The long flight to exceptional returns

Key points

- Understand how investment cycles play out
- Use a multi-decade view to assess fund managers
- Learn why sustained fund outperformance is rare

Investment Cycles

For more than 20 years, PM Capital has advocated that valuation and patience are the most critical investment parameters. Valuation determines long-term investment returns; patience ensures those returns are delivered.

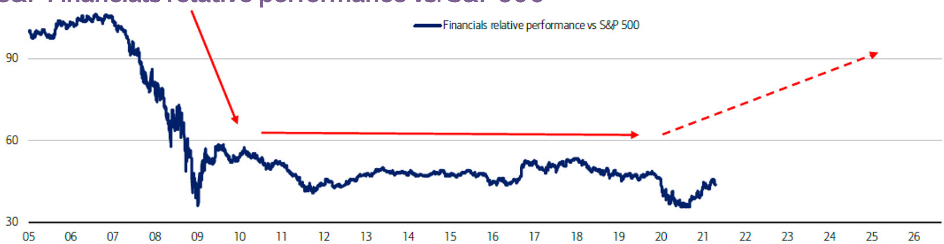
In our experience, investment cycles take 7-10 years to play out, on average. It can take years for the market to recognise when a stock is badly mispriced, or for problem sectors to recover. Fund managers that focus on short-term returns and the in-crowd miss these opportunities.

Consider the chart below of US tech stocks. When tech stocks crashed at the turn of the century, it took two decades for the sector to deliver the same level of outperformance.

S&P Tech relative performance vs. S&P 500

The next chart shows US financial stocks. While these have experienced a long period of depressed prices, underlying fundamentals have been steadily improving and yet to be fully recognised by the market. PM Capital believes the global financial sector will outperform this decade. The PM Capital Global Companies Fund exited many of its long-held positions in US tech-stock oligopolies over the past 2 years as these stock achieved top-quartile valuations. The Fund has increased its global bank holdings during Covid in 2020 when the sector was oversold and offered outstanding long-term value.

S&P Financials relative performance vs. S&P 500



Source for charts: BofA US Equity & Quant Strategy, Bloomberg

Decades, not years, matter with fund returns

So, over what period should you assess a fund manager when deciding where to invest? One year, three years, five years, seven years? As we've mentioned, investment cycles take 7-10 years. Assessing a fund manager only on one, three or five-year returns is risky.

Consider an asset manager that launched a global equities fund in 2015. This manager allocated a large part of its fund to US tech stocks and held them for the next five years. It invested with the in-crowd and its five-year fund returns looked great. But that fund's outperformance may have been due more to timing than skill.

Now, consider a different approach when choosing a fund manager. You assess the manager's return over 10 years to tell how it performed over a full investment cycle. Better still, you assess the manager over two full investment cycles (20 years) to see how it performed. That reduces the risks of a manager outperforming due to luck, timing or sticking with the in-crowd.

Morningstar, a funds-management researcher, neatly summed up the case for long-term assessment of fund performance in a 2018 report . It wrote: *"Standard performance-measurement periods, such as three, five or even 10 years, are far too short to evaluate a manager with confidence. Investors who believe they picked a good fund must show more patience than is commonly assumed."*

The Morningstar study concluded with a reminder that 'active investing is a long game'. *"It is unwise for fund consultants to put too much stock in three- or five-year returns. … investors who have confidence in their pick [fund] need a big dose of patience, an investment virtue that has not been emphasised enough. It turns out that even if you have the acumen to pick a good manager, this may be of little avail if your [investment] patience fails you."*

Managers that consistently outperform over one full investment cycle are hard to find; those that do it over two cycles, such as PM Capital, are rare.

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Fund return rankings in the Morningstar peer group are sourced from Morningstar Direct. As at 30/9/2021. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf . You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information.

1.. The PM Capital Enhanced Yield Fund was named Money Magazine's 2020 Winner for Best Income Fund – High Yield and Credit.

2. Pro forma Fund performance has been calculated based on the new fee structure (implemented 1 December 2018), assuming it had applied from the Fund's inception. These returns do not represent the actual net Fund performance and are included for illustrative purposes only.