LPACOnline
ASX LISTED PRODUCT ACCREDITATION COURSE

# BLENDING STOCK PICKING WITH PASSIVE INVESTING:

# THE MOST IMPORTANT ISSUE FOR FINANCIAL ADVISERS TODAY.

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## *I. Overview*

The financial press has ignited of late with advocates of traditional active investment management re-opening the debate about the "de-merits" of passive index investing. That's probably a timely response to the frequent brickbats thrown by some passive index managers, who argue that because of the "average" under-performance of active managers, passive index investments should be used for the whole of the portfolio. Neither extreme is entirely true and begs the crucial related question – what are the ***merits of direct investing*** in a concentrated portfolio of stocks?

Understanding the reasons for, and the uses of, each of these styles of investments is the ***biggest challenge*** and opportunity facing financial advisers and clients today.

For most clients a careful blend of concentrated, low turnover stocks and passive index funds will provide an efficient investment portfolio. There is also a case for the use of traditional "benchmark aware" actively managed funds in specific circumstances.

## *II. Direct, passive or active: why it's important*

When we deliver the ASX Listed Products Accreditation Course (www.LPAConline.com.au ) to financial advisers using direct share investing as a core part of their business, we focus on the utility of stockpicking as a tool for retail investors and advisers. We also assert that investments are a core part of the value proposition of the modern financial adviser – in fact, that ***investment advice is the most valuable part of the financial advisers' business***.

The last sentence is a massive statement and flies in the face of the old school mantra that financial advisers shouldn't focus on investments as a core part of their value proposition. Thinking carefully about using stock picking and passive index investing is more than merely about compliance, although the need to form a "reasonable basis for a recommendation" does shine the spotlight on the real merits of each of these three types of investment.

The core relevance of the statement stems from the market research around SMSFs and why they are so popular, which shows that more SMSF trustees set up and use their SMSF to promote "investment control" than for any other reason. These clients and the advisers seeking to service them need to have a strong and well informed understanding of the benefits and risks around these three types of investment.

## *III. Direct investing avoids "short gamma" portfolio management*

Apart from helping control fees and taxes, direct investing into a concentrated portfolio of low turnover stocks avoids the problem of "short gamma," which is a core problem of benchmark aware, actively managed funds. "Short gamma" describes the portfolio management practice of selling stocks when

markets fall, crystallizing capital losses but preserving cash with the aim of limiting losses if markets continue to fall – thereby hoping to outperform benchmark indices. The problem with "short gamma" portfolio management is that it sells out of assets irrespective of their fundamentals, and the high turnover style it fosters largely deprives the portfolio from the ability to benefit from growing dividend streams over time.

Direct investing allows the portfolio to maintain exposure to stocks based on their fundamentals and to benefit from rising dividends, much like a landlord benefits from steadily rising rental income over time. In this respect, ***direct investing offers an important "third way"*** for investors to manage their portfolios, benefitting from the opportunities arising from stock picking but with enhanced risk management and control, compared to traditional "benchmark aware" active management.

### *IV. APRA critical of active management*

Stockpicking comes in two main forms, and we need to carefully distinguish each:

- concentrated low turnover portfolios (held directly, or via an SMA/MDA or IMA, or MIS based unit trust);
- actively managed, benchmark aware, traditional managed funds.

To kickstart the discussion let's consider the merits of actively managed, benchmark aware, traditional managed funds – the dominant form of investment used by the Australian financial advisory community.

The complexity of the issue was neatly parsed by Graham Rich (CEO of Portfolio Construction Forum) in a recent comment:

> "Regardless of which side of the active/passive debate you fall on and for which types of investments, if a 1987 style equity market crash does eventuate as some are suggesting, investors in passive funds are in for a certain whipping. What's less certain is whether investors in active funds will do any better."(http://evotv.com.au/nomorepractice/10520/portfolioconstruction-blog-will-your-portfolio-hold-up-in-a-market-crash).

