HOME SWEET HOME

Don't bother outsourcing your international equity exposure to foreign managers.

Stephanie Condra, CFA

Earlier this year, the CFA Society Toronto & Hillsdale Canadian Investment Research Award was given to a paper that explored the performance of international equity funds. The paper—"Does Sub-advising Abroad Improve the Performance of International Mutual Funds?"—questioned whether the risk-adjusted performance of international sub-advised funds was improved by hiring third-party (outsourced) managers abroad and looked to identify the source of any underperformance or outperformance.

Here, we summarize the approach taken by the authors—Dr. Pauline M. Shum-Nolan and Mr. Michael Densmore of York University, and Dr. Markus S. Broman of Syracuse University—recap their conclusions and explore the potential application for the investment community.

The Paper

In the authors' words, the objective of their research was to "test whether there is any value in sub-advising fund management duties to managers with a potential local information advantage." The researchers used performance data on international and global equity funds sold in the U.S., and referenced SEC filings to identify whether the fund had appointed a sub-advisor with headquarters overseas. Sub-advisors were then classified as either in-house or outsourced (i.e., a third-party manager that's unaffiliated with the mutual fund company that launched the fund).

The Conclusions

The researchers found that funds using overseas sub-advisors (whether in-house or outsourced) were either unable to or did not exploit local information to improve their relative performance. Put another way, the research suggests that U.S.-based asset managers aren't disadvantaged if they choose to manage their international equity portfolio on home turf.

When asked to reconcile the outcome with prior literature on local information, Densmore suggested that changes in the information environment—easy access and increased transparency—may eliminate any local information advantage sub-advisors can provide. While a time-series comparison between local information advantage and ease of access or transparency was beyond the scope of the paper's research, Densmore's explanation is intuitive.

The paper also had the following conclusions:

- funds that hire outsourced (third-party, unaffiliated) rather than in-house international sub-advisors underperform on a risk-adjusted basis by up to 112 bps annually, relative to funds that are not sub-advised;
- funds that outsource to international sub-advisors have significantly lower active share and turnover relative to other funds—thus, the relative underperformance of outsourced international sub-advisors can partly be explained by these managers being less active in managing the assets, particularly in their local holdings; and
- the underperformance of outsourced international funds is similar, or even stronger in most cases, among funds with single sub-advisors, which rules out the possibility of co-ordination problems among multiple sub-advisors driving the result.

What This Means for the Investment Community

As investors continue to rebalance their equity exposure away from domestic holdings and into global allocations, more attention is being given to how best to structure an international equity portfolio. The paper's authors are mindful of the limits of their research and warn against any over-extrapolation of the conclusions. However, professionals in the industry might use these insights to help guide their investment and business decisions.

- For asset managers: The research in the paper backs the case for supporting domestic businesses and hiring local Canadian firms and professionals to manage international mandates. Performance will not be improved by setting up a sub-branch or satellite office of portfolio managers overseas. Furthermore, asset managers should not overlook in-house or affiliated portfolio management teams when constructing global equity portfolios. Small asset management firms, which typically lack internal expertise on international or non-domestic equity markets, may still need to appoint a sub-advisor, but that sub-advisor's focus should be on identifying managers that are truly active.

L–R: Michael Densmore, Dr. Pauline M. Shum-Nolan, Chris Guthrie

- For consultants/advisors: Similar to small asset management firms that might need to look outside their business for expertise, guidance for consultants, advisors, or fund of funds managers is to look at factors like active share and turnover—both of which have been known to positively predict future performance.
- For asset owners/investors: Promotional materials for funds may promote open architecture or use of third-party managers as a performance enhancer, but be mindful to challenge any bias or assumption that local asset managers have an information advantage.

The CFA Society Toronto & Hillsdale Canadian Investment Research Award is granted annually to research papers that advance the knowledge of investment management practices. Now in its ninth year, the award recognizes the value of high-quality Canadian investment research that contributes to our Society's collective body of knowledge and supports continuing education of our professionals. The authors presented this paper at CFA Society Toronto's 10th Annual Local Research Challenge and Awards Ceremony, and will also be presenting it at a number of upcoming conferences.

Read the full research paper here.

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