Brent Sheather's
RESEARCH

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SPIVA COMES TO TOWN – PART 1

As this column noted a month or so ago (Fund Management Moving The Goalposts) performance is the name of the game in fund management. Outperform or, more commonly, convince naive investors and compliant financial advisors that you have outperformed (when really you haven't), and the cash will come rolling in. Because there are large economies of scale in the fund management industry a 10% higher level of funds under management can have a proportionately greater impact on profitability and employee bonuses.

One of the many famous quotes made by Charlie Munger, long-time partner of Warren Buffet, included "Show me the incentives and I will show you the outcome". One less obvious take away of this insight from Charlie is that in the fund management industry the advantages of scale are so great (the incentive) that many of the bright sparks who work there spend their time manufacturing fake outperformance outcomes. There are many ways of artificially engineering outperformance but most if not all of these techniques rely on the understanding that "the best way to look tall is to stand by a shorter person". The investment methodology of "standing by a short person" is not taught in the CFA programme however, as it is a lot easier than actually outperforming, the strategy is pervasive and entrenched in the investment industry, both locally and overseas. Some examples of the skill include comparing your performance to other underperforming competitors funds rather than proper benchmarks – this is what the Responsible Investment Association Australia (RIAA) does in its Annual Responsible Investment Benchmark report. See https://www.nbr.co.nz/on-the-money/esg-investment-part-2/ Another essential skill for presenting fund managers as winners is to not adjust for survivorship. What this means is that in the fund management area poorly performing funds get liquidated and the best ones tend to survive so if you want to produce compelling numbers you simply exclude from your analysis the poor performers i.e. those funds that turned up their toes. This is a well-known problem with statistical analysis and it is referred to as survivorship bias. Again it appears the RIAA report doesn't adjust for survivorship. A very basic error and not an entirely Responsible Investment Benchmark.

Other strategies involve choosing a benchmark index that is less risky than your fund (e.g. comparing a junk bond with a government bond fund) and if you want to get prospective customers to buy shares rather than residential property show them that shares have outperformed by including dividends when you calculate the performance of shares but exclude rental income when you calculate the performance of residential. A local stock broking firm did just that recently and a division of the NZX did the same thing a few years back.

In an ideal world retail investors should be able to rely on their " independent " financial advisor to filter fact from fiction but because so many are conflicted one way or another this assumption is, as per the Radiohead song, a Nice Dream. The reality is that, to sell stuff to clients, advisers require a compelling narrative: eg "this fund manager outperforms" or "you can do good and outperform by buying ESG funds". Any inconvenient facts that get in the way of the narrative and the sales objective are ignored. Advisers that call out the fake news will be warned that they aren't team players and their bonuses will be adjusted accordingly. No one dare says "The Emperor Has No Clothes On". Because most financial advisory firms are compromised, some more than others, the " research " they provide to their retail clients needs to be considered carefully. This is particularly the

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case when the firm is a vertically integrated organisation which provides both fund management and advises retail clients.

Fortunately some institutional fund managers, particularly those who are looking to grow their bonuses through performance rather than asset gathering, are awake to this sort of nonsense so they are happy to pay independent research organisations to provide fair comparative data. One of the biggest of these is S&P Indices versus Active (SPIVA). This organisation has for many years looked at the extent to which active managers underperform their relevant benchmarks. Its research "has been the de facto scorekeeper of the ongoing active versus passive debate since its first quarterly report in 2002". It calculates how well various types of managed funds perform relative to their benchmark index and their database allows them to do this for shares and bonds in the USA, Canada, Europe, Japan, Australia and a number of emerging markets.

Last month the Asia-Pacific office of S&P Dow Jones Indices advised by email that their calendar 2023 performance numbers were to be published shortly and for the first time NZ domestic equity funds would be included in the analysis. The fact that SPIVA has taken the trouble to include NZ, given it accounts for just 0.1% of the world stock market, is great news for NZ investors. Previously there has been something of an information vacuum for many retail investors as regards the extent to which local equity funds outperform the index. The significance of this is that one can "buy the index" via a low-cost index fund which will pretty much guarantee you do just as well as the index. Over the years this absence of data has permitted a few fund managers to claim that it was easy to outperform given the ability of their local research teams to exploit the trading of silly retail investors and the fact that, as a relatively small market, share prices in NZ weren't priced as efficiently as larger markets. As an aside one well-known cheerleader for higher-cost actively managed funds regularly derides passive funds on the basis that "you will only do as well as the market less fees. So why would you invest passively given that you are guaranteed to underperform?" Read on – SPIVA has the answer.

In today's story, finally, and part 2 in two weeks time, we will look at the SPIVA Australia report, which I have suggested in future should be renamed the SPIVA NZ and Australia report. So what are the major findings of SPIVA's analysis of the NZ equity-oriented managed funds sector? Firstly, as is the case, in most other developed markets over the long term (15 years) about 77% of NZ fund managers underperformed the S&P/NZX 50. Over 10 years 75% underperformed, over five years about half underperformed and in the year ended 31/2/2023 46% underperformed. It is important to note that these numbers are reasonably consistent with other markets in that as the investment horizon extends the number of funds which underperform increases i.e. outperformance generally does not persist but fees do. Most investors buying a share fund do so with the intention of keeping that investment for 10 years or so therefore given that only 25% of fund managers outperformed over 15 years it doesn't sound like a good bet.

That is probably enough for this week. In two week's time we will drill further down into the SPIVA data, look at the results for other markets and consider what implications the SPIVA findings have for retail investors in NZ.

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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