

The industry debate around active versus passive management is certainly nothing new. In fact it has existed for more than 10 years, fuelled by increased investor interest in investment markets due to mandated employer contributions and a buoyant stock market. Matthew Sherwood, Head of Investment Markets Research, discusses how the global financial crisis has again put the debate under the spotlight.

As the global financial crisis takes centre stage in the world media, the debate about active versus passive management has once more come to the fore, with both investors and advisers now questioning the ability of active managers to add value in the current conditions.

What is active management?

The main premise of active management is that pricing anomalies exist in the market and can be exploited by investors. The task of the active manager is to have a larger (or smaller) exposure to a stock than the index in expectation that the stock will deliver above index (below index) returns in the future. The active manager's goal is to deliver returns that are in excess of the index after fees.

Passive investing, on other hand, is based on the principle that markets are efficient and cannot be exploited. Passive investment managers therefore aim to match the performance of the index. Many researchers however have concluded that not only are markets inefficient¹, but also that the active managers can outperform over the long term².

The analysis and results

To examine whether this is true in Australia, we analysed how the average active Australian share fund (AAASF) performed after fees against the index.

Using data from the Mercer Consulting Survey of Retail Investment funds (after fees) for Australian funds, we have found that the average active Australian retail share fund³ has returned 9.0% pa (after fees) between January 1994 and April 2009 relative to 7.3% pa for the index after fees.

Since this initial date an investment of \$100,000 with the AAASF would be worth just under \$373,000 (after fees), which is well above the index return of just over \$292,000 (after fees).

We also found that the AAASF performs well in most market conditions, but it does not outperform the index at every point in the investment cycle.

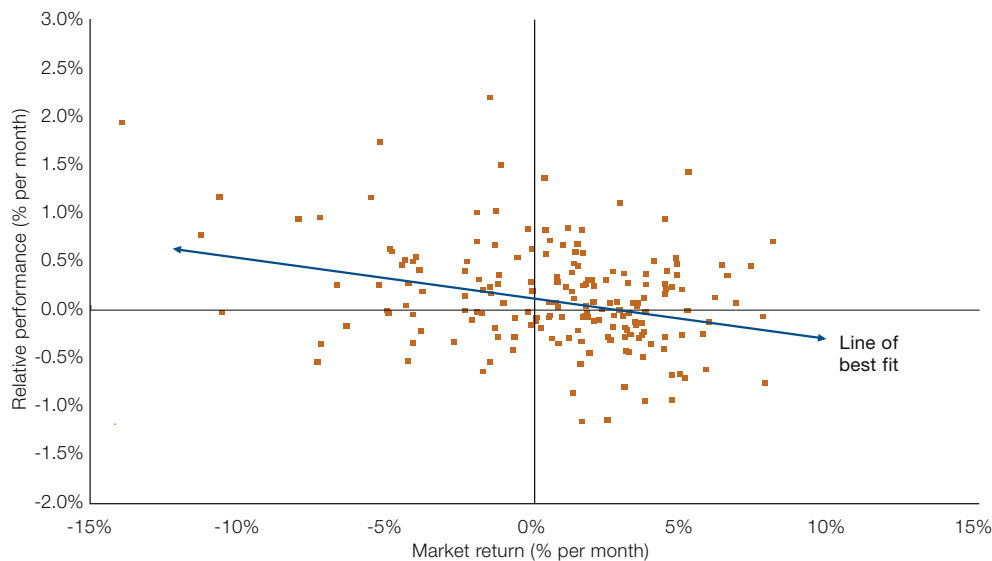
So during which types of markets does the AAASF outperform?

Market sentiment has a large impact on relative performance:

- If markets were increasingly bearish (as was the case over the past year to 30 June 2009 and also during the tech wreck), the relative outperformance of the AAASF was strong.
- When the Australian sharemarket experienced a negative monthly return (this has occurred 65 times since the start of 1994), the AAASF outperformed in 62% of these occasions (see Chart 1).
- When the Australian sharemarket experienced a monthly decline of greater than 9%, around 80% of Australian active share funds outperformed the index (by an average 1.9%).
- When markets recorded less dramatic declines, the outperformance declined but remained significantly positive (an excess return of 0.3% when the market had a monthly return between -3% and -6%).
- When the Australian sharemarket recorded a positive monthly return (119 occasions since January 1994), the AAASF outperformed in 51% of these occasions.

Chart 1 – Active managers perform well in most markets conditions

AAASF monthly outperformance relative to the index (%)



Source: Mercer Consulting Survey of Active Australian Share Funds as at 30 April 2009.

Your portfolio does its most important work in down markets

Albert Einstein once said that ‘the most powerful force in the universe is compound interest’. Whether or not this is true or Einstein was solely making a comment about greed, the power of compounding is critically important to investors. One of the most important things to do in managing a portfolio is to accurately evaluate risk and investment opportunities.

For example, imagine you have the option to do one of the following:

- invest in a portfolio that has a return of -40% in the first year and then 8% per annum for the next 10 years
- invest in a portfolio that has a return of -50% in the first year and then 10% per annum for the next 10 years.

