Montaka
Global Investments

CONCENTRATED, PATIENT & DISCIPLINED

THE 3 PILLARS OF ACTIVE MANAGEMENT OUTPERFORMANCE

2023

Over recent decades, equity markets have favoured index funds and index-hugging funds, with indices benefitting from a range of tailwinds, including falling yields, favourable fiscal policies, and relatively stable geopolitics. But those days now appear to be over. Yields are rising, global growth is slowing and we face heightened geopolitical risk, all factors that are now creating major headwinds for markets.

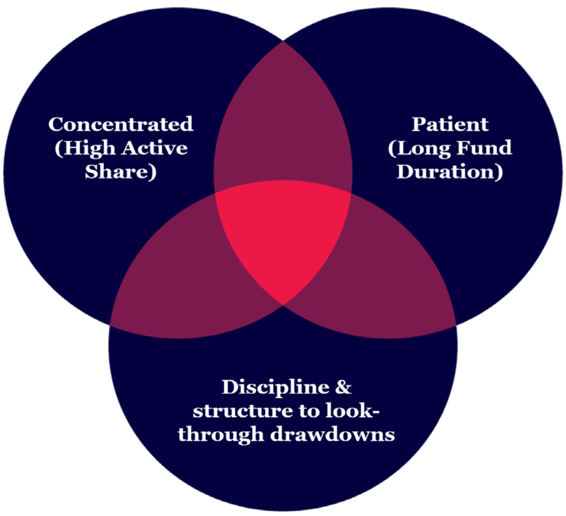
And with the advent of new revolutionary technologies, seeded by rapid breakthroughs in AI, we are also evolving from a market characterised by relatively similar performance among stocks (low dispersion), to a new market environment characterised by big winners and losers (high dispersion).

To reach their important financial and retirement goals, investors will therefore need to increasingly allocate to active fund managers who can navigate this new environment and deliver superior long-term returns.

Not all active managers, however, are created equal. One of the most important difference between active funds is their investment strategy and structure. Rigorous academic research has shown that a clearly identified cohort of funds have the strategy and structure that significantly increases their probability of generating long-run outperformance.

Research has found these high-potential funds have three distinctive characteristics that mark them as different from run-of-the-mill active funds:

- They have concentrated portfolios that differentiates them from the market;
- They patiently hold their positions for lengthy periods; and
- They are disciplined and have the right structure to hold their positions through drawdowns.



Combined, these three factors unlock a 'zone of likely outperformance' that characterises high-potential funds.

In the current market environment, investors should be focused on adding these high-potential funds if they are to benefit from long-term compounding and to maximise their wealth building.

In this paper, we look closely at each of the three factors and the deep academic research upon which they are based. We are particularly interested in the implications of combining these three factors into a single fund. Evidence supports the increased likelihood of the fund delivering extraordinary performance and wealth creation.

And we look at how, at Montaka, these three factors are deeply and deliberately embedded in our own investment philosophy, which we believe positions our portfolio to deliver our investors superior returns well into the future and through a market environment that is going to look very different to what has been observed in the past.

Factor 1. Concentrated – Successful active managers invest differently from the market

In 2016, Martijn Cremers and Ankur Pareek published a ground-breaking research report. They looked closely at the factors that determined whether a fund would go on to meaningfully outperform the stock market over very long periods. These characteristics are not just useful in hindsight. Investors can use them in advance to select funds that outperform.

The first factor they discover is that active outperformers have high 'Active Share'. Active Share is the proportion of a portfolio that is invested differently from the market at the beginning of a period. Highly concentrated stock pickers, for example, have high Active Share of 90% or more typically. On the other hand, 'closet indexers' with diversified and undifferentiated portfolios that look like the market (often despite claims otherwise) have low Active Share of 60% or less.

In their study of more than 3,000 equity mutual funds over 26 years from 1990 to 2015, Cremers and Pareek found that only funds in the top quintile of Active Share – typically the stock pickers scoring above 90% – tend to outperform the broader share market by almost 1% per annum, while lower Active Share funds generally underperform, some dramatically so.

