



Index funds: Leaving active in the shadows

Index funds hold plenty of power in funds management. The Australian ETF sector is growing seven times faster than the overall market and smart beta strategies are becoming ever more appealing. All the while active funds continue to underperform.

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01:
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02:
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Globally there are “I told you so” sentiments floating about the index investors in funds management.

Those who have championed index investing for decades are using their aggregated clout to deliver a strong message: active management doesn’t win the long term game.

Recent press and research solidifies this argument but there never appears to be a final, knockout blow.

US-based Morningstar investment researcher and regular columnist John Rekenthaler recently expressed a wariness of predicting continued, uninterrupted success for index funds. Yet he has been questioning the future of active funds for more than two years.

He says there are some market conditions that will embellish active management’s reputation but there’s still plenty of groundwork to be laid before fortunes improve.

“It is not as if active management is being unjustly punished for having relatively good performance, or for having a large number of happy ongoing exceptions to the general rule, or for collectively making a large bet against an index – a bet that could pay off in a major way,” Rekenthaler says.

He cites fixed income funds as one example where active managers will battle.

“The Barclays US Aggregate Bond Index isn’t faring so well, performing about in line with the typical active bond fund, but active managers will require more than parity to reverse the sentiment. To change investors’ minds, active bond funds will need to beat the aggregate index by a wide margin and for a long period of time,” Rekenthaler says.

This month S&P Global also painted a terrible picture for active Australian fund managers. The Mid-Year 2016 S&P Dow Jones Indices Versus Active Funds (SPIVA) Australia Scorecard showed the majority of local active managers were underperforming their relevant industries in FY16.

S&P Global senior director global research and design, Priscilla Luk⁰¹, says there is nothing novel about the index versus active debate. It has been a contentious subject for decades and there are few strong believers on both sides, with the majority of market participants falling somewhere in between, Luk adds.

“Since its first publication 14 years ago, the SPIVA Scorecard has served as the de facto scorekeeper of the active versus passive debate. Over the years, we have heard passionate arguments from believers in both camps when headline numbers have deviated from their beliefs,” Luk says.

The research, issued bi-annually, tracks about 1000 Australian active equity and bond funds against S&P Dow Jones indices. In the large-cap category (measured against the S&P/ASX 200), more than 59% of active managers



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underperformed over a one-year period, about 66% over three years and 69% over five years.

In mid and small-caps (measured against the S&P/ASX Mid-Small Index), more than 61% of managers underperformed over one year, about 51% over three years and 38% over five years.

Bennelong Australian Equity Partners investment director, Julian Beaumont⁰², says it is “bloody hard” to outperform in large caps. However the boutique fund manager has shown outperformance is possible and recently received industry recognition for doing so, winning Zenith Investment Partners’ Fund Manager of the Year Award.

Beaumont says where the fund manager finds most of its outperformance is really from the mid and small-cap markets.

“Generally they’re less efficient, there’s less brokers looking at it, it’s less picked over, and it’s less market-cap and perhaps isn’t as important to some managers. That’s where you tend to find the best ideas and the value adding ideas. It’s proven to be a part of the Aussie market where fund managers can actually outperform,” he says.

“If you’re going to pay active fees you want active performance. You only really get active performance from those that are willing to diverge significantly from the benchmark and those who have high conviction portfolios,” Beaumont says.

He points out the Bennelong Twenty20 Australian Equities Fund is one example where investors can have both indexed and an active management, high-conviction exposure. This is achieved through the fund’s combination of an indexed position in the S&P/ASX 20 and active investment in BAEP’s successful ex-20 strategy.

Changing investment and advice models

Vanguard senior key account manager, broking and wealth management, Tim Sparks⁰³ told a recent forum in Sydney that exchange traded funds (ETFs) were by and large a passive index investment tools that are now being used in a “very active way.”

Sparks says ETFs are rarely used in isolation and often used in conjunction with other investment vehicles whether it is direct stocks or managed funds. He adds that although ETFs are widely seen as a technology, innovation is not coming from the investment vehicle itself but rather what’s changing to the advice model.

“The traditional investment adviser was focused on outperformance, on picking stock winners, on market timing – which as you know even with a large research team is very difficult to do year-on-year. We’re seeing that model move over for the strategic adviser who will fo-

cus on asset allocation, portfolio construction and most importantly guiding clients towards their long-term investment objectives. We’re seeing ETFs being used more and more in that strategic advice model. It’s driving ETF growth globally,” Sparks says.