That's a massive statement and invites the need for a careful appraisal of the evidence. Let's start with what our peak superannuation regulator thinks. Commenting about the performance of traditional active managers, and how they fare in down markets, APRA was scathing in its 2009 watershed report on fund managers:

> "…the average (funds management) firm under-performed their net benchmark by 0.9% per year…***this raises a question about the value of the active approach to risk management*** of

> investment portfolios and may support our doubt about the appropriateness of the Sharpe ratio in measuring performance…
>
> ***The net under-performance of the average firm appears more pronounced in down markets***. This suggests either inactive risk management where investment managers appear to forego value adding opportunities in down markets or unsuccessful risk management in down markets perhaps due to costs…" (Sy W and Liu K: "Investment performance ranking of superannuation firms" (APRA Working Paper, 23 June 2009), p. 18. Author's comment in italics and parentheses).

In this statement we can see the peak superannuation regulator expressing three concepts:

1. APRA has doubts about the value of the active approach to risk management;
2. The *average* fund manager under-performs their benchmark;
3. The *average* fund managers' under-performance is more pronounced in down markets.

### *V. Picking the "Best" active managers – performance persistence*

It would be misleading to ignore the incidence of some great returns from some outstanding active managers – but the problem is, it's hard consistently to spot them in advance (and it's normally too late to invest after the great returns have been generated).

Before we move onto analysis of the technical risks and merits of the active approach to investment management, let's deal with the first level response many advisers and researchers make to comments two and three above.

In these points APRA refers to the performance of the "average" fund manager; begging the response that the role of the good adviser and researcher is to avoid the average manager, and to identify and instead invest with only the "best" managers.

The problem of course is that its hard consistently to pick the "best" managers; performance persistence is notoriously weak as Exhibit 1 below shows (which shows that of the fund managers that manage to beat the benchmark in 1 year, only 38% remain above benchmark performers 3 years later).

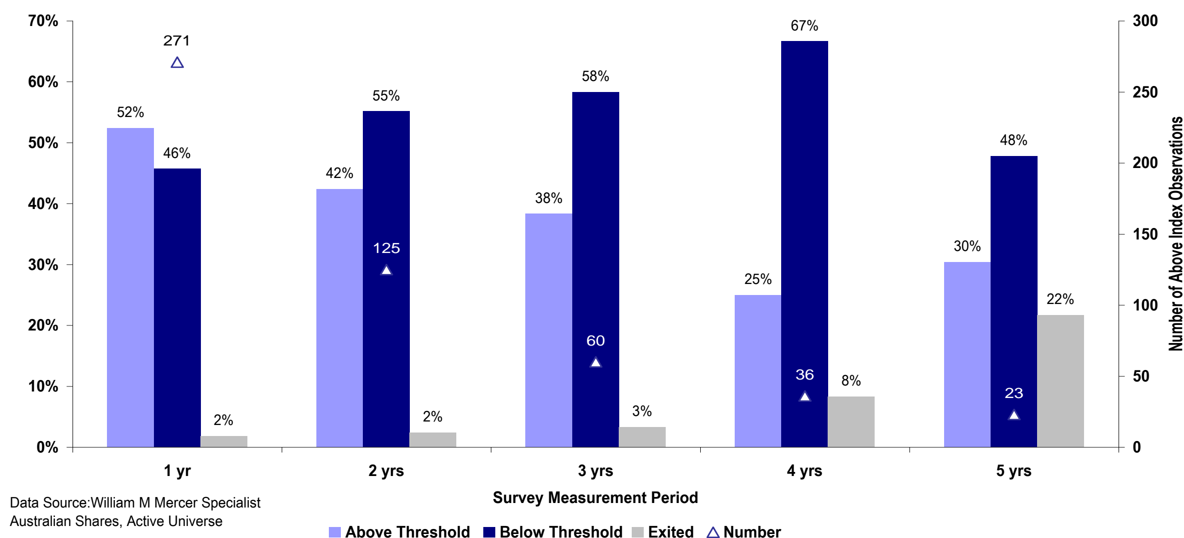



Exhibit 1. Source: Mercer, StateStreet Global Advisers. Threshold of Index + 2% represents the median cost of investing into the universe of funds analysed, ie as a retail investor or wholesale investor via platform. Period 1991 to 2005. See discussion below regarding later periods. Advice fees are not included.