This seemingly small yearly benefit becomes extraordinarily large when compounded over more than a quarter of a century, when the market appreciated at 9.4% per annum on average. A portfolio of the highest Active Share funds would have beaten the market by more than 180%. A hypothetical investor with initial capital of $US1 million would be almost $2 million wealthier by allocating to the most active managers, instead of a passive index fund.

The result is powerful and underscores the importance of distinguishing concentrated active funds from the rest, especially closet index funds, which Cremer first recognized in a 2009 paper.

Factor 2. Patient – Successful active funds hold positions for longer

But to outperform over the long run, it is not enough just to be differentiated from the market.

It requires another factor: patience.

Outperforming active funds have long Fund Duration. Fund Duration is the average length of time a fund has held the stocks in its portfolio over the previous five years.

Managers with long Fund Duration hold stocks at least two years, while short Fund Duration managers usually sell stocks eight months after purchasing them.

Cremers and Pareek examined how patient managers performed when compared to funds trading frequently. The results were more striking still.

Among the funds with highest Active Share, the researchers found that only those also in the top quintile of Fund Duration – the long-term investors that stick to their convictions longer than two years – outperform … and by almost 2% per annum.

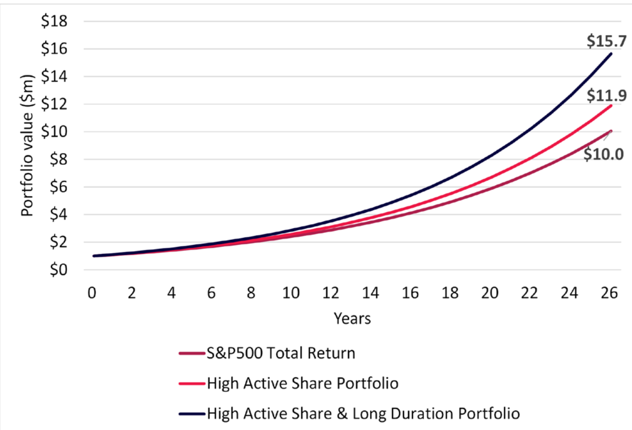
Less patient managers underperformed regardless of how active and concentrated they were, and, in fact, the more they traded the worse they performed. Basically, patience paid off in spades.

But the most powerful combination is a fund that invests differently from the market and is patient.

By allocating the initial $1 million of capital to a portfolio of those most concentrated active managers that were also the most patient with their holdings, the earlier hypothetical investor would have outperformed the market by an additional 380% and be another $3.8 million richer.

Concentrated and patient active portfolios compared to the market

(Initial capital of $1 million grown over 26 years)



Source: Montaka

Factor 3. Discipline & Structure: Successful active funds weather drawdowns

Armed with the insight that outperformance requires active managers to be both highly concentrated and very patient, it may then be surprising to learn that the set of managers who are both is very limited.

The researchers suggest this is easier said than done because there are strong perverse forces at play in the funds management industry. Being concentrated and holding long-term convictions may be a pathway to superior profitability in the long run, but it comes with a high likelihood of frequent short-run underperformance, jeopardizing a fund manager's career and irritating impatient clients. And most fund managers do not have the right structures in place to withstand these forces.

The problem is that investors have been promised an elixir of big returns and low volatility. But the truth is that to achieve outstanding long-term returns, investors must be prepared to endure large drawdowns along the way – even for the best-performing stocks and portfolios.

History shows that investors need to stay the course with winning businesses – the likes of Apple and Amazon – if they want to reap great rewards in the future.

This is the reason successful active investors need a third characteristic – discipline and structure – if they are to weather these periods on the path to outperformance.

In July 2020, Hendrick Bessembinder, a finance professor at Arizona State University, published a series of papers with an important and surprising conclusion: that even the stocks of companies that had created the most wealth for shareholders over a decade experienced deep and protracted share price reversals along the way – often several times.

Bessembinder had become well-known after he demonstrated that all the stock market's value creation over the long run was concentrated in just a few stocks with extreme outperformance. (He also demonstrated that around 60% of all publicly listed companies perform worse than Treasuries, which is a sobering statistic for investors in index funds.)

