Winners and losers: equity investing and the Premier League

Investing is a zero-sum game. Thus the view that "it must be the case that before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar...". It is the same thing with football where, in the 2019-20 Premier League season, 10 teams had winning records and 10 teams losing records. Of course, some teams win more than others – they are the "winners". If we think of the winners being those teams finishing in the top 5 of the table, then how many winners are there? Remarkably few as it turns out. Only 9 teams have finished in the top 5 over the past 10 seasons.

On the face of it, picking the likely winners seems likely easier than at first thought. Obviously a lot of factors go into being a winner; actually, just three: money, skill and luck. The very same factors at play in equity investing.

Equity investing is not a zero-sum game in the same way as football. Over periods of rising markets there are more winning records than losing records. From 2010 to 2020 (YTD Sep) 69% of securities in the S&P 500 had a winning (positive total return) record each year.

The dispersion of securities in the S&P 500 over the last 10 years has been remarkable. Only 4 issuers have ranked in the top 5 by total return each year since 2010 (Advanced Micro Devices (3 times), NVIDIA (3), Netflix (2) and Wynn Resorts (2); 45 different issuers make up the rest. In 2020 (YTD Sep) a surprisingly small number of companies equate to the positive change in the index: just 3 index constituents (Apple, Microsoft and Amazon) have equalled the entire index gain. As one might expect, over a longer timeframe, the index gain has been more diversified.

\[\text{Sharpe, William F. (1991), "The arithmetic of active management."} \]

Chart sources: Premier League & Bloomberg /GIB UK analysis
Is the concentration of contribution to return the result of 2020 as a crisis year? Maybe, but probably not; the number of constituents representing aggregate index gain coming out of the great recession looked much more like the even balance of the Premier League.

2020 can probably be best explained by the unprecedented nature of the crisis and, therefore, the difficulty to build forecast models for the market as a whole. It has been easier to react and pick obvious winners (WFH technology) and losers (airlines and tourism).

All this goes to say that consistent outperformance of a passive index, such as the S&P 500, by active managers is concentrated in the hands of those with the money and skill (and luck) to do so. Historically, active investing has been epitomised by the plethora of hedge funds opening and closing each year. Most are private so it is easiest simply to look at Berkshire Hathaway, publicly listed throughout Warren Buffett’s control. Buffett is famous for the quote “Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing”.

Chart sources: Bloomberg /GiB UK analysis
Buffett clearly knows what he is doing as measured by his track record particularly over the long haul.

But knowing what you are doing doesn't mean you get it right all the time. Berkshire Hathaway has investments that have not fared so well (e.g. Teva Pharmaceutical) and others (e.g. Apple, Berkshire's largest public equity holding) that have been outstanding successes.

In this context, Buffett's investment advice is surprising. "I've often been asked for investment advice... My regular recommendation has been a low-cost S&P 500 index fund." 2

Buffett counsels asset owners to select investment managers with skills to adapt to different market cycles for the benefit of their clients. We agree. Skills matter and will outscore luck over the long term. The market pivot to sustainability requires winning investment managers to adopt a different set of skills. By the same token, we wonder who will have the skills to win this year's, Premier League.

Note: returns are from Berkshire Hathaway Inc initial investment date to 2020 (YTD Sep)

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Chart sources: Bloomberg /GIB UK analysis

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