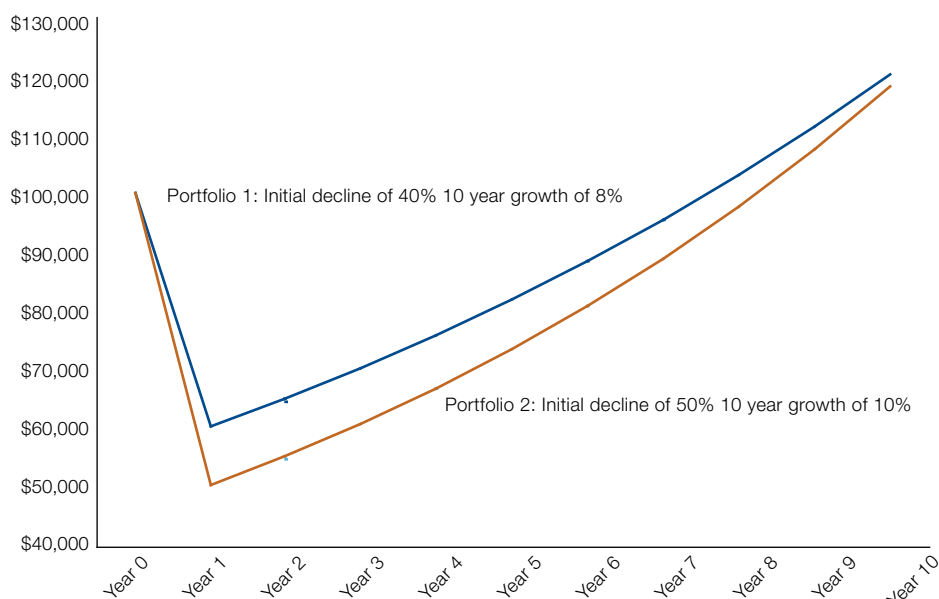
What would you do?

A declining sharemarket is the point of time in the cycle where an investor’s portfolio is doing its most important work for them, even though they may not realise this. Given Einstein’s comment, most investors would think that a portfolio growing at 10% per annum for 10 years would be able to more than offset a \$10,000 larger loss in Year 1. However, this is not the case (see Chart 2).

If investors experience larger-than-necessary losses, they will have a much lower capital base to work with. This means their money has to work much harder for a longer period of time to make up the difference. In declining markets, investors should aim to reduce their exposure to highly stressed companies, which are leading the market down and have a much larger exposure to the quality companies that are outperforming.

Chart 2 – Declining markets is when an investor’s portfolio is doing its best work

Portfolio value: two portfolios (\$)



Source: Perpetual Investments as at 7 July 2009.

In which sort of markets does the AAASF underperform?

Chart 2 demonstrates that compounding is a less powerful force than the power of a higher capital base. The line of best fit in Chart 1 (which details each month's index return and excess return of the AAASF) passes through the Y-axis at a monthly market return of 2.7%. This suggests that monthly returns in excess of this are, on average, increasingly more difficult for the AAASF.

Examining rolling rates of return (the lines in Chart 3) shows that short-term returns have been notably impacted by market bubbles, such as Australia's second mining boom earlier this decade. This period was characterised by the Australian market experiencing a major deviation between share prices and earnings lasting over a year, especially in the mining sector.

Active managers who focused on earnings, dividends and balance sheets may not have bought many of these resource companies, as many of these have not delivered earnings and have traded at extremely high valuations. This suggests that when the market is extremely bullish and records a monthly return greater than 6%, the AAASF will underperform.

Calendar years in which the Australian sharemarket has experienced returns well in excess of its historical average (12% since 1882) are more challenging for active managers. This is because unusually large market rises are not always associated with earnings, dividend, interest rate and balance sheet fundamentals. In fact they are typically, but not exclusively, driven by valuation expansion as a combination of strong economic growth, low interest rates and low unemployment resulting in heightened investor speculation.

