Some active managers succeed while the majority struggle

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The active versus passive debate rolls ever onwards, and Cuffelinks has published many articles from both sides of the debate. For example, Chris Cuffe has explained how he picks active managers that have outperformed the index over the years, while we have reported in the past on the S&P Indices Versus Active Funds (SPIVA) Australia Scorecard.

According to S&P's latest report to June 2016, the majority of active Australian equity and bond funds continue to consistently underperform their benchmarks.

However, while it's not pretty overall for most active managers, there are sectors where active does well, and it's possible to identify active opportunities in sectors where passive managers are more successful overall. Even if the majority of active funds do not justify their fees, it does not mean that it's not worth finding those managers who do add value consistently.

The report evaluated the performance of 608 Australian equity funds (large, mid, and small cap, and A-REITs), 294 international equity funds, and 66 Australian actively managed bond funds over one, three, and five-year investment periods.

SPIVA's annual scorecard is now in its 14th year and serves as "the de facto scorekeeper of the active versus passive debate", the report states.

"There is no consistent trend in the yearly active versus passive index figures, but we have consistently observed that the majority of Australian active funds in most categories fail to beat the comparable benchmark indexes over three- and five-year horizons," the report adds.

Flat year, flat funds

In a year in which the S&P/ASX200 was almost as flat as a pancake, registering only a 0.56% gain, Australian large-cap equity funds posted an average return of 0.09%, with close to 60% of them underperforming the S&P/ASX 200. Over the five-year period, 69% of funds in this category underperformed the benchmark.

Large-cap funds were not alone. The majority of ASX equity funds underperformed benchmarks over all three time frames. International Equity, Australian Bond, and A-REIT funds were the worst performers over the three time frames.

A-REITs big relative underperformers

A-REIT funds recorded an average return of 22%, lagging the S&P/ASX 200 A-REIT benchmark by 2.5% over the 12-month period. The majority of funds lagged the benchmark, with 87.5%, 93.1%, and 92.4% underperforming over the one, three, and five-year horizons respectively.

Adrian Harrington, head of funds management at Folkestone Limited, said success as an active A-REIT fund over the long run depends on the management and their investment approach. The smaller conviction-based funds don't worry about benchmark weights and are not bound, like bigger A-REIT funds, to invest in the ASX200. The top six managers in the A-REIT sector outperform the index, usually because they manage smaller, high-conviction funds that can invest in individual A-REITs based solely on merit.

The larger funds, he said, had been victims of their own success:

“They have so much money that they’re bound by rules which prohibit them from stepping far outside the high market-cap property stocks. Westfield and Scentre comprise 36% of the index, while the top eight stocks comprise 80%, so it’s very highly concentrated. Those funds have to hold a certain percentage of Stockland or Mirvac stock in their portfolios, regardless of whether they like them as investments or not. The index has nearly a 60% exposure to retail shopping centres, which is ok in boom times but in reality represents a higher investment risk during periods of more normalised returns.”

Mid and Small-Caps outperform over longer term

The majority of ASX Mid and Small-Cap funds lagged their indexes over the shorter one and three-year periods, but a healthy 62% outperformed the benchmark over the five-year period by an average of 3.6%, and some by a far more significant margin.

Glennon Capital Managing Director Michael Glennon said he was not surprised by the longer-term result. “Small cap managers understand markets and businesses and they have a feel for momentum. To invest solely in small caps you need to understand what the market has an appetite for and what is behind a company’s growth story.”

Glennon said small-cap funds are not constrained by weightings and can pretty much invest in whatever they like. “The companies we invest in can potentially double their market caps in a relatively short space of time, whereas a $25 billion fund is not likely to grow to $50 billion in just a few years.”

International equities, bonds poor relative performers

The S&P Developed Ex-Australia LargeMidCap recorded a return of 0.9% over the 12-month period. However, international equity funds posted an average loss of 2.1%, and 80.7% of those funds underperformed the benchmark. Over 90% of international share funds underperformed the benchmark over the three and five-year periods.

The average return of international equity funds consistently lagged the S&P Developed Ex-Australia LargeMidCap by more than 2.6% in the three and five-year periods.

The S&P/ASX Australian Fixed Interest Index gained 7% in the 12 months to June, while Australian bond funds recorded a smaller average gain of 5.6%. Some 89.5% of funds underperformed the benchmark, while 92.2% and 88.7% of funds lagged the benchmark over the three and five-year periods respectively.

Funds merging and liquidated

Five per cent of Australian funds from all measured categories merged or were liquidated over the year ending in June. International equity funds disappeared at the fastest rate (6.9%).

ASX funds had an overall survivorship rate of 78.4% over the five-year period. Bond funds had the highest rate of survival (83%), while international equity funds had the lowest, with more than a quarter either merging or being wound up.