Brent Sheather's
RESEARCH

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SPIVA COMES TO TOWN – PART 3

Two weeks ago we covered the SPIVA Australia Scorecard and noted their important finding that over 15 years about 77% of NZ fund managers underperformed the essentially buy and hold everything strategy of an index fund. Today in the third and final SPIVA Comes To NZ story we will briefly rehearse the differences between passive and active funds, the rationale for passive and think about appropriate strategies for NZ retail investors, also having regard to how pension funds, both locally and overseas, choose between the active and passive alternatives.

Investopedia defines passive management as follows: "Passive management is a style of management associated with mutual and exchange-traded funds (ETF), where a fund's portfolio mirrors a market index. Passive management is the opposite of active management, in which a fund's manager(s) attempt to beat the market with various investing strategies and buying/selling decisions of a portfolio's securities.
Followers of passive management believe in the efficient market hypothesis. It states that at all times, markets incorporate and reflect all information, rendering individual stock picking futile".

The academic rationale for investing in index funds is based on the efficient capital market hypothesis (EMH). The essence of this theory is that because companies are closely analysed by investors their share prices efficiently reflect their value. Therefore attempts to outperform by finding cheap stocks based on publicly available information are doomed to fail primarily due to the high costs, including trading costs, associated with these endeavours. The reality is that share price movements are random and primarily driven by unforeseen events. Fund managers aren't stupid. Disingenuous, greedy and unethical on occasion, but stupid, no. Indeed up until recently there was concern that too many bright young minds in the US aspired to do a finance degree at Harvard or Yale and get super rich via fund management or investment banking when they should be getting proper jobs as engineers or doctors. So if the brightest brains around the world can't beat the market the chances of a research team in Auckland outperforming the index, let alone Joe Blow in Rotorua "keeping a close eye on his stocks" by reading the newspaper, aren't particularly good, and that's being charitable.

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So what are the key takeaways from the above for retail investors? The most important conclusion is that it is virtually impossible to beat the market, despite all the claims from stockbrokers and financial planners that they can pick winners by owning a concentrated portfolio of 10 stocks in each of NZ, Australia and the rest of the world. That sort of portfolio is almost certainly going to underperform, sometimes drastically so, and will definitely result in a much more risky portfolio. This latter factor shouldn't be underestimated – when markets fall, if your portfolio falls by more than the average, the pressure to throw in the towel and sell is that much greater.

The SPIVA data shows that passive investing by owning a low cost, highly diversified fund is the way to go. As we noted two weeks ago, the big factors making it hard to outperform are fees and skewness. The cost factor is easy to understand – most active funds have reasonably high fees so that is going to impact returns but the skewness issue is equally if not more important. I explained the skewness issue in a story back in 2017. A research paper, "Do Stocks Outperform Treasury Bills?", by Professor H. Bessembinder of Arizona State University makes the following points:

- Even though the average of the stock market outperforms short term government bonds most individual shares do not - 58% of all US stocks listed on the US stock exchanges between 1926 and 2015 underperformed short term government bonds over their full lifetimes.
- The reason the share market outperforms bonds is due to a small number of outperforming stocks. The entire gain in the US stock market since 1926 is attributable to the outstanding performance of the best performing 4% of listed stocks. In statistics this is known as positive skewness.

Cutting to the chase, in layman's terms, active fund managers tend to underperform the market due to the impact of their (often) high fees and, because they can't own every stock in the market, they frequently don't own the best performers (the skewness issue). That's a pretty compelling case for passive and whilst I've been investing in passive funds since 1990 I still encourage clients to have some exposure to low cost active funds. Why? We have run out of words so we will cover that in two weeks' time.

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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