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Private Asset Management Ltd

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MORNINGSTAR - ACTIVE Vs PASSIVE FINDINGS

Just recently NBR published a story that looked at the relative performance of active and passive funds in the equity and bond sectors which referenced a study by Morningstar Australia. Commenting on the article an NBR reader said "I feel a Brent Sheather article coming on …." Well I've taken the bait so here goes…. Whilst most of the Morningstar conclusions make sense there are a few that look to me to be at variance with other research on the topic and even the stuff that makes sense needs a bit of perspective added so that it's more useful for retail investors. Before we get into that I would stress that, despite the following, a 100% passive approach is not an optimal solution. Markets and economies require informed price discovery and given that everyone benefits it's fair that everyone pays their share of this cost. Low cost active funds exist in most markets including Australia.

Firstly the Morningstar research confirms the fact that in the large-cap area passive usually outperforms active but what is missing from the analysis is the fact that the large-cap sector (S&P/ASX 50) accounts for about 82% of the Australian total equity market capitalisation. Therefore the midcap and small company sectors are just 18% of the Australian stockmarket. So whilst even if you accept the Morningstar assertion that active outperforms outside the large-cap space, it still means that many investors should invest passively for the vast majority of their Australian portfolio. In Australia the attractions of passive are compounded by, with a couple of notable exceptions, the high fees of the active alternatives. Probably the leading authority on the performance of active funds relative to their benchmarks is that produced by S&P Indices versus Active (SPIVA). The SPIVA analysis for the same period, ie ending 30 June 2023, contradicts the Morningstar conclusion that active outperforms in the smaller, less efficient component of the Australian stockmarket – its numbers suggest that over 10 years 75.7% of fund managers specialising in this area underperform the index. That doesn't sound like good odds and those numbers are consistent with the degree of underperformance in the smaller company sector in other developed markets. For example over 20 years the SPIVA analysis finds that 94% of US small cap and 95% of US mid cap equity funds underperformed their benchmark.

Next up we focus on Morningstar's conclusions re international bond funds. Morningstar finds that "even in global bond markets, active funds available in Australia have outperformed passive". This is a particularly important conclusion for investors as bonds typically represent about 40% of an average risk, balanced portfolio. The Morningstar

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analysis suggests that over three years Australian active bond funds outperformed passive by about 200 basis points and over 10 years, at 2.2% and 2.1% respectively, by 10 basis points.

Everything that I have read on the performance of active bond funds topic suggests that it's even more difficult to outperform in the bond sector than it is in equities ie the bond market is more efficient. Two of the most common ways of generating genuine “alpha” (finance talk for outperformance), excluding leverage, in the bond market are via duration management and finding mispriced securities. The first strategy involves the difficult task of predicting the direction of interest rates and positioning the portfolio accordingly – by altering the maturity profile. For example if you thought interest rates were going to fall you would be overweight long dated bonds. The second strategy is equally difficult - finding a bond issued by a company whose credit rating will improve, before the market becomes aware of this likelihood. Importantly, Morningstar’s conclusions in respect of bonds are at sharp variance with SPIVA’s historic findings. In virtually every other bond market, including Australia, bond fund managers underperform over long time frames. For example in the USA 94% of investment grade bond funds underperformed over 15 years. In Europe, over 10 years, across all bond categories, about 80% of managers underperformed. In Australia SPIVA only has data for five years. Readers should note that the SPIVA data is for Australian bond funds investing in Australian bonds whereas the Morningstar data is for Australian bond fund managers investing in global bonds. SPIVA finds that over five years 62% of Australian bond fund managers underperform the local benchmark index.

What could explain the Morningstar conclusion? I asked Vanguard Australia for their take on the data. A Vanguard spokesperson made the following comments by email, “In 2022 and 2023 there has been significant dispersion in the performance of global bond investment strategies. The primary driver of performance has typically been the interest rate duration of any particular strategy. The rise in central bank official rates and upward shift of global bond yield curves has had a larger negative impact on longer duration strategies. I believe that Morningstar are referencing their global bond universe which has a very diverse range of strategies. For the benchmark aware strategies in the universe, the indices used for products range from cash to long duration. Passive products are more likely to be full market capitalisation and therefore have longer duration which at this point in time have underperformed short duration strategies. This is a very unusual occurrence and has occurred in the period following what is widely considered the biggest bond market sell-off in modern history. Another way to re-consider the Morningstar comments, is in the context of SPIVA data. Unfortunately, SPIVA (who use Morningstar data for their Australian reporting) does not have a global bond category for Australia. We suggest that the reason SPIVA does not have a category is that the AU Morningstar universe (SPIVA’s underlying data) is too heterogeneous, and comparisons are compromised. The US SPIVA breakdowns give a clearer picture of longer-term underperformance of active strategies.”

Research by Cliff Asness of AQR (“The Illusion of Active Fixed Income Alpha”) and Lauren Cohen of Harvard Business School together with Umit Gurun of the University of Texas and Huaizhi Chen of the University of Notre Dame (“Don't Take Their Word for It: The Misclassification of Bond Mutual Funds”), previously reported in NBR, might also provide some insight. As outlined above genuine outperformance of a bond benchmark can occur via either picking the direction of interest rates or finding underpriced bonds. Mr Asness

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however explains that the most common way that bond fund managers outperform is by taking more risk and comparing themselves to a lower-risk benchmark. This obviously isn't true outperformance but it is easy to do and it fools many people, much of the time.

The Asness paper concludes "across multiple categories of active fixed interest managers we detect little evidence of manager skill. Despite impressive active returns posted by a variety of managers, once we control for well-known traditional premia, the residual alpha appears to be negligible". Mr Asness also notes that the obvious downside of the higher returns derived by owning junk and emerging market debt is that it "threatens to significantly dampen the strategic diversification benefit of allocating to the fixed interest asset class". In other words when shares go down the bond market bifurcates and good bonds go up in price whereas junk debt goes down in price.

The second paper, "Don't Take Their Word for It", finds that in the US$40 trillion bond fund sector managers deliberately understate the assessed risk of their portfolios when they self-report this data to Morningstar. The paper shows that, in the US anyway, Morningstar relies on summary details, provided by fund managers, of their weightings in AAA bonds, AA bonds, BBB bonds etc. Morningstar apparently does this without checking this data against the actual portfolios thus fund managers are easily able to misrepresent the true riskiness of their portfolios. The authors conclude that "funds report holding significantly higher percentages of AAA, AA and investment grade issues generally than they do" and they give the example of one fund which told Morningstar it was 100% invested in investment grade bonds when actually less than 1% of their portfolio was investment grade.

Obviously higher risk bonds are priced to produce higher returns than low risk bonds hence if fund managers understate the riskiness of their portfolios then if you compare them with a lower risk benchmark they are going to look clever. I'm reminded of a comment in the FT a few years back which described this strategy as "the best way to look tall is by standing beside a short person".

Commenting on my report Morningstar made the point that their data compares the performance of active funds with that of passive funds, rather than an index. Morningstar also commented: "Regarding the AQR study on bond ratings, while many of the ratings are advised by managers, they also need to report their portfolios annually to the SEC (all mutual funds need to provide an annual report which disclose their fund holdings) which we also collect for use in our data. We rely on surveying managers and not all managers provide it."

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

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