Monthly Blog

PM's Perspectives

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Why do top performers tend to switch places every ten years?

When we look at the past performance of Japanese stocks, value stocks and growth stocks handed over the position of top performers to each other approximately every ten years, excluding the IT bubble period. We believe that there are three reasons why a particular investment strategy wins or loses in a certain period.

First, investors shift their funds based on the investment returns of each product over the past few years. When asset managers design new products, they usually pick securities with strong performances (track record) or favorable simulation (backtracking) results under certain assumptions. And they often underscore good performances of these products in selling them by saying "The fund has performed well over the past three years," or "If you had invested in this fund five years ago, you could have earned this much." Furthermore, when institutional investors and consulting companies evaluate funds, they place a high value on funds with strong performances for the past three to five years. While a fund with a poor performance is likely to receive a lower grade and suffer an outflow of money, the one with a strong performance should enjoy a high score and an inflow of funds. In this way, a particular investment strategy that performed well for the past few years tends to attract investment funds not only in terms of product planning but also from the perspective of sales and fund evaluation.

Second, a change in the ratio of stock indices or a reshuffling of their component issues promote fund transfers. For example, if growth stocks continue outperforming value stocks for five straight years, the ratio of stocks with growth images to the overall stock index should increase during the period due to fluctuations in the market value of individual stocks. Since active portfolio management in Japan aims for outperforming specific benchmarks such as the TOPIX, asset managers have to adjust their portfolios when the composition ratio of the indices changes. Given the reshuffling of the index's component issues means stocks that have performed well in the past are adopted in the index while those with poor performances are excluded from it, it should provide a boost to the investment strategy that had been successful. An index fund manager is supposed to adjust his portfolio in accordance with the reshuffling of an index's component issues, while an active fund manager must sell stocks that were excluded from the stock index or those whose category of company size changed from medium to small if he has an upper limit ratio of stocks that are not included in the benchmark or that of small cap stocks. The liquidity of the stock declines when it is excluded from the index, so a sell-off under such a situation further worsens his performance.

Third, excessive valuations are corrected. When a certain investment strategy performs well, money flows into that healthy fund. If it continues to perform well, we will see the excessive climb in the valuation of individual stocks. When growth stocks continue rising to the level that cannot be justified in terms of the P/E ratio, we have to use other indicators for valuation such as PEG (Price Earnings Growth Ratio) and PSR (Price to Sales Ratio). When resource prices continue rising, value stocks including resource stocks (typical cyclical value stocks) become overvalued in a phenomenon called the commodity super-cycle. These overvaluations will be corrected over time because they are unsustainable.

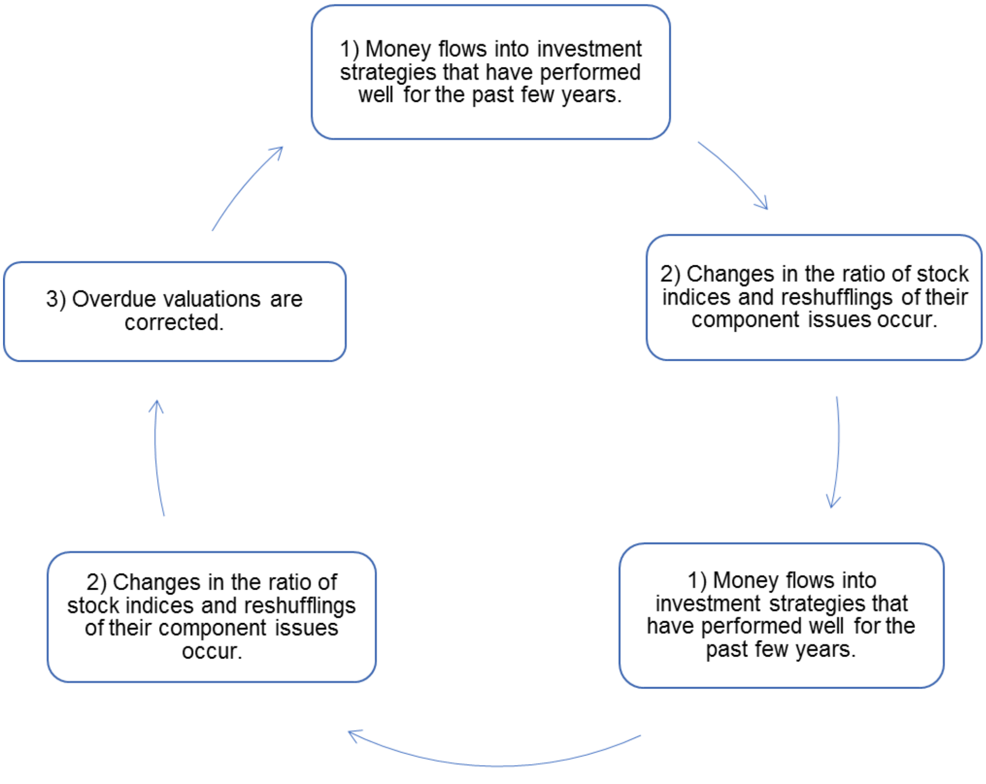
Author

Takuya KAMIISHI, CMA
Co-Lead Portfolio Manager
Value + Alpha Group

Sumitomo Mitsui DS Asset Management

Performances of funds with investment strategies that have been successful will deteriorate in this adjustment phase, while those of the others with different investment strategies will improve. Thus, money starts to flow into products with different investment strategies.

In summary, there seems to be a cycle in asset management. First, specific investment strategies that performed well in the past few years draw funds. Second, the inflow is promoted by changes in the ratio of stock indices and reshufflings of their component issues. These two phenomena repeat themselves. In the third phase, undue valuations are corrected. Then back to the first and other investment strategies draw funds.



Fund managers may not only have to gain excess returns in normal times but move away from a familiar strategy that has brought them gains for a certain period and try others before or after the third phenomenon occurs in order to maximise client assets. But they cannot put this into practice, unless the design of funds allow them to do so while they themselves have to build up trustful relationship with their clients in advance. They may also have to convince their clients that new products whose relevant issues have lackluster track record should outperform in the future.

Takuya KAMIISHI, CMA
Co-Lead Portfolio Manager, Value + Alpha Group

Mr KAMIISHI joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

Mr KAMIISHI obtained a BA degree in Economics from Keio University (2009) in Japan.

Note: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

Disclosures

Contact Details

Business Development and Client Relations	
Junya OKADA	+44 (0)20 7507 6436
Jennifer SANDS	+44 (0)20 7507 6424
Marius ERIKSEN	+44 (0)20 7507 6438
Email: uksales@smd-am.co.jp	

Sumitomo Mitsui DS Asset Management (UK) Limited
5 King William Street, London, EC4N 7DA
United Kingdom
www.smd-am.co.uk