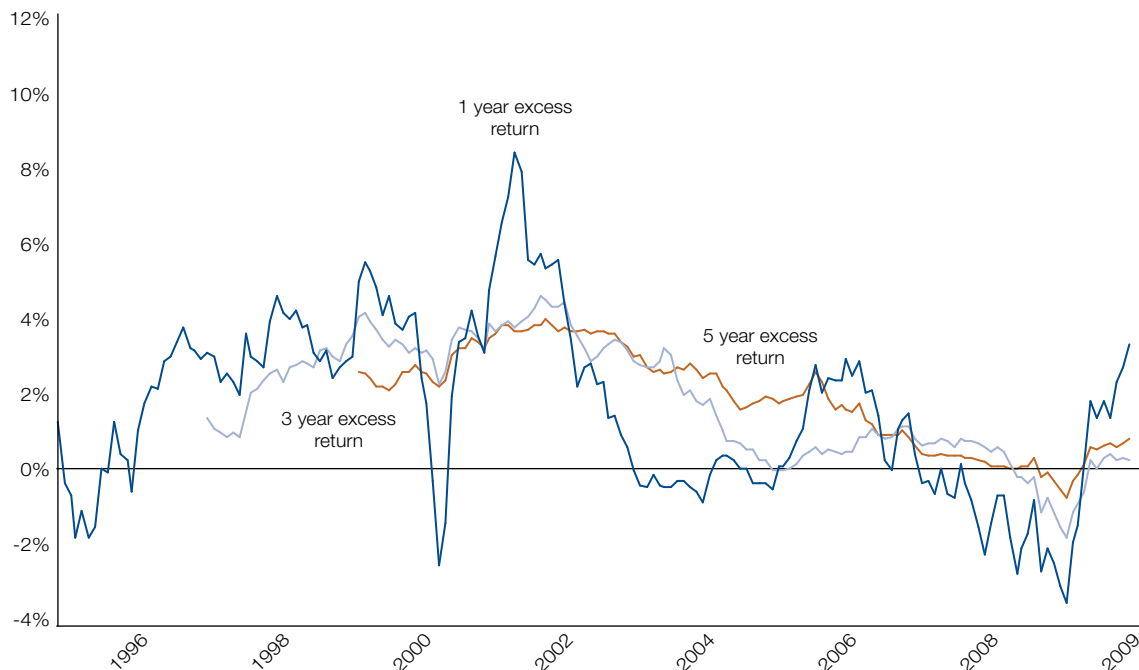
This highlights the temporary impact that sharemarket bubbles can have on the relative investment performance of active managers.

The impact of tax

The impact of tax on investment returns depends on many factors that are specific to the circumstances of each investor. The amount of tax paid by investors depends on portfolio turnover, capital gains, franking credits, marginal tax rates and whether the fund is for superannuation or non-superannuation purposes. Therefore, any broad post-tax analysis provided by a firm that does not know an investor's specific circumstances should be viewed cautiously, as any 'assumptions' may not be applicable and the level of turnover and franking credits are most likely unknown.

Chart 3 – Average relative performance provides no information about manager quality

Average active Australian share funds performance – January 1994 = 100



Source: Mercer Consulting Survey of Active Australian Share Funds as at 30 April 2009.

What are the attributes of successful active managers?

Although the investment performance of the AAASF since 1994 is quite reasonable, examining average active returns is not particularly insightful as investors do not seek to place funds with the 'average active fund manager'. Investors face the risk that the fund they select will underperform the index, as there are many strong and weak active managers contained in the sample group.

There is little doubt that if investors can identify better active managers, then the returns that they experience will be even better. There is also little doubt that some fund managers frequently underperform the index. This is particularly evident for those organisations with a weak or inconsistent investment process, high staff turnover and modest research capability.

In an industry with new fund managers starting up each year, declining establishment costs and eroding barriers to entry, the performance of strong fund managers may increasingly be offset by losses recorded by weaker managers. However, the existence of weaker active managers might be welcomed by stronger active managers as any security mis-pricing opens up investment opportunities for higher-skilled managers.

However, it is not possible to distinguish a highly effective active fund manager from a more challenged one by reading marketing material, short-term performance tables or information flyers. Widespread market inefficiencies exist and create the opportunity for all active fund managers to outperform over the short term. However, index-beating results over the long term are the end result of an investment manager's skill to detect market mis-pricing and use this information within the confines of a rigorous and sustained investment process and an appropriately resourced investment team.

Perpetual's investment philosophy

Perpetual is an active fund manager. Our disciplined approach focuses on quality companies at attractive prices. This gives our investors the best chance of achieving consistent returns and dividends over the long term, and peace of mind that these companies will survive even in the most difficult of times.

Our investment philosophy is based on the premise that:

- the index is not an efficient portfolio
- opportunities for adding value exist through stock selection
- investing in quality companies minimises downside risk
- outperformance can be achieved through the selection of stocks trading at a discount to their inherent value
- these can be identified through thorough in-house fundamental research.

In summary:

- Quality comes first. We add a lot of value by not investing in certain stocks.
- Our portfolio is value biased. This is an output of our stock selection process.
- Monitoring and accountability is important, so that we know where value is being added or lost.

1 Robert Schiller 1987, 'The Irrational Stock Market', Scientific American March 1987, pp 60.

2 Cremers, Martijn and Petajisto, Antti, 'How active is your fund manager? A new measure that predicts performance'. (Paper presented at the annual meeting of the American Finance Association, Chicago 7 January 2007.)

3 This article uses data contained in the Mercer Investment Consulting Survey of Retail Investment Funds (after fees) for Australian shares after fees. From this list, index managers and multi-manager funds are removed (to address the impact of endogeneity in the latter case) and all remaining funds (whether they exist today or they have failed or closed) are included in the monthly analysis to remove the impact of 'survivorship' bias. The number of funds contained in the sample group has grown from two in December 1986 to 119 in April 2009. The monthly average growth rate for all available active managers is used to compile an index of active Australian share funds rebased to 100 in January 1994. For this article's purpose analysis begins in January 1994 (when there were 12 fund managers with performance statistics in the survey). The results detailed were not materially impacted by the starting date as analysis three years earlier or three years later produced similar results. Accordingly, the results don't seem to be biased by time dependency.

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