His more recent research focussed on the characteristics of those 'outlier' stocks, including their interim share price movements.

Bessembinder studied the wealth creation of all publicly listed US stocks across each of the seven decades from 1950 to 2019. He then concentrated on the top 100 performing stocks, measuring their maximum peak-to-trough share price drawdowns.

He found that, on average, the most successful 100 stocks created $US219 billion of wealth over a decade-long horizon. However, shareholders had to endure a maximum drawdown in the same decade of 33% that lasted for 10 months.

Those shareholders that invested earlier in these top stocks, in the decade preceding their decade of greatest performance, would have suffered a maximum 52% drawdown lasting 22 months, on average, on their way to extreme wealth creation.

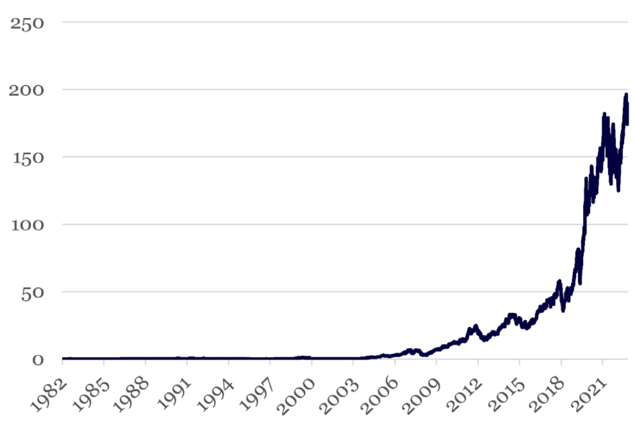
* * *

Case study: Apple and Amazon the rule not the exception

Apple and Amazon are two striking examples of remarkable companies with exceptional long-term stock performance that have been accompanied by staggering drawdowns.

Apple's value creation

Apple share price since IPO, US$ per share*



* Adjusted for stock splits

Source: Montaka

Apple created the most wealth in a decade of all the companies in the study, adding $1.5 trillion of shareholder value from 2010 to 2019. But this hasn't stopped the stock from making substantial retracements. For example, in this decade Apple's share price fell by 40% over 9 months in 2012.

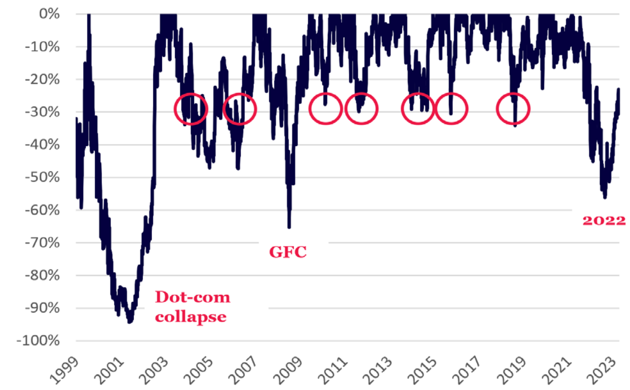
Looking back further, shareholders since Apple's IPO in 1980 have earned a compound annual average return of 20% but have experienced drawdowns of more than 70% on three separate occasions.

Amazon is another of the most successful investments in history and the fourth-highest performer in the Bessembinder study, with shareholder wealth growing by more than $600 billion between 2010 and 2019.

Still, Amazon stock has not been impervious to very large drawdowns. Although shareholders from the 1997 IPO have made compound annual average gains of 33%, they also suffered through the dot-com crash of the early 2000s, when Amazon's share price fell by a gut-wrenching 91%, as well as numerous subsequent drawdowns of more than 30%.

Amazon - Plenty of large draw-downs

Percent drawdown from prior 2-yr high



Source: Bloomberg; Montaka

Some investors would be quick to point out that while these companies may be the best of the best, they are still just individual stocks, and a portfolio approach should limit the drawdown risk. Perhaps surprisingly, the research shows otherwise.

