

MEASURING THE VALUE ADDED BY PORTFOLIO MANAGERS

The true cost of investing in the UK. Most investment managers consistently underperform the market and those who do outperform don't reliably repeat, says Shane Mullins

While investment practitioners rave on about the benefits of asset allocation, stochastic modelling techniques and active management, perhaps the building blocks they use to construct portfolios is worthy of closer inspection. There is strong evidence that UK asset managers are destroying investors wealth through active trading, single stock bets and excessive charging and, although some managers appear to be adding value, when you dig a little deeper it reveals a very different story.

The key question for any wealth manager is whether they can systematically predict superior performing investment managers year-by-year and create excess returns above market averages net of costs? The arguments about this age-old dilemma are numerous and there has been some forty years of academic research looking at this very subject, most of which stems from the US.

Reviewing these studies helps us to draw some straightforward but alarming conclusions; there are more investment managers who consistently underperform the market rather than outperform it after costs. Those who do outperform do not reliably repeat over statistically significant or meaningful periods of time. So where does this leave the investor?

Economic evidence would suggest that the major capital markets of the world are pretty efficient and that, at any given time, prices reflect the knowledge and expectations of all investors.

In one sense, the information about a particular stock is rapidly communicated, understood and reflected in its price – this is irrespective of the application of research, investigation or pure gut-feel that a stock might be mispriced, which then represents either a buy or sell opportunity to an investment manager. If this is the case, the traditional approach to active investment management has to be challenged head-on and alternatives considered.

Daniel H Kahneman, 2002 Nobel Laureate in economics, said that the concept, that any single individual without extra information or extra market power, could beat the market is extraordinarily unlikely. Yet the market is not only full of people who think they can do it, it is also full of other people who believe them. Kahneman asked: Why do people believe they can do the impossible? And why do other people believe them when they say so?

INDEXING/TRACKING

At least in part, some of the challenges of the active/passive debate have been overcome by adopting an indexing approach whereby tracker funds would be used in portfolios to replicate the performance of a benchmark index such as the FTSE 100, charging much lower management fees.

In 1996, index funds as a percentage of UK authorised funds were 2.3% and by the close of 2005 this was up to 6.1% (source IMA). Fees for managing these funds can be as low as 25-50 basis points compared to an actively managed retail fund that might charge as much as 150 basis points or more per year.

Pure indexing does have its critics and understandably so. Since 1973 which saw the birth of index funds, investment managers have replicated indices through periods where single stocks have made up more than 10% of an index – which was recently the case with Vodafone Plc – and where the largest ten stocks can often account for over half the index.

This not only adds unnecessary single stock risk to a fund but also a forced buyer and seller situation whereby, every quarter, managers must rebalance back to their benchmarks and buy and sell stocks coming into and falling out of the index, whether they want to or not. This adds unnecessary dealing costs and can have a drag on performance by being forced to sell stock, not because it is a bad investment but simply because it does not form part of the index.

ENHANCED INDEXING

Enhanced indexing through risk-calibrated portfolios has more recently come to the fore, particularly in the US and Australia but now also within the UK and Europe.

By building portfolios with broad market exposure to known risk factors rather than simply clustering them by IMA descriptions, it is possible to capture true market rates of return at much lower cost without compromising at all on investment performance.

Structure determines the vast majority of long-term investment returns in a portfolio and the most certain of financial concepts is that risk and return are related. By taking greater levels of known risk factors, portfolio returns can be increased and risks managed in a systematic way rather than simply taking bets on the market at any point in time or indeed individual fund managers.

Most active investment managers must also slavishly follow a benchmark brief, which in itself is no bad thing – but, if their benchmark is divorced from the investor’s requirements then, at some stage, there will be disenchantment with the investment experience.

COUNTING THE COSTS

Many still argue that it is worth attempting to beat the market through active management and trading. The largest part of the fund management industry is sold on this assumption and the assumption that investors are happy to pay them to try. Looking at the issue of costs alone might leave you wondering why?

Historical trends in both the US and Australia have led to widespread publishing of total expense ratios (TERs), a measure of annual operating expenses of a given fund. While equity funds TERs average out at 1.68% in the UK, their US counterparts are much lower at 0.92%.

When adding the all-important costs of active management it is not unreasonable to conclude that dealing charges alone could conservatively add a further 1% per year in costs for the average actively-managed fund, over and above the TER.

This may not seem like much of an issue. However, in some circumstances, reducing costs by 1% per year over a 20 year period could mean the difference between being able to afford to retire at 55 rather than 60. By deconstructing portfolios and the costs of managing them, one can begin to see just how much the issue of costs alone can impact upon the long-term performance of portfolios.

Costs are not the only issue to consider and investment performance will largely be determined by the asset allocation decisions made within a portfolio.

Other factors, such as market timing and individual stock selection, play their part but, in reality, these things do very little to add value to portfolio returns.

THE ALTERNATIVE APPROACH

Most investors assume that they need to adopt active management and do not consider the alternative approach of simply capturing market rates of return through structured portfolios without trying to beat the market. This is probably due to the fact that they do not know how successful capitalism is in its own right or in fact that these alternatives exist.

Multitudes of studies have reached the same conclusion; the average actively managed fund does no better than the market after fees, transaction costs and tax. For active managers to consistently succeed, markets must consistently fail.

Diversification is key

Many investors are afraid of the market because it has periods of negative returns and employ active managers to keep them safe in the bad times. This does not work, but broad diversification over the long-term does. Diversified portfolios have not only provided the highest average returns but also have fewer negative quarters. Investors should not only diversify across securities within an asset class but across the asset classes themselves.

Maintain investment discipline

Investors will not effectively capture market returns if they abandon their long-term strategy in response to recent market events or predictions of



“The only problem is, at the time of writing, there is no scientific method for identifying the so-called star managers in advance or whether they will continue to be star managers”

the future. Most of the City and the financial media promote a short-term perspective that is diametrically opposed to the principles of modern portfolio theory.

Keep costs down and manage taxes

Markets are uncertain, but costs and taxes can and should be controlled. By reducing these through straightforward tax-planning, it is possible to retain a greater share of investment returns or enable a lower risk profile to be adopted for the same net result.

CONCLUSIONS

The active/passive debate goes on and by definition there will always be winners and losers in the investment world. Some investment managers will outperform the market and others will underperform. The only problem is, at the time of writing, there is no scientific method for identifying the so-called star managers in advance or whether they will continue to be star managers. That’s the bad news; the good news is that you don’t need to beat the market to be a successful investor ■

SHANE MULLINS
MANAGING DIRECTOR
Fiscal Engineers