would yield a limited sample size, given value and growth style segments are not consistently discernible over the past five years.

Morningstar categories have been mapped to SPIVA peer groups in the following manner:

SPIVA category Australian Equity General is mapped from Morningstar categories Australia Fund Equity - Australia Large Blend, Australia Fund Equity - Australia Large Growth and Australia Fund Equity - Australia Large Value.

SPIVA category Australian Equity Mid- and Small-Cap is mapped from Morningstar categories Australia Fund Equity - Australia Mid/Small Blend, Australia Fund Equity - Australia Mid/Small Growth and Australia Fund Equity - Australia Mid/Small Value.

SPIVA category International Equity General is mapped from Morningstar categories Australia Fund Equity - World Large Blend, Australia Fund Equity - World Large Growth and Australia Fund Equity - World Large Value.

SPIVA U.S. SCORECARD

Table 4: Percentage of U.S. and International Equity Funds Underperforming Their Benchmarks

	20 Year (%)	10 Year (%)	5 Year (%)
All Domestic Funds	86.01	83.22	72.80
All Large-Cap Funds	94.00	82.32	75.27
All Small-Cap Funds	88.06	76.31	65.12
Global Funds*	86.55	82.63	70.00
International Funds*	91.25	79.51	74.37

Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2020. All returns in USD. Past performance is no guarantee of future results. Table is provided for illustrative purposes. *Represent International Equity Funds.

Table 5: Average International Equity Fund Performance (Equal-Weighted)

	10 Year Annualised (%)	5 Year Annualised (%)	3 Year Annualised (%)	1 Year (%)
Global Funds				
Average Fund	8.40	11.64	10.39	18.01
First Quartile	*10.90*	*14.85*	*14.70*	*27.38*
Hyperion Global Growth Companies Fund (Managed Fund) (Net) ^	**N/A**	**24.28**	**29.19**	**60.33**
International Funds				
Average Fund	5.49	8.62	6.09	12.05
First Quartile	*6.60*	*10.31*	*8.40*	*19.11*
Hyperion Global Growth Companies Fund (Managed Fund)^	**N/A**	**24.28**	**29.19**	**60.33**

Source: Hyperion, S&P Dow Jones Indices LLC. Data as of Dec. 31, 2020. All returns in USD. Returns shown are annualized. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. The fund returns used are net of fees, excluding loads. Equal-weighted returns for a particular style category are determined by calculating a simple average return of all active funds in that category in a particular month. The p^{th} percentile for a set of data is the value that is greater than or equal to p% of the data, but is less than or equal to (100-p)% of the data. In other words, it is a value that divides the data into two parts: the lower p% of the values and the upper (100-p)% of the values. The first quartile is the 75th percentile, the value separating the elements of a population into the lower 75% and the upper 25%. The second quartile is the 50th percentile and the third quartile is the 25th percentile. For fund category quartiles in a particular time horizon, the data used is the return of the largest share class of the fund net of fees, excluding loads. ^The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

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SPIVA Styles and Lipper Fund Classifications

The CRSP Survivor-Bias-Free US Mutual Fund Database is the only complete database of both active and liquidated or merged mutual funds. It was created in 1995 and contains fund data from December 1961. Current and historical data from August 1998 has been supplied by Lipper and Thomson Reuters. The fund classifications are based upon the Lipper fund classification system. The SPIVA Scorecard covers domestic equity, global equity, and global fixed income categories.

SPIVA covers major capitalization levels (large-, mid-, small-, and multi-cap funds) and investment styles (growth, core, and value). S&P Dow Jones Indices uses the Lipper fund classifications, which determine a fund portfolio's capitalization and investment style assignments. Lipper assigns a market capitalization to each fund based on the percentages of a fund's three-year weighted equity assets that fall into each of Lipper's three defined market capitalization slices. The market capitalization breakpoints are calculated using all common stocks, excluding all non-U.S. domiciled stocks and ADRs, trading on the NYSE, AMEX, and NASDAQ. Funds are assigned to the capitalization level in which they have a 75% or higher weighting. Any fund that has less than 75% of its three-year weighted allocation in any of the three market capitalization ranges is classified as a multi-cap fund.

For international equity, SPIVA reports on four major categories (global, international, international small-cap, and emerging markets) of interest to global asset allocators. These categories also include multiple Lipper capitalization and style classifications.

SPIVA Global Funds include Lipper Funds classified as Global Large-Cap Growth Funds, Global Large-Cap Core Funds, Global Large-Cap Value Funds, Global Multi-Cap Growth Funds, Global Multi-Cap Core Funds and Global Multi-Cap Value Funds.

SPIVA International Funds include Lipper Funds classified as International Large-Cap Growth Funds, International Large-Cap Core Funds, International Large-Cap Value Funds, International Multi-Cap Growth Funds, International Multi-Cap Core Funds and International Multi-Cap Value Funds.

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