He told the forum how investing in a portfolio of ETFs could easily track global and well-recognised indices or provide simple thematic exposures. To invest “around the world” in three trades, for example, investors may consider the Vanguard US Total Market Shares Index ETF; the Vanguard FTSE Europe Shares ETF; and the Vanguard FTSE Asia ex Japan Shares Index ETF.

“Alternatively you can use those three trades to build out international equity exposure. You can take a view there may be some growth opportunities in the US relative to Europe. If I’m worried about the volatility in Europe I may want to overweight the US market,” Sparks says.

He added an index investment focus may come via global developed markets and global emerging markets. If for example, a client put \$90,000 in to the Vanguard MSCI Index International Shares ETF and \$10,000 in to Vanguard FTSE Emerging Markets Shares ETF, they would get a strong correlation to a popular international equity benchmark.

“Any active fund manager that’s picking all the best stocks around the world will more often than not benchmark themselves to MSCI ACWI and you can build that in to ETF trades. MSCI ACWI performance over the last 10 years was up 25%,” Sparks says.

The end game, from a risk and return perspective, is developing investments that begin to look like or mirror the risk profile of a growth portfolio. Sparks says that for advisers it narrows the gap to the efficient frontier, or an appropriate amount of client return for a minimal amount of risk.

This is where BAEP’s Beaumont warns investors and advisers need to be careful, especially if they’re setting up an index or passive investment core and an actively managed satellite portfolio.

“If you’re getting good diversification in your active or satellite portfolio exposure, then you’re really getting something similar to the index anyway. What you really want to back is skillful, experienced fund managers in that active space and they’re generally those who pick the best stocks,” Beaumont says.

He adds that ultimately passive and active investment does turn in cycles. Although there’s currently some heavy investment on the indexing side of the boat, the other side remains unbalanced and less popular where you investors can actually find opportunities.



03:
Tim Sparks
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04:
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He adds many advisers are coming around to an approach where they will use index investing when there is less opportunity to outperform. As money appreciates it becomes harder to outperform, and once that's taken out of that market, competition increases to achieve outperformance elsewhere.

Beaumont says as more investors continue to place money in index funds and take the average there potentially becomes less and less outperformance.

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The tide continues to rise

Rainmaker's June 2016 Roundup industry report shows the indexing sector is where some of the most important investment market developments are occurring.

It says despite the rise and rise of ETF investing, the sector still accounts for only 6% of the indexing market. However some ETF managers are now among Australia's fastest growing investment houses, as shown in Rainmaker's June quarter ETP Report (see Figure 1).

"Indexed funds under management increased 4.2% during the past 12 months to \$368 billion, representing the equivalent of 18% of the market," noted the researcher.

While ETF assets hit \$22.4 billion and are a star sector – increasing 22%, or seven-times faster than the overall market – it still represents only a small part and captures a disproportionate amount of attention, the researcher said.

Showing the impact ETF managers are having on the broader market, ETF managers Van Eck and BetaShares, in percentage growth terms, are now among Australia's fastest growing. Reinforcing this, Rainmaker said Vanguard in FUM terms was the nation's fastest growing manager during 2015-16 while also achieving 45% growth in their ETF assets under management.

Rainmaker added that while ETFs are seen as synonymous with indexing, already 5% of this sector is held in actively managed funds. This active share is expected to grow as investment managers increasingly see exchange tradability as merely a distribution mechanism rather than being about investment management style.

BetaShares managing director, Alex Vynokur⁰⁴, says there has been significant growth towards index-based investing in Australia over the last few years and it's more than consistent with what's happened over the past decade globally.

"Investors are redefining what index investing means. The traditional association was investment in vanilla, market-capitalisation weighted indices. That was the first generation of 'indexees'," Vynokur says.

Vynokur adds ETFs are growing at such a rate they are becoming the primary vehicle in which investors, both retail and institutional, are starting to adopt indexing strategies.

"ETFs are growing as the dominant vehicle for implementation. The reason for that is because ETFs are accessible, there's no paperwork in appointing a manager or filing a manager. ETFs are transparent, liquid by nature and cost effective," he says.



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The ETF manager says growth in the index market is on the one hand driven by the relatively poor performance of active managers net of fees, which is continuing to be seen at one, three, five and 10 year track records.

However he also points out that in Australia there has been acceleration because of significant regulatory changes including FoFA and the MySuper regime – especially due to its focus on lower-cost and transparent investing.

