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Active management versus index management

There have been two themes that have caught our attention in recent weeks that reflect the dilemma facing investors: active management under-performance and the increasing use of 'quant' based strategies, such as index funds and exchange traded funds.

Firstly, Morningstar have produced research that demonstrates that some 70-80% of active Australian equity managers fail to beat their index after fees. This is not necessarily new news, and supports much of the research produced out of the US and our own studies of the local market. In fact, only local smaller cap managers appear to collectively have skill in beating the index, with between 50% and 80% out-performing on a three to five-year basis to March 17.

That is not to say there are not good active managers. Indeed, there have been good examples locally and internationally where fund managers have shown real skill in delivering meaningful returns above an index. However, the research suggests the identifying these good stock pickers can be difficult.

To a degree funds management firms have perhaps been a victim of their own success. Funds under management has ballooned to the point where being able to stray too far away from the index is difficult. Either for peer group risk reason (that is the fear of under-performing the competition) and/or an inability to trade small or illiquid stocks and being forced to hold the large cap liquid stocks that dominate the index. In effect, funds management firms risk being less about seeking performance and more about brand and marketing.

Active funds are typically unconstrained by capacity, meaning they have an ability to manage a substantial amount of money, except for small cap managers, where to their credit they tend to limit capacity to preserve the ability to out-perform. Interestingly it is also the small cap manager that shows an ability add real value.

If active management cannot out-perform an underlying index, it does raise the question: why do active funds remain prevalent?

Part of that may be behavioural, where an investor believes they can do better by selecting the right manager. But Morningstar's research would suggest outside of small cap managers an investor has a one in five chances of picking the right manager. Or there may be an anchoring bias and a reluctance to exit an under-performing manager as it reflects that the investor has made a mistake. It could also be a reflection that traditional fund management houses have brand recognition that an investor identifies with that provides a sense of comfort.

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Average Fund Returns

	6 Month	1 Year	3 Year	5 Year	10 Year
Equity Australia Derivative Income	6.55	13.29	5.17	8.73	3.90
Equity Australia Large Blend	8.42	17.13	6.25	10.00	3.65
Equity Australia Large Growth	6.61	15.63	6.62	10.52	4.45
Equity Australia Large Value	9.33	17.74	6.69	11.19	4.58
Equity Australia Mid/Small Blend	-3.40	11.56	8.03	8.81	5.15
Equity Australia Mid/Small Growth	-3.72	9.66	8.46	9.18	4.38
Equity Australia Mid/Small Value	3.17	20.62	12.73	13.22	6.65
Equity Australia Other	4.98	13.19	6.79	9.21	1.61
S&P / ASX 200 Accum Index	10.25	20.49	7.52	11.09	4.32
S&P / ASX Small Ords Accum Index	-1.03	13.67	6.44	2.28	-0.83

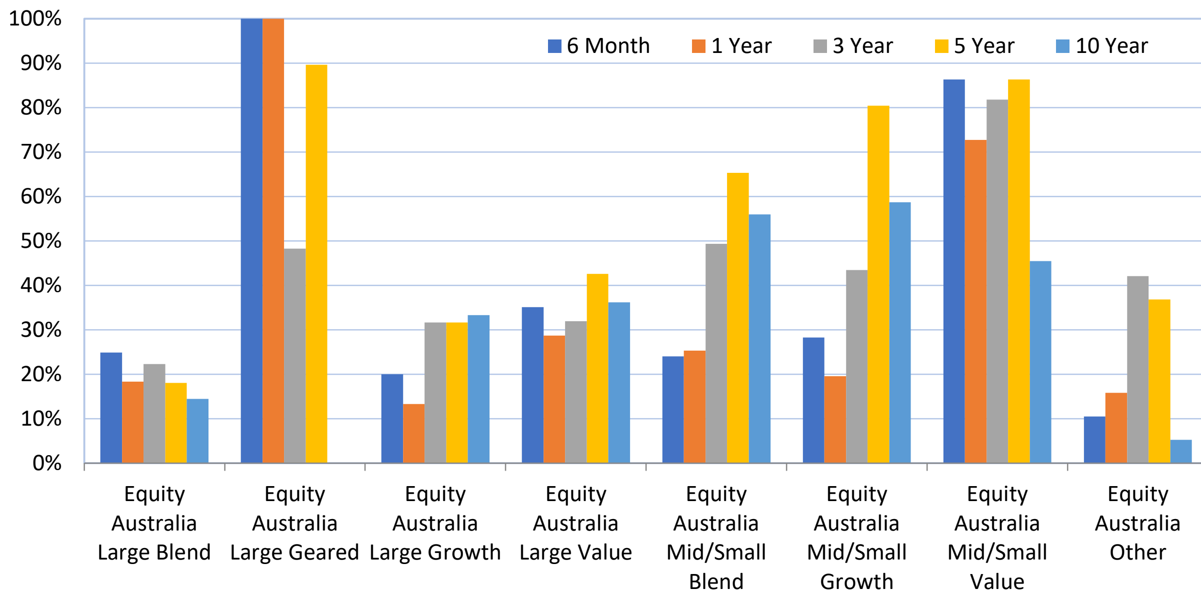
Average Excess Return v respective Benchmark