### *VI. “Benchmark aware” active management – what does the data show?*

So whilst it’s easy to conclude that the average or median active manager under-performs, it’s harder to extrapolate to a conclusion that all active managers should be avoided. But on the other hand, nor is it good enough to ignore the problem of fees and taxes – for it’s the real fees and taxes that retail investors pay and bear that makes it hard for active managers to be of consistent benefit to them.

When we consider the value added by active managers compared to their benchmark index, we need to evaluate both the ***frequency*** as well as the ***magnitude*** of outperformance. Focusing on the frequency but not magnitude - and the incidence of fees and taxes - can disguise a significant part of the problem.

For example consider the disappointing perspective taken in the recent Centre for International Financial Regulation (“CIFR”) study on the “My Super” regime. The study was co-authored by CIFR and Chant West, and contained an undisguised preference for active managers, in the context of an evaluation of the increased use of passive index funds as a way of reducing costs for My Super offerings:

> “First off, it is Chant west’s opinion that members in retail funds are worse off as a result of these changes. Chant West bases this view on two notions. First, that active management adds value when evaluated at wholesale management fees, noting that Australian managers have

been comparatively successful in the Australian equity market…For instance Mercer report that the median Australian equity manager outperformed the S&P/ASX 200 index by 2.3% over a 12 month period, 1.5% over a 3 year period and 0.9% over a 5 year period. These gross returns comfortably exceed the management fees paid to wholesale managers" (CIFR My Super Landscape, April 2014, p. 21 (inc footnote 25)).

When compared with the Mercer data in Exhibit 1, which in that period identified the median cost of accessing active Australian equity funds for retail investors as 2% pa (before taking into account advice fees), only the 12 month return figure in the CIFR quote shows any meaningful value added by Australian active equity managers. (The Mercer data referred to above refers to pre GFC years, we analyse this below using a range of assumptions to reflect the drift towards lower fees for some active managers. For example the CIFR report shows average retail fees for actively managed funds "My Super" funds ranging from 1.95% pa for a $10,000 account balance reducing to 1.17% pa for a $500,000 account balance).

Considering that the Chant West comment was made in a research report assessing the impact of My Super on the costs and returns of ***retail*** investment, it is unhelpful to debate the value of the active funds management approach using ***wholesale fees*** as the reference point.

But let's dig deeper into the recent returns reported in the CIFR paper by considering recent Share Price Versus Active ("SPIVA") data supplied by Standard & Poors, set out in Exhibit 2 below. This shows that for the period since the GFC, Australian active managers have shown improved frequency of out-performance vs index, compared to the earlier period surveyed in Exhibit 1.

This SPIVA data shows that there:

1. continues to be evidence of active managers adding value over their benchmark;
2. and suggests that there may be "seasons" in which active management is more likely to add value (we discuss this point in further detail below).

| Fund category | Comparison Index | One Year % | Three Year % | Five Year % |
|---|---|---|---|---|
| **Australian Equity General** | S&P/ASX 200 | 63.6 | 32.4 | 39.6 |
| **Australian Equity Small Cap** | S&P/ASX Small Ordinaries Index | 93.9 | 88.5 | 81.9 |
| **International Equity General** | MSCI World Ex Australia | 62.3 | 32.7 | 35.7 |

Exhibit 2. Share Price vs Active as at June 2013. Source: Standard & Poor's

So at this point we can observe that there has been an ***increased frequency*** of active managers showing out-performance vs index since the GFC (in comparison to the 2 decades prior to the GFC), although there is ***relatively low magnitude*** of that out-performance after retail fees (in the last 3 and 5 year periods the performance after retail fees are taken into account is small to negative compared to the underlying index).