Apple has drawn down over 70% three times

*Adjusted for stock-splits

Source: Bloomberg; Montaka

Case study: Not even God can avoid drawdowns

Wesley Gray, Phd, an asset manager and former US Marine, published a paper in 2016 concluding that a hypothetical stock portfolio constructed with perfect foresight would deliver stratospheric long-term returns … but still could not avoid agonizing drawdowns.

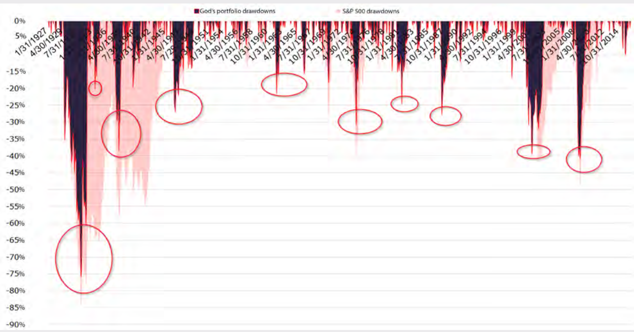
Gray created what he called 'God's portfolio' which invested exclusively in the top decile of stocks based on their performance over the next five years. After five years he rebalanced the portfolio to invest only in the top performers for the next five years, and so on. He ran this exercise from 1927 to 2016 covering the 500 largest publicly listed stocks in the US.

Over the 90-year investment horizon, God's portfolio compounded at more than 29% per year which would have turned an initial investment of just $1 into almost $12 billion! (The S&P500 index of the top 500 US listed stocks returned on average just under 10% per year in this time and a $1 investment would have grown to about $5,000.)

While the theoretical value created by God's portfolio is no doubt staggering, the drawdown profile is more astonishing. Instead of protecting against large reversals in fortune, God's portfolio endured the pain of drawdowns that exceeded 20% on ten different occasions. The worst of these was a 76% decline over almost three years in the Great Depression – not dissimilar to the stock market's 85% drawdown around the same time.

God's portfolio still has large drawdowns

Drawdowns since 1/1/1927, per cent



Clearly it is impossible to create Gray's divine portfolio in the real world, but that's the point. Knowing which stocks to select in a portfolio based on the returns they will achieve with certainty would deliver exceptional long-term gains. But only if investors could stay invested through the short-term pain.

* * *

Concentrated, patient and disciplined

At Montaka, 'High Conviction' and 'Long-Term Perspective' are two of our core principles. And we have created a structure and mindset required to achieve superior long-term compounding by owning a concentrated portfolio of high-conviction investments and patiently holding them for many years or even decades.

This can be clearly observed by applying the research measures of Cremers and Pareek to our funds.

Montaka's funds have very high Active Share. The Montaka Global Long Only Equities Fund (MOGL) scores around 90%, in line with the most concentrated stock pickers on the planet. This reflects large investments in the best opportunities – our top holdings are north of 10% in size, and even higher in the Montaka Global Extension Fund (MKAX).

While the funds hold some of the world's largest companies in common with the index, given we believe they represent extraordinary long-term compounding opportunities, we back them heavily. For example, Blackstone, is a 9.7% holding in MOGL and 14.6% in MKAX whereas the MSCI World Index only holds a position of approximately 0.3% in this excellent business.

Montaka's funds also have very long duration holdings; much longer than some of the most patient equity funds in the world. The average holding period of the top 10 stocks in the long portfolios is approximately four years – double the threshold in the study – and we expect continued low turnover in future.

Not only are we concentrated and patient, but we are also disciplined. Importantly, these three vital characteristics are enabled by our structure, culture and supportive client base.

Sell-offs and drawdowns are difficult. But at Montaka, we take a long-term view, and we accept that drawdowns are the price you pay to benefit from the powerful, wealth-building compounded returns from equities and the stocks of remarkable companies.

Montaka's recent experience with Meta was a clear illustration of this point. Over the last two years, Meta's stock price declined by three-quarters, but then increased by nearly 4x. While unpleasant, Montaka's structure and disciplined process enabled us to own Meta all the way through – and even add to our position along the way at cheaper prices.

When you combine the three characteristics of a high-potential active fund, as we do at Montaka, we believe, as the research shows, these represent the foundations for long-term success.

