

ABR Dynamic Funds' Portfolio Construction Series: Part 16

The discretionary vs. systematic debate

There are numerous ways to evaluate discretionary vs. systematic investing. What follows is a brief survey of some of the more interesting data, organized into two sections:

- Discretionary decisions
 - Security selection
 - Market timing
- Systematic decisions
 - Security selection
 - Market timing

Generally speaking, systematic decisions have had the potential to improve results while discretionary decisions have hurt results, sometimes quite significantly. No method of addressing this debate is perfect, and legitimate criticisms have been leveled at all of them, including some of the data we present below. We do not delve into the criticisms in this brief survey. Although some of them are legitimate, in our view they are not sufficient to overcome the lopsidedness of the data and swing the conclusion away from systematic decision-making.

Discretionary Decisions

Discretionary decisions can be difficult to evaluate because they are, by nature, inconsistent across time periods and managers. Of course, that isn't just a criticism of the evaluation, but perhaps also of discretionary investing itself. Nevertheless, there is still some telling research on the average results.

Security Selection

S&P Dow Jones publishes a "Persistence Scorecard" on fund performance. It might as well be called the Impersistence Scorecard. The following points suggest that winning was probably mostly a matter of luck, not skill, and investors who selected funds based on a past lucky streak were likely to be disappointed.

- There were 631 domestic equity stock-picking funds in the top quartile of performance as of September 2014. Two years later, a mere 2.85% of them could still be found in the top quartile.
- Only 4.47% of large-cap funds maintained top-half performance each year over the 5-year period from 2012-2016. By sheer luck, the number would be about 6.25%.
- The numbers over slightly longer time-frames paint a similar picture. From 2003-2016, only 39.6% of domestic equity funds outperformed the market in any given year.¹
 - Finding a reliable winner was difficult from 2003-2016. On average, only 7% of the winners in any given year, as defined in the previous point, were still winners 3 years later.¹

Market Timing

Dalbar publishes a "Quantitative Analysis of Investor Behavior. The figures in it do not paint a rosy picture of manual market timing, especially in the face of volatility:

- From 1985-2014, the average equity investor achieved just a 3.8% annual return. Over that same time-frame, the S&P 500 gained 11.1% per year. The lag is partially attributable to timing decisions. In other words, the average investMENT has outperformed its average investOR due to bad investor timing decisions.
- The 5 worst months for the average equity investor, in terms of underperforming the S&P 500, all occurred in months in which the S&P 500 moved 10% or more. In those months, the average S&P 500 move was 15.2%, and the huge moves likely caused and magnified investor errors.
 - Investors underperformed the S&P 500 by an average of 5.4% in each of those 5 months. That's 27% of underperformance in just 5 months, all of which occurred at highly volatile times.

Systematic Decisions

It is easier to precisely demonstrate the track record of systematic strategies, two of which are shown below. However, first recall from [installment 7](#) that it takes a very long time to be able to evaluate an investment solely based on its total return. Systematic strategies can be tested over longer periods of time than the lifetime of most funds and their management teams. These tests may allow investors to identify, with at least some confidence, favorable investing strategies over necessarily long time frames. However, these backtests are also not without their criticisms.

Security Selection

To demonstrate a way to systematically select securities, we will use an MSCI multi-factor index. It consists of value, momentum, quality, and size. We have chosen it for the simplicity of the factor implementation and the transparency of a published methodology, **not** as an endorsement.

The following graph shows the multi-factor index vs. the benchmark over the same time frame covered in the above section on discretionary security selection (2003-2016). **The systematic selection of stocks, based on carefully tested stock performance factors, led to outperformance of the benchmark.**

**MSCI USA Diversified Multi-Factor Index (white) vs. MSCI USA Index (green)
2003-2016 (normalized to 100 on 12/31/2002)**



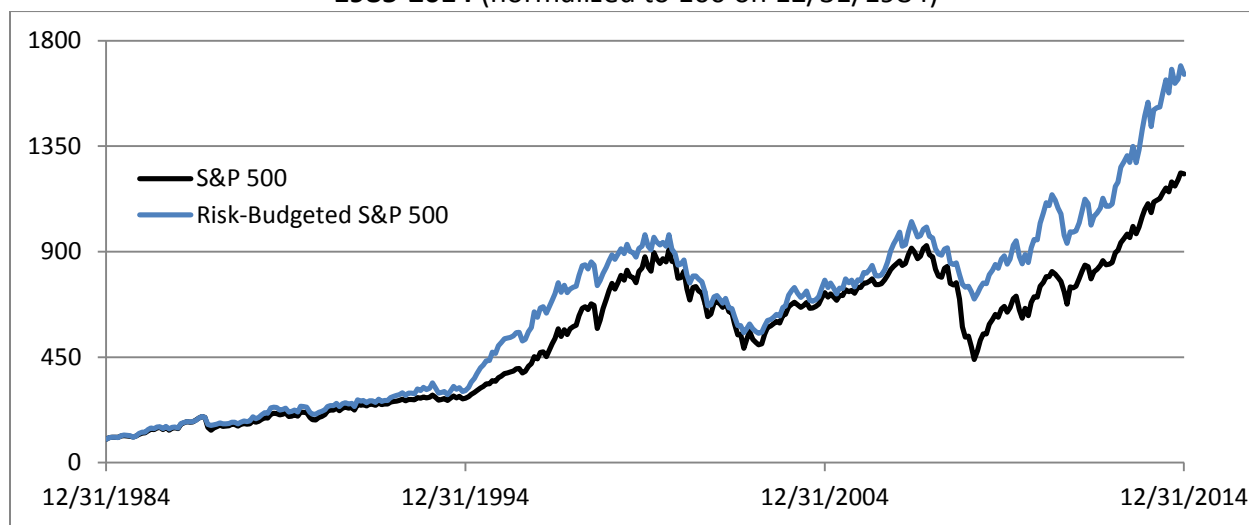
Source: Bloomberg

Market Timing

To demonstrate a way to systematically time market exposure, we will use the risk budgeting methodology from [installment 4](#) of this series on portfolio construction. It is once again chosen for the simplicity of the strategy and transparency of the methodology (fully laid out in Installment 4), **not** as an endorsement. It also shows how volatility could have helped investors, instead of hurting them as it did in the discretionary market timing section.

The following graph shows the results of the risk-budgeted S&P 500 vs. the S&P 500 over the same time frame covered in the above section on discretionary market timing (1985-2014). **The systematic sizing of market exposure, based on the carefully tested idea of volatility as risk, led to outperformance of the market.**

**Risk-Budgeted S&P 500 (Blue) vs. S&P 500 (Black)
1985-2014 (normalized to 100 on 12/31/1984)**



Source: ABR white paper (data from Bloomberg)

Conclusion

Generally speaking, systematic decisions have had the potential to improve results while discretionary decisions have hurt results, sometimes quite significantly. There are numerous methods to evaluate the discretionary vs. systematic debate. Although none of those methods is perfect, the results were still worth a look. Different (as well as more exhaustive) analyses suggest similar conclusions to varying degrees.

Despite the overall better return of the systematic decisions above, it is worth noting once again that quite a long time is required to evaluate a strategy solely based on its total return, and these systematic strategies underwent extended periods of underperformance too.

1. Poirier, R., and Soe, A. (2017). *Fleeting Alpha: Evidence From the SPIVA and Persistence Scorecards.*

Next Week's Preview: Long/short fixed income alternative strategies have often just provided diluted fixed income exposure.