Short-Term Outperformance vs. Long-Term Outperformance

Here's a headline I read this week that seems a bit counterintuitive at first glance:

This is a story from Bloomberg about the PruLev Global Macro Fund that was up 52% in 2017, making it the best performing hedge fund in its class. But the return of volatility in the markets saw this fund fall 16% last month.

Being the top performing fund has to work wonders for your marketability to new investors. Hedge fund investors love the cache of investing in the space so when you add in the bonus of being involved in the "best performing fund" that counts for something from an irrational psychological perspective.

The downside is you'll likely attract the wrong kinds of investors who are only chasing performance. And while there's nothing wrong with an approach that looks to shoot the moon per se (someone has to do it I suppose) and take on a substantial amount of risk to do it, it's a suboptimal way to keep clients around unless you really know your investor base.

I remember seeing pitches from a number of hedge funds who came out after the financial crisis pitching the fact that they were looking for the next subprime trade with an asymmetric risk-return profile.

And who wouldn't want to earn enormous, life-changing returns with a favorable risk profile?

Unfortunately, that subprime ordeal was probably a once-in-a-generation trade. It's not like those things come around on a regular basis.

You could probably count on one hand the number of investors who try this type of strategy year-in-and-year out who see longevity in the asset management business. It's more likely that the top performers vary from year-to-year with little persistence in their performance at the top. And eventually the risk of this strategy catches up with them and they quickly come back to earth.

Not only are the clients of these funds chasing performance but so are the managers of the fund.

Reading that Bloomberg story reminded me of a great anecdote from Howard Marks on what it takes to be at the top of the heap over the long-term. This was from a client letter he wrote way back in 1990:

I would like to cite the approach of a major mid-West pension plan whose director I spoke with last month. The return on the plan's equities over the last fourteen years, under the direction of this man and his predecessors, has been way ahead of the S&P 500. He shared with me what he considered to be the key:

We have never had a year below the 47th percentile over that period or, until 1990, above the 27th percentile. As a result, we are in the fourth percentile for the fourteen year period as a whole.

I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times -- is:

- *less likely to produce extreme volatility,*
- *less likely to produce huge losses which can't be recouped and, more importantly,*
- *more likely to work (given the fact that all of us are only human).*

There's nothing wrong with wanting to outperform the market. It's certainly not an easy endeavor once you factor in things like competition, costs, taxes, and human behavior. But most investors who do try to beat the market probably have the wrong approach even when they do take these variables into account.

The way to outperform over the long haul typically isn't done by being the top performer in your category every single year. That's an unrealistic goal. A better approach is to simply avoid making any huge errors and trying to be more consistent.

The top performers garner the headlines in the short-term but those headlines work both ways. The top performers over the long-term understand that's not how you stay in the game over the long haul.

Sources:
[World's Best Performing Macro Hedge Fund Lost 16% Last Month (Bloomberg)]
[The Route to Performance (Oaktree)]

Further Reading:

[One Way to Beat the Market]