### *VII. Are their "seasons" in which active management is likely to outperform?*

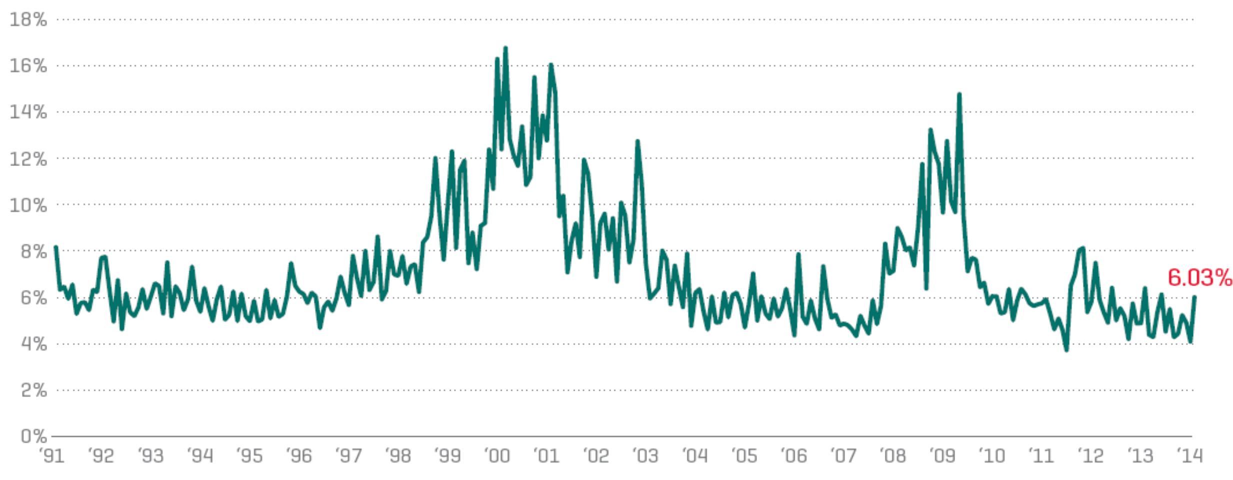
Exhibit 1 shows us that there are always periods in which active managers can beat the index, even after fees – and the tools they use to do so rely on stock picking. This is crucial evidence supporting the value proposition for advisers and investors using direct stock investing, and shows why there is utility in not just relying on passive index funds for the entire portfolio.

But when we focus on the frequency and magnitude of active manager out-performance, it is relevant to consider whether there are fundamental reasons for the higher incidence of active manager out-performance in the post GFC period, compared to the 2 decades prior to the GFC.

In a recent commentary, Standard & Poor's has suggested that the concepts of ***correlation*** and ***dispersion*** may explain the fluctuating fortunes of active managers:

> "Is there a way to measure the degree to which a market environment is more or less conducive to successful stock selection? We think that the answer lies in a concept we call dispersion. From a definitional standpoint, dispersion measures the average difference between the return of an index and the return of each of the index's components." (Standard & Poor's Insights Spring 2014, p. 4).

In support they examine levels of dispersion and volatility over time (data shown is for the S&P 500 Index).




*Source: S&P Dow Jones Indices. Data from Dec. 31, 1990 through Jan. 31, 2014. Chart is for illustrative purposes only. Past performance is not an indication of future results.*

Exhibit 3. Dispersion for the S&P 500. Source: Standard & Poor's.

Dispersion is at historically low levels now, and peaked at the end of 2000 and 2009. When overlaid against the performance data for active managers, an interesting picture emerges: the performance gap between top and bottom quartile active managers is widest following periods of high dispersion:

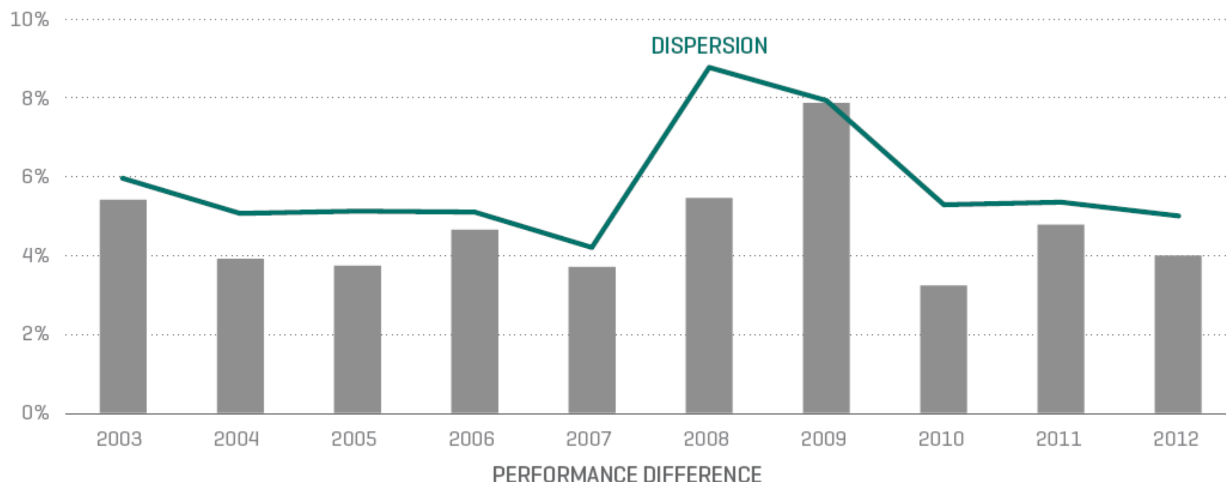



Exhibit 4. Interquartile range of active funds vs S&P 500 Average Monthly Dispersion. Source: Standard & Poor's.

Standard & Poor's reflect on this data to conclude that:

> "although the relationship isn't perfect, in periods of high dispersion the gap between the best performing managers and the worst performing managers is relatively wide; when dispersion is low the performance gap narrows." (Standard & Poor's Insights Spring 2014, p. 5).

Although we don't have dispersion data matched against manager performance for the Australian market, we can observe in the SPIVA data an increased out-performance for the post GFC period for active managers; and because we also know that the relative performance of the banking and resources sector was far stronger during that period compared to other sectors, it's reasonable to assume that a similar spike in dispersion of stock returns was at work after the GFC in our local market…and that these factors may have contributed to the uptick in active vs passive performance in the post GFC period. Similarly it may also be the case that the frequency of active manager out-performance may decline as Australian stockmarket dispersion falls, if the US trend occurs here. Further work needs to be done to assess this point in relation to the Australian market.

### *VIII. What about taxes and turnover?*

So far our analysis of the active vs passive debate has ignored the very different tax outcomes between these two styles. Due to the high portfolio turnover of the benchmark aware active manager, which averages around 80% pa, the tax cost of the active approach has been measured at around 0.60% pa (source: Towers Watson Tax Effective Investing Report May 2011). To generate the same after tax return as a low turnover portfolio of direct stocks, the active manager needs to add 0.60% pa – a hard task in most markets.

In contrast, the turnover in passive index funds is far lower and arises only when the index composition changes – so for the S&P/ASX 200 index, with turnover < 5% pa, the tax cost is far lower than the 0.6% pa attributed to the average active manager.

The Towers Watson measurement of tax costs for active managers coincides with an earlier study conducted by Macquarie Investment Management which is shown in Exhibit 5 below:

