

## *Preface*

### **Special Issue on ‘Delegated Portfolio Management’**

A number of countries, including Australia, have adopted a move to compulsory retirement saving as a policy response to the demographic challenge of an aging population. One key result of this response has been a huge increase in the amount of money available for investment in those countries.

Much of the decision making associated with the management of these investment funds has been outsourced to professional advisors and money managers. Thus, there has been a dramatic increase in the extent to which *delegated* portfolio management is taking place. This decision making includes: the selection of the appropriate asset allocation on behalf of the ‘end investor’; the choice of the fund manager(s) with responsibility for making the investments; and the selection of individual asset holdings by those managers. There has also been significant growth in that part of the industry that monitors and evaluates the performance of professional money managers, and the consequent development of a range of techniques for doing so.

Estimates of the size of this investment pool in Australia vary, but it is generally regarded as being on the order of A\$1 trillion, with strong growth forecast for the foreseeable future. The fees paid to the professional managers charged with investing this pool are therefore considerable. In addition, the high degree of reliance of many investors on their retirement savings means the consequences of manager underperformance, or even failure to remain ‘true to label’ for those managers chosen to deliver a particular style of investment strategy, have never been greater.

This Special Issue of the *Australian Journal of Management* presents a range of papers that address a number of issues relevant to the topic of Delegated Portfolio Management. These include: whether managers are subject to ‘drifting’ away from their notional style of investing; the factors that might influence the flow of money into particular funds; the consequences for portfolio construction and manager performance evaluation when investment returns are not normally distributed; the factors that drive relative investment performance; the extent to which overconfidence can adversely impact on the advice provided by professional financial planners; and whether investors are able to display persistent skill in their selection of professional money managers.

Ainsworth, Fong and Gallagher examine the issue of style drift. Equity managers are often selected on the basis of having a particular ‘style’ (for example, a tendency to hold either value or growth stocks). The potential for managers’ styles to vary over time, and hence for them to no longer be ‘true to label’ would make such manager appointments problematic. They find that Australian equity managers generally do not suffer from style drift, and in fact actively re-balance their portfolios to maintain their stated style. Such trading has implications, however, in terms of portfolio turnover and related transaction costs, and this is explicitly considered.

Benson, Tang and Tutticci address the question of the determinants of fund flows. In their case, they examine the relationship between ‘fund family’

characteristics (such as prior returns, age and size of the fund, and product proliferation within the family) and fund flows. Their conclusion is that the characteristics of a family as a whole convey information regarding the individual members of the family. In contrast to Gharghori, Sujoto and Veeraraghaven, they find that larger families of funds tend to benefit from higher inflows. They also find that older funds, and those that belong to families that specialise in certain investment classes, tend to attract greater inflows.

Benson, Gray, Kalotay and Qiu address the question of portfolio construction and manager performance evaluation when the underlying return distributions are not normal. They also examine the implications of the fact that for many investors the term 'risk' refers not to the range of possible investment outcomes, but to the probability that a portfolio will fail to meet some pre-specified performance target. They present evidence regarding the usefulness of Stutzer's (2000) proposed Portfolio Performance Index, a measure designed to accommodate investors' preference for reduced 'downside risk'. They find that applying this Index results in different rankings of equity funds' performance, compared with those obtained using more traditional performance measurement indices such as the Sharpe ratio.

Brailsford and O'Brien look at the (to date) conflicting results for the Australian stock market regarding the existence of a momentum effect, whereby stocks with above average recent performance continue to outperform and vice versa. By categorising stocks on the basis of both prior performance and size (measured as market capitalisation), they are able to demonstrate that the momentum effect is present only for larger stocks. Thus, prior studies that have adopted different portfolio construction techniques (not based on company size) have produced conflicting results. They also find that the most pronounced momentum effect is for 'loser' stocks that continue to underperform. A consequence of this finding is that exploiting this momentum effect would be difficult in practice, due to the need to maintain short positions in losing stocks.

Chaudhry and Johnson also address the issue of investment performance measurement in the presence of non-normal (and skewed) returns. They consider the power and bias of tests based upon the Sortino, Sharpe, Student t, and decay rate measures. They find that the Sortino Ratio, which is specifically designed to distinguish better performing strategies when performance below some pre-specified return target is of interest, produces better results. In particular, it has both lower bias and higher power, relative to alternative measures.

Fong, Gallagher and Lee look at the question of whether the physical location of Australian equity managers influences either their stock selection ability or their investment behaviour. For example, they ask 'do Sydney-based fund managers tend to be overweight (relative to a passive alternative) in Sydney-based stocks'? And do such managers display more skill when it comes to selecting Sydney-based stocks, relative to managers based in (say) Melbourne? Similar studies in the U.S. have found evidence that geographic proximity is a factor in explaining manager performance and behaviour. Given institutional differences between the U.S. and Australia (for example, in the corporate disclosure regimes that apply), a comparison of the two countries in this regard is informative. They find only weak evidence of a 'location effect' in Australia, suggesting that the city from which a fund manager chooses to operate has little impact upon the stocks chosen, or the performance delivered.

Gharghori, Sujoto and Veeraraghaven look for evidence of a ‘smart money’ effect, whereby investors are able to select superannuation funds that will deliver subsequent superior performance. On balance, they find that while investors do not appear to be able systematically to identify superior performing funds ex-ante, they are, on average, able to identify poor performers, and to dis-invest accordingly. They also examine the relationship between fund size and flows of money, and conclude that investors tend to direct their new investments towards smaller funds, and that the subsequent performance of these funds tends to be below average.

Van de Venter and Michayluk address the issue of overconfidence on the part of professional financial planners. They draw upon the growing literature in behavioural finance, and in particular a range of studies that document a pronounced tendency for individuals to have unjustifiably high levels of confidence in their own ability. For example, Svenson (1981) reports that 80% of drivers surveyed consider themselves to have above average driving skills. Similarly, virtually 100% of those surveyed typically consider themselves above average when it comes to getting along with other people. Their findings suggest evidence of overconfidence in financial planners’ forecasting ability, with the effect being more pronounced for male planners compared to female ones, and among more experienced, as opposed to less experienced, planners. Given the typical gender and age profile of participants in the Australian financial planning industry, this finding is particularly relevant.

Each of the studies presented here has implications for those who delegate the management of their investment portfolios to others. Some are also relevant for fund managers. We thank all those authors who submitted papers for consideration. We also express our gratitude to Sussanne Nottage, from the Australian Graduate School of Management, who has provided invaluable assistance via her superb handling of the various administrative aspects of producing this Special Issue. It has been a pleasure working with her.

**Phil Dolan**

*Applied Finance Centre  
Macquarie University*

**Tom Smith**

*School of Finance and Applied Statistics  
Australian National University*

