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Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

MAKING THE CASE FOR ACTIVE

Maybe I hang out with the wrong people, but it seems like just about every financial advisor these days, both locally and overseas, are into low-cost passive funds. That's a huge change in attitudes from when I first bought Vanguard passive mutual funds in the US for myself and clients back in 1989. Back then, in NZ, advisors were largely commission-based and supported active funds which paid high levels of commission, trailing fees and lavished salespeople with trips to exotic locations under the guise of providing continuing professional development. One of the key players at the time, certainly in terms of commissions, trailing fees and other conflicts of interest was Armstrong Jones which was voted Fund Manager of the Decade by the recipients of its largesse.

Therefore it's pretty obvious that low-cost passive vehicles which didn't pay any fees or offer free holidays and stressed low costs as the key to a successful savings strategy, were a clear and present threat to the livelihoods of much of NZ's financial planning industry. Similarly, fund managers saw passive as a menace that needed to be contained, given their own high fees and poor performance relative to benchmarks. A passive fund with low fees and tracking the index really was the stuff of nightmares. Passive bashing probably peaked locally with the advent of the TeNZ ETF in June 1996 with both fund managers and stockbrokers threatening to boycott the NZX for sponsoring the vehicle. I dug out a story I wrote for the NZ Herald in 1996 which documented some of the hysterical venting by various conflicted players at the time. Here are a few of the highlights.

- Unit trust researcher, Financial Planning Group (FPG), then NZ's foremost promoter of high cost, tax-inefficient managed funds, described TeNZ as "unethical, flawed and potentially illegal" and added that "the manager is ideally placed to start buying or selling the index because it has prior insider knowledge of index changes". Subsequent to this outburst and with the threat of defamation proceedings from both the NZ Stock Exchange (NZSE) and NZ Guardian Trust, the FPG Managing Director apologised to all involved. FPG's analysis of TeNZ was reportedly described by the Chief Executive of the Stock Exchange as "ill researched and silly" while law firm Chapman Tripp, an advisor to TeNZ, decided against legal action because it "could give FPG's comments a credibility they didn't deserve". Hilarious.

- A further anti-TeNZ barrage came from the late Brian Gaynor writing in the National Business Review. He made the comment that it was inappropriate for the NZ Stock Exchange to own TeNZ as the Member Firms were effectively competing with their institutional clients. This was fair criticism to a degree but ignored the fact that many NZSE members had private client arms which had been competing with their institutional clients for years. Roll forward 26 years and passive funds are a key tool in private wealth offerings.

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The listing of TeNZ was a gutsy move by the NZX, simultaneously upsetting its own shareholders (stockbrokers) and its major institutional customers. But it has ultimately paid off and now Smartshares has $7.7 billion under management, stockbrokers love it and it is producing useful cash flows. If the NZX hadn't done it, someone else would have sooner or later but it was great to have TeNZ and the Midcap Index fund listed on the NZX back in the 90s.

Despite all that, today's story will not sing the praises of passive funds but instead make the fundamental case for active investment management – an argument which is obvious but doesn't get too much airtime. The rationale is simply this – the stock and bond markets, and indeed every investment market in the world, relies on price discovery to ensure assets are efficiently priced. In turn that information is used to calculate the cost of capital so that companies can make capex decisions – like do we buy XYZ company or invest in that new plant. These are absolutely critical inputs to an efficient economy and someone needs to fund this process. Is it fair that an individual who just owns index funds and therefore doesn't contribute much or anything to price discovery benefits from the resultant efficient markets? To me, an obvious analogy is an individual who doesn't own a car but relies on random strangers to take him/her to work, to the beach or down the road for a coffee. Thinking about this, the degree of dependence is even more pervasive than that: not only do investors who 100 percent index not have a car, they also need the person who picks them up to tell them where they are going as well. All things considered individuals who index 100% are bludging off other market participants, pure and simple.

Of course index funds are a great idea and yes, they can probably get a lot bigger as a proportion of total investment assets before market efficiency is seriously impacted but even then someone, somewhere has to pay for the vital function of price discovery. It is simply not equitable that these major beneficiaries of price discovery don't contribute their fair share. This bad contract has deteriorated in the last 10 years or so as costs have become an increasing factor in determining financial advisor competitiveness. Therefore many advisors who charge a high annual fee to manage retail investor portfolios have determined that the best way to ensure that their own profitability is not impacted is to recommend a low cost, all-passive approach to their clients, thereby keeping client's overall fees lower . There is an obvious dichotomy in this approach from an ESG perspective as every component of ESG investing relies on efficient investment markets and the economic allocation of capital within an economy. As a consequence these advisors, whilst proclaiming that their strategies are ESG compliant, are actually undermining everything ESG stands for.

So that's quite a change from the late 90s but then again it's possible to detect a consistent overarching theme: financial advisers maximising their profitability and putting their own interests ahead of that of clients and society as a whole. The obvious rebuttal to the argument against 100% passive is "why should rational investors buy active funds charging high fees which persistently underperform?" That's a good question which we will address in two week's time.