As the market environment continues to evolve from one of low-dispersion, to one characterised by winners and losers, we would expect the conclusions of the research contained in this paper to only strengthen.

And this is great news for investors in high-potential funds, including Montaka.

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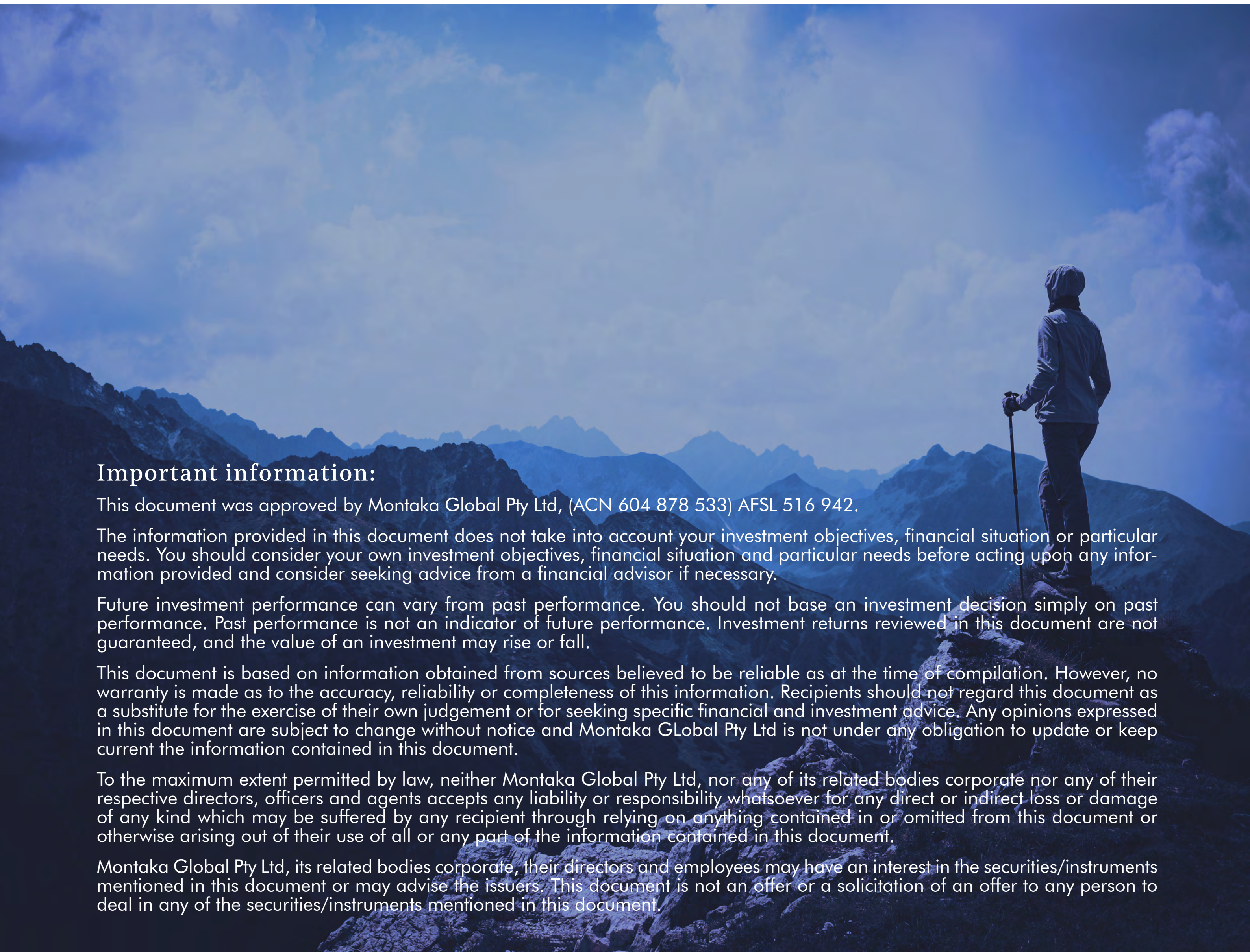

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