That said, Vynokur believes the choice for investors should not really be an active versus passive decision and BetaShares' vast majority of clients construct portfolios using both.

"Index or ETF exposures can really represent a core of the investment portfolio. An investor might use active managers as a satellite and for alpha generation. It's not antagonistic or one versus the other. There is room for appropriate coherence between the two," he says.

Given the rise in ETF investment you could question whether the industry is creating a generation of index pickers, not stock pickers. However Vynokur says asset allocation is what the end game is all about.

"There is no doubt asset allocation is responsible for more than 90% of your returns as an investor. The recognition we need to make is if all you're focused on is picking stocks then you're not really seeing the wood from the trees," he says.

He adds that post-GFC global markets have been driven by macro events rather than individual stock situations. Given this outcome, BetaShares has been ramping the idea of global themes and has launched ETFs across several sectors including health, agriculture and cyber security among others.

"There are certain areas and managers that tend to add value. We think it's about choice for investors ultimately and that's a great thing about the Australian ETF market."

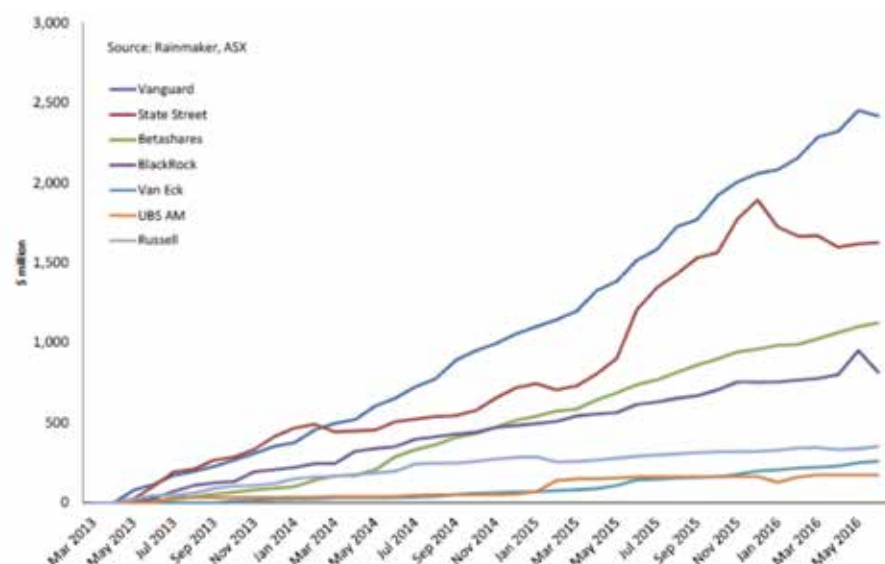
Will smart beta deliver?

What can't be argued is that as indices have improved and become better understood, the investment landscape for index funds has become slightly more complex. Most notably fund managers have tried to find a middle ground between passive and active strategies, leading to the rise of smart beta.

Vynokur says in today's world there is a significant adoption in smart-beta strategies. Academic literature and significant practitioners in the industry are recognising that there are advances in the way indices are constructed and of benefit to investors, he explains.

"Whether it's fundamental investing which we've seen before, or whether it's factor expo-

Figure 1. Cumulative net flows Australian equities strategies by manger





05:
Vis Nayar
global head of
investment processes
and deputy chief
investment officer for
equities, HSBC



06:
David Semple
emerging markets
equity strategy
portfolio manager,
VanEck

“sures, investors are recognising the vast majority of returns from active managers come down to factor attribution or other smart beta attribution factors,” Vynokur says.

In its latest white paper Standard Life Investments says the active versus passive debate has evolved following the growth of transparent algorithmic investment approaches, or smart beta. It says smart beta investing is more complex than many investors perceive and requires careful consideration.

“Despite this, the widespread availability of these alternative passive strategies has undeniably changed the investment landscape,” Standard Life said.

SLI head of multi-asset quantitative strategies, Arne Staal, says advances in technology, the increasing availability of data and the rapid growth of smart beta strategies results in a fast-changing and expanding opportunity set for investors.

“However, they have more complex evaluations and choices to make, and a wider range of associated costs to assess against desired outcomes,” Staal says.

HSBC global head of investment processes and deputy chief investment officer for equities, Vis Nayar, has been visiting Australia for the past few years and says there has been plenty of institutional interest and questions on smart beta. He sees a situation where institutional investors will look to further allocate explicitly around these types of strategies.