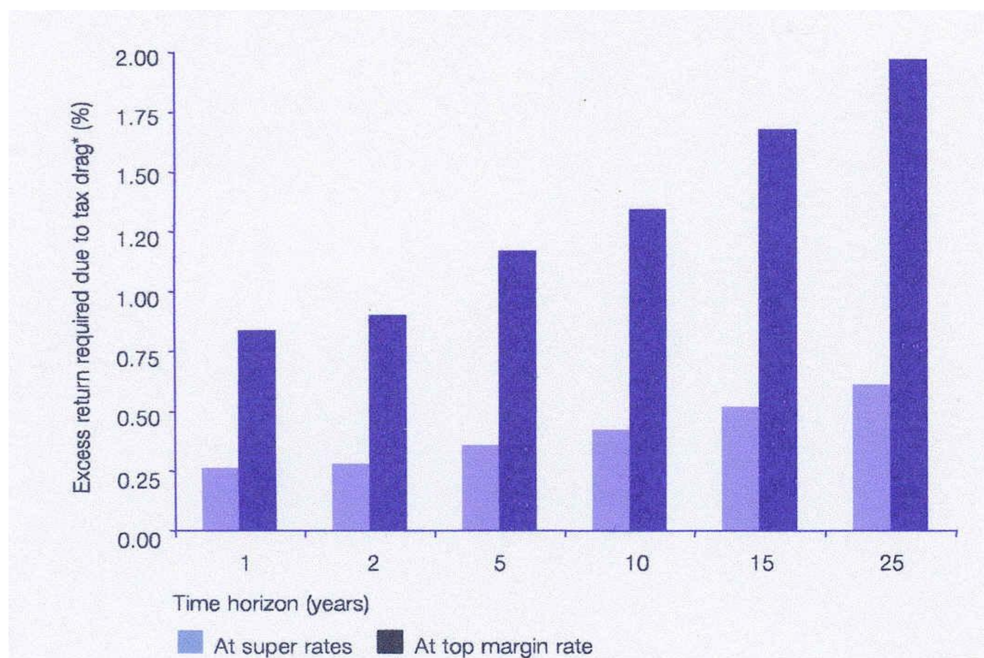



Exhibit 5. Tax Drag of Active Manager. Source: Macquarie Investment Management Precision Winter 2004

When we factor in the high tax cost of active management, alongside the relatively small levels of after fee out-performance in the best years for active managers, the case for making a significant portfolio allocation to traditional benchmark aware, large cap active Australian equity managers becomes tenuous. If an active manager is used for this part of the portfolio, only stand out managers in the top decile should be used (with a weather eye to the prospect of weak performance persistence for even the best active managers).

To illustrate the point: using the Mercer data referred to above showing the average active manager out-performed the index by 2.3% in the last 12 months, if we factor in retail investor costs (but not including advice fees) in a range of 1% - 2% pa, coupled with the tax drag of 0.6% pa, the net after tax performance differential of large cap active managers becomes small to negative.

For example if retail fees are 1% pa coupled with a tax cost of 0.6% pa the net out-performance of the best active funds reflected in the SPIVA data shown above is 0.7% pa over 1 year, -0.1% pa over 3 years and -1.4% over 5 years. If retail fees are 2% pa coupled with a tax cost of 0.6% pa the net performance of the best active funds in the SPIVA data are negative for all periods.

### *IX. What about small cap active managers?*

Returning to how we work with advisers in the LPAC course, one of the fundamental pre-requisites we suggest for advisers seeking to build a robust and compliant direct equities business model, is to ensure

they have access to similar quality stock research to that available to institutional fund managers. This has become increasingly possible with the drift of high quality stock analysts into the broader research community, but the trend is far more pronounced in the large cap segment than it is in other sectors. Brokers don't cover many small cap stocks, due to their illiquidity and small fee generating capacity, so small cap research is typically available to retail investors and advisers through investment newsletters whose coverage may be less consistent and systematic.

The far higher frequency with which small cap active managers beat their benchmark is seen clearly in Exhibit 2 above – with less than 10% active small cap managers failing to beat their benchmark in the last 12 month period. This is consistent with the Fama & French observation of anomalous "factors" which help some styles of active investing to beat the returns of a passive index – as with "value" investing, the Fama & French concept of "factors" expresses the notion that markets are more efficient (and harder to beat) in the large cap sector than they are in less well researched areas like small caps.

### *X. Concentration – portfolio size does matter*

But if markets are more efficient in the large cap sector (and the index is harder to beat) – what hope does this create for advocates of direct investing? Looked at another way – if most active managers are smart, hard working and have great systems and information access, what hope does the financial adviser or retail client have to beat them?

Assuming access to similar quality research, the answer largely lies in the adoption of sub-optimal investment management techniques by traditional active managers. For example, many active managers hold up to 80 or 100 stocks in their portfolio, despite best practice indicating that around 15 is the optimal number of stocks to hold. (The optimal number of stocks ranges from 10-20 in Ben Graham's The Intelligent Investor, 10 in the seminal 1968 Journal of Finance study by Evans and Archer, and 20 in Burton Malkiel's Random Walk down Wall St ).

