Brent Sheather's RESEARCH

Private Asset Management Ltd

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SPIVA COMES TO TOWN – PART 2

In the last story we covered the topic of benchmark abuse and rehearsed the many ways in which underperforming fund managers are able to present themselves as winners through the judicious choice of an unsuitable benchmark. We noted that this inappropriate behaviour has been happening for years both locally and around the world. However, last month was notable for those in pursuit of the truth because one of the major players in presenting the realities of fund manager underperformance, S&P Dow Jones Indices (SPIVA), for the first time published data on NZ fund managers managing local equity portfolios. The report showed that over 15 years about 77% of NZ fund managers underperformed the NZX50 index. Today we will look closely at the SPIVA Australia Scorecard and see what lessons their analysis might have for retail investors in NZ.

First off though we need to disclose why S&P Dow Jones Indices, the owner of SPIVA, goes to the trouble and expense of producing these reports. Sue Lee, Director and APAC Head of Index Investment Strategy at S&P Dow Jones Indices, explained as follows: "Our job as an index provider is to provide data that inform the market and help investors in their decision making. The indices we provide play an important role of telling market participants how things are moving in the market, through different lenses of asset classes, regions, sectors and factors etc. As you mentioned in your article, indices have brought transparency to the professional investment industry, as fund managers are now assessed properly against the benchmark indices for the returns they make as well as the risks they take to generate those returns. We believe our SPIVA work for the past 20+ years has made some positive contributions to the investment industry."

So let's have a look at the results; as mentioned above the SPIVA data shows that NZ fund mangers have, over the long term, found it as difficult to beat the market (by owning stocks that do well and not owning stocks that don't) as overseas managers have. One major feature of the SPIVA analysis is that its performance numbers include funds that have closed or merged over the period. The study notes that many funds cease to exist, usually because of continued poor performance. Therefore if index returns were compared to fund returns using only surviving funds the comparison would be misleading due to survivorship bias – only the strong survive. SPIVA shows that over 15 years 1/3rd of the funds that existed 15 years ago were closed, almost all due to poor performance.

The SPIVA report also looks at Australian actively managed funds and as many of these are marketed to NZ investors the findings have some relevance. It wasn't a great year for Australian managers investing in their home stock market – according to the report 76.5% of the more than 400 funds focusing on domestic equities underperformed the index. Over 15 years a massive 85.4% underperformed the essentially "buy and hold" approach of the S&P/ASX 200. It is the same depressing story in respect of managers investing in global equities with 94.4% doing worse than the relevant global equity benchmark.

So why is it so difficult to outperform a strategy of simply owning all the stocks on the stockmarket weighted according to their size? The big problems for fund managers include the following:

- Markets are efficient. What this means is that because there are so many clever people all over the world spending all day, every day, analyzing stocks and bonds most things are priced correctly.

- Fees reduce returns and the higher the fees the lower the returns. Furthermore in NZ and Australia there are very few active managers with low fee structures and, as regards Australia, the heavily tax advantaged retirement savings system has had the effect of making fee considerations less of an issue for retirees.

I asked Sue Lee for her take on why outperformance was so difficult and she said "We think that active performance shortfalls can be attributed to the following three factors: (1) **The professionalization of investment management** - As assets move from underperforming active managers to passive, the average ability of the remaining active managers go up and the competition among surviving active managers become fiercer, resulting in an increased difficulty for active managers to outperform; (2) **Cost** – to simply quote what a Nobel Laureate William Sharpe said over three decades ago, "*properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs*."; and (3) **The skewness of stock returns** - the positive skewness in the cross-sectional distribution of stock returns makes stock selection hard and works against the concentrated portfolio approach which active managers often choose (relative to broad benchmarks). Since each of these factors is likely to persist, we believe that the advantage of indexing over active management is likely to persist. " For more details, please refer to [Shooting the Messenger - Research | S&P Dow Jones Indices (spglobal.com)].

That's enough for this week. In two weeks' time, we will look at the key takeaways from the SPIVA report for NZ retail investors.