“Smart beta draws on all this academic work from the past 40 or so years where people have identified these characteristics and groups of

stocks that are able to deliver better risk-adjusted returns. That’s why people are interested in this area,” Nayar⁰⁵ says.

In Australia, like many global markets, once cost becomes an important element people become much more innovative in this area. Australia appears to be a leader and there appears to be a shift of allocating towards these smart beta strategies, he adds.

Nayar says ETFs clearly have an interesting structure for particular clients and in smart beta there is possibly two types of solutions – an ETF structure gives certain clients the opportunity to implement asset allocations, or tax-effective allocations and the like. However a lot of the institutional clients often seek customised solutions.

“We have a very material resource around research and the ability to deliver customised solutions to large clients. We often have debates with clients around this – we’re now at a stage where a large client does not need to buy an off-the-shelf solution,” Nayar says.

Standard Life Investments says there are several pitfalls investors should be aware of when considering smart beta strategies, including a lack of clarity in investment objectives and limited sustainability.

As the active versus passive paradigm shifts, traditional market benchmarking will be increasingly superseded by outcome oriented mandates. Smart beta has a role to play but it should not be used as a static allocation, SLI says.

It adds that flows in smart beta have been significant and can strongly influence asset prices. This presents opportunities to ac-



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tive investors who take a multi-strategy approach and offers new chances in the area of stock selection.

HSBC’s Nayar says the firm has been advocating factor purity for a number of years. The real issue they’re worried about is that factors are not simple concepts. Any given stock is simultaneously exposed to a number of factors and many products that are out there can have a degree of unintentional or incidental exposure to other factors.

“We think on the concept of factor purity, if you adopt smart beta or anything that is not market-cap weighted, you will have a tracking error and it should be kept as best as possible coming purely from the factor you sought in the first place,” Nayar says.

He adds this places quite a high hurdle in terms of research as firms try to maximise client exposure to the factor they seek, without being compromised by other factors.

SLI’s Staal says an awareness of the pitfalls in utilising transparent algorithmic investment strategies such as smart beta is increasing but not yet widely discussed. He advises investors to approach smart beta investing with similar levels of due diligence as they would for active managers.

“Most active managers deliver a combination of smart beta and pure alpha. Those that consciously position their business model to build portfolios through security selection and active allocation to a broad range of strategies will be best placed to achieve better outcomes for clients and benefit from this evolution in asset management,” Staal says. **FS**

Emerging markets have momentum

As investors look for increased global equities exposure index fund manager VanEck says emerging markets are likely to become a good momentum bet.

VanEck emerging markets equity strategy portfolio manager, David Semple⁰⁶, says the asset class outperformed global indices in the third quarter of 2016 and continue to gather momentum.

“Emerging market equities have generally underperformed over the past four or five years, however the tide is turning. Emerging markets growth relative to developed markets is at its highest since 2014 and we believe it will continue to outperform developed markets over the next five years,” Semple says.

According to Semple, there are several factors driving the strong performance of emerging market equities including dollar and commodity stabilisation, low global bond yields, improving earnings and relief in China.

“China offers pockets of opportunities. After two quarters of weakness, MSCI China was one of the top country performers in the third quarter. The question really shouldn’t be if to invest in China but rather where to invest. The local population no longer want to see ‘black stinky water’ and instead want better air quality, cleaner water and good healthcare. We see opportunities in companies focused on providing

middle-income services and companies focused on the environment,” Semple says.

Emerging market small and mid-cap companies also offer opportunities but are poorly captured by widely used benchmark indices and instead investors should be considering an emerging markets equity strategy that has the flexibility to go anywhere across the market-cap spectrum to find the best growth opportunities, Van Eck says.

“While most emerging market large-caps have shown strong performance, we believe that much of their performance is cyclical. Small to mid-cap companies offer strong performance opportunities because they are less developed, domestic demand driven but not necessarily more risky,” Semple says.

He believes emerging market companies are better positioned than previous years given the majority have adapted to a low growth environment and are meeting changing domestic demands. They also have better management structures and cost saving mechanisms in place, resulting in better earnings and profit margins.

“Most investors are under-allocated to emerging market equities because they are skeptical about performance. We expect this sentiment will shift as investors continue to see strong performance into 2017 and as a result, we expect they will significantly increase their exposures,” Semple says.