Institutional investors hold a far larger number of stocks because of liquidity risk management, due in part to the need to maximize liquidity to meet a potential "run on the fund" which is possible when open ended unit trusts are used as the issuance vehicle (most closed ended LICs hold far fewer stocks than open ended unit trusts). Benchmark hugging is also driven by the needs of career security, something fund managers justifiably think about!

Academic research recognises both of these problems, as noted by Dominic McCormick in his excellent recent piece "Active vs Passive" for Portfolio Construction Forum in April 2014 (http://portfolioconstruction.com.au/perspectives/active-versus-passive):

> "In fact, the premise that underperformance of funds comes from various attributes of the industry and not from poor stock picking skills is supported by a paper, "Best Ideas", by Cohen,

Polk and Silli (2010). They found that US mutual funds' highest conviction ideas did indeed outperform, but that this was offset by their willingness/pressure to hold a larger range of stocks, many of which performed more poorly. In their view, the industry - and investors - would benefit if mutual fund managers held more concentrated portfolios."

### *XI. Direct investing and control – the "landlord effect"*

The "short gamma" approach to portfolio management compounds the problem for active managers, forcing them to sell stocks in falling markets in an effort to beat their index benchmark. As we noted above the "short gamma" approach sells stocks irrespective of their fundamentals, and places the cash generated on deposit to preserve capital, pending re-investment into the stockmarket as its fortunes improve.

In the LPAC program we advocate the use of concentrated, low turnover portfolios of stocks (primarily large cap Australian stocks – because this is the segment with most readily available high quality research). These portfolios can be purchased directly, or via MDA or SMA platforms – or in some cases, via MIS based unit trust funds. LICs often use the same investment approach, but due to their propensity to trade at discounts or premia to their NTA (arising from their use of the closed-ended company as the issuance vehicle), are sometimes of limited utility to advisers seeking a scalable solution.

In this approach the chosen portfolio is held unless and until there is a fundamental change in the income generating capacity of a stock/s. Market fluctuations don't impact on the make-up of the portfolio – unless changing economic and market conditions impair the fundamentals of a stock.

This has important consequences for portfolio management during times of financial crisis – the problem which Graham Rich refers to in the quote above in the context of the "active vs passive" debate.

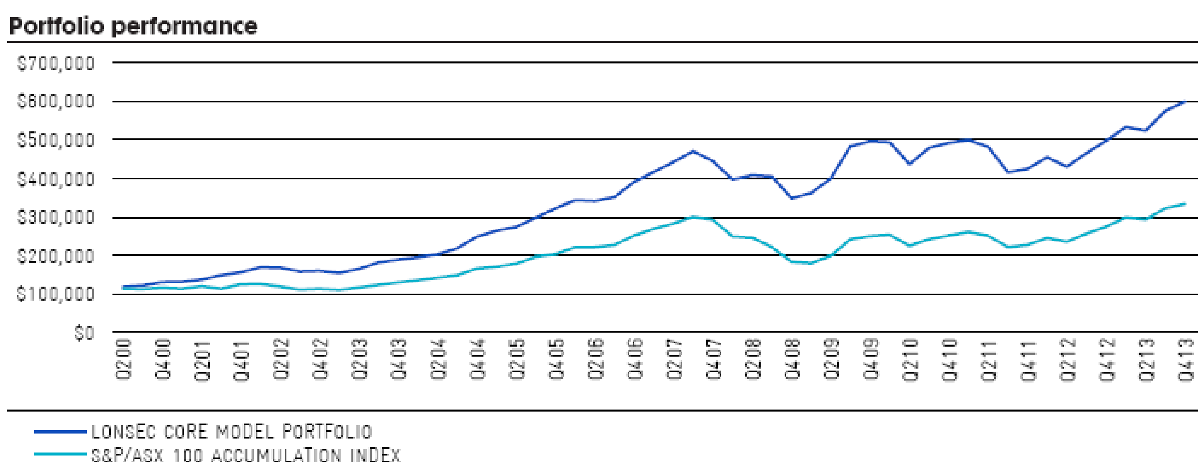
One way to think about this is to reflect on the equity risk premium and how markets react in times of fear or euphoria. Stocks like CBA lost 50% of their market price during the GFC, implying a doubling of the equity risk premium the market attached to them. This implies that the market assumed that the earnings of the stock were going to halve. "Short gamma" fund managers sold down their holdings of these stocks, irrespective of their fundamentals.