	6m Excess	1 Yr Excess	3 Yrs Excess	5 Yrs Excess	10 Yrs Excess
Equity Australia Large Blend	-1.83	-3.36	-1.27	-1.09	-0.67
Equity Australia Large Growth	-3.64	-4.86	-0.90	-0.58	0.13
Equity Australia Large Value	-0.92	-2.75	-0.83	0.10	0.26
Equity Australia Mid/Small Blend	-2.37	-2.11	1.59	6.53	5.98
Equity Australia Mid/Small Growth	-2.69	-4.01	2.03	6.90	5.21
Equity Australia Mid/Small Value	4.19	6.96	6.30	10.94	7.49
Equity Australia Other	-5.27	-7.30	-0.73	-1.88	-2.71
Average	-1.54	-2.51	-0.40	0.93	0.56

Ratio Funds Exceeding Benchmarks

	6 Month	1 Year	3 Year	5 Year	10 Year
Equity Australia Large Blend	24.9%	18.4%	22.3%	18.0%	14.4%
Equity Australia Large Growth	20.0%	13.3%	31.7%	31.7%	33.3%
Equity Australia Large Value	35.1%	28.7%	31.9%	42.6%	36.2%
Equity Australia Mid/Small Blend	24.0%	25.3%	49.3%	65.3%	56.0%
Equity Australia Mid/Small Growth	28.3%	19.6%	43.5%	80.4%	58.7%
Equity Australia Mid/Small Value	86.4%	72.7%	81.8%	86.4%	45.5%
Equity Australia Other	10.5%	15.8%	42.1%	36.8%	5.3%
Total	30.4%	25.3%	35.1%	43.7%	44.7%

Source: Morningstar Australia Investment Trusts as at 31 March 2017 and Equus Point Capital



The second theme we have noticed is the attention being given to the use of index funds and exchange traded funds as a cheap alternative to expensive actively managed product. Now these products may not be strictly considered 'quant' but they do use maths to map a portfolio to an index, and that index in turn is constructed based on pre-set rules. If active management cannot add value after fees, then using an index based product with a much lower cost provides a valid alternative. Note, however, using an index fund is almost guaranteed the investor under-performs the underlying index as the portfolio manager attempts to match the return of the index before fees. But the investor has greater confidence that the scale of that under-performance will be limited to the fee size, plus or minus a small margin of error.

The move to index funds and exchange traded funds has also seen the rise of factor investing, sometimes rightly or wrongly referred to as smart beta. Indeed, the Future Fund announced in early May that it was moving part of its equity portfolio to internal management based on factor investing given external managers have failed to create "enough sustainable value to justify their fees".

Put simply low-cost algorithms tilting a portfolio to take advantage of factors such as value, small cap and momentum can incrementally achieve index plus returns without the cost structure and manager selection risk of pure active, fundamental based management. This is also a reflection that a market cap index, such as the S&P / ASX 200, does not necessarily capture the underlying fundamental value of its constituents, and an alternative and transparent weighting methodology based market inefficiencies or factors, may be better suited to improving diversification, improve risk outcomes and provide better risk adjusted returns.

There is, however, one glaring risk that remains, irrespective of choosing an active, an index or smart factor based product. They all have 'beta' risk.

Beta risk is simply reflecting that active and index funds are correlated to market. If the market declines, all 'long only' type products will be highly correlated to the behaviour and direction of

the market and will suffer losses. These losses may be tempered if a manager can avoid some of the losses by holding cash, but index funds and ETF's will not have this luxury and will invariably track the performance of the index.

At Equus Point Capital we manage portfolios in a materially unique way to more traditional equity managers.

1. We are index unaware. Meaning we are prepared to take positions that are materially different from the index.
2. We are deliberately capacity constrained, recognising that the best opportunities are in limited supply. Instead we focus on producing superior risk adjusted returns and limiting capacity ensures our focus remains performance and not asset accumulation.
3. We are not a long only manager. We are prepared to take long positions in the expectation that a stock's price might increase in value relative to the index, but we are also prepared to take short positions in the expectation that prices might decrease in value relative to the index. This preparedness to both take long and short positions increases the opportunity set to harvest meaningful alpha.
4. We are market, or beta, unaware. We deliberately hedge out residual market risk. This allows us the freedom to seek out alpha opportunities without being constrained by market cap or sector limits.
5. We actively minimise portfolio volatility.
6. We seek to preserve capital and limit draw down by reducing risk in negative markets and will hold cash if stock selection opportunities are scarce.
7. We measure performance on a risk adjusted basis. That is portfolio return less the risk-free rate, divided by the volatility of performance. We believe this is a true reflection of a manager's ability to add value for each unit of risk.

In summary the biggest risk an investor makes is not necessarily choosing active over passive, but accepting market risk. Choosing to invest in an actively managed long only fund the investor needs to understand that the chance of the manager out-performing the benchmark after fees is statistically not high in long term. In a low return environment underperformance will make a substantial difference to long term investment outcomes. But even passive funds, be they market cap weighted or factor weighted, will be subject to the vagaries and whims of the market.

At Equus Point Capital we recognise that traditional beta exposure plays a key role in an investor's portfolio. We also believe investors should be circumspect about paying significant active management fees for products that are highly correlated to their benchmark indices and do not offer the potential for genuine alpha. A strategy that is uncorrelated to the market, achieving strong returns in both up and down markets and preserving capital in volatile periods, can provide valuable benefits to investor portfolios.

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