In fact, CBA led the Australian market rebound after the GFC when it posted a strong cash earnings increase in February 2009. Direct investors who weren't convinced that the fundamentals of stocks were impaired by the GFC could exercise control over their portfolios by holding these stocks, and benefitting from continued exposure to stable or rising dividends: assessing the reality of earnings capacity by waiting till the next dividend (and reliant on continuous corporate disclosure of material information in the interim).

Like rental properties, rising dividends and yields ultimately drive the capital value of stocks – markets fluctuate with sentiment, irrespective of fundamentals. Capital value is important in draw down phase but prior to that, income from investments is the primary driver of their value and the main driver of retirement incomes.

Quality stocks held in concentrated low turnover portfolios are an efficient way to generate strong incomes and capital growth over time.

Consider the outstanding track record of the Lonsec Core Model Equity Portfolio – which in Exhibit 6 shows that concentrated, low turnover investing can add strong investment "alpha":




Source: Lonsec Limited Investment Insight March 2014, p. 19

The performance differential shown in Exhibit 6 can be quantified as:

- A $100,000 investment in the Core portfolio at inception (17 April 2000) would now be worth around $600,000.
- A similar investment in the S&P/ASX 100 Accumulation Index would now be worth around $334,000.
- Both figures include dividends (but not franking credits) and are gross of fees.

The Lonsec Core Model Portfolio holds between 10-20 stocks and has annual turnover between 20%-30% pa.

### *XII. Wrapping it all up*

Even though there is clear evidence of out-performance (above that of the relevant benchmark) by some traditional large cap active managers, the frequency and magnitude of this outperformance is relatively low, especially when retail fees and the incidence of taxes are taken into account. There are some great managers whose out-performance is relatively persistent, but the average manager typically under-performs.

The problem seems to stem in part from the sheer size of major funds, their desire to hold an inefficiently large number of different stocks, and the "short gamma" style of portfolio management. There are an increasing number of academic articles which agree with these statements, and the problem has been categorically summarized by APRA (the peak industry regulator) which has stated that it has "doubts about the value of the active approach to risk management."

High portfolio turnover adds another layer of inefficiency with the tax drag of typical actively managed funds being measured at 0.6% pa, compared to lower turnover forms of investing.

There is evidence that the performance of the average active manager has improved relative to its benchmark in Australia since the GFC and recent commentary suggests that in periods of high dispersion of returns, active managers may be more likely to add value compared to an index than in periods of low dispersion.

The data also shows that out-performance is far more prevalent in the case of small cap active managers, perhaps due to the relative inefficiency in this part of the market (which contains "factors" leading to inefficiency, as per the Fama and French perspective).

In conclusion it is arguable that a portfolio constructed as follows could be an efficient solution for investors:

- A core holding of low cost, passive index funds or ETFs for large cap Australian and international equities to generate investment "beta";
- Satellite holding/s of low turnover/concentrated portfolios of stocks to generate investment "alpha," held directly or via an MDA/SMA (in the case of Australian large cap stocks) and via an MDA/SMA or MIS/unit trust (in the case of large cap international stocks);
- Satellite holdings of top decile active/benchmark aware managers may also be considered for use to generate investment alpha for large cap Australian/international stocks, although the frequency and magnitude of out-performance after fees and tax costs are considered would exclude the majority of active managers from consideration;

- Active/benchmark aware managers in small cap Australian stocks to generate investment "alpha" or to provide exposure to less well researched markets or sectors, or hard to implement styles will often be a more efficient investment solution than passive index funds or direct investing.

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