

## Research and Insights

### Active investment management – the quiet achiever

October 2021

**In all the recent talk on the rise of passive investment strategies, their active counterparts have been steadily compounding outperformance in the wake of the worst effects of the pandemic. An active approach to Australian shares continues to deliver across large, small and microcap market segments.**

#### Back to basics: What investors want

Investors may direct their surplus income or capital into financial markets for a variety of reasons, but for the vast majority of us the key driver is the desire to maintain quality of living well beyond our working lives. Indeed, the prospect of toiling for 40 to 45 years only to retire with an inadequate level of purchasing power and economic choice is a truly frightening one. It is no longer flippant to contemplate a retirement phase that lasts almost as long as our working lives. The ultimate aim of our savings behaviour should be to minimise financial stress right across the long twilight of one's 'innings'.

#### Making sense of the barrage of information

We are surrounded by a cacophony of research, data and commentary that seldom looks beyond an investment horizon of between one to three years. Witness the common financial press. When it does refer to particular or aggregate outcomes produced by investment managers and superannuation funds utilising active investing, it inevitably refers to the shorter term and compares to a relevant benchmark. The benchmark or index, of course, does not take active decisions, it is simply a 'weighing device', typically based on market-cap criteria and the net sum of investor behaviour at any given point in time.

By contrast, with an eye to producing superior, risk adjusted long-term returns, the thoughtful active manager will use judgment to avoid such short-term traps and invest in the inevitability of economic and market growth, and mean reversion over time. It makes sense that there will be periods of underperformance because, after all, this risk recycles as a source of future long-term excess return.

In this way, whether referencing an index or an active return, any given short-term result offers a poor guide for the future prospects for investment performance. In fact, it isn't telling us much at all. We can only assess the efficiency of a market index, or the effective judgment of an active manager, over the very long term.

Given this and the complementary point that the common person's investment span is genuinely multi-decade, it remains a mystery as to why so many pundits develop a prognosis based on data and records that extend for only a few years. Surely it makes sense to draw inference from market and manager results that have endured the rigour of varying cycles, peaks and troughs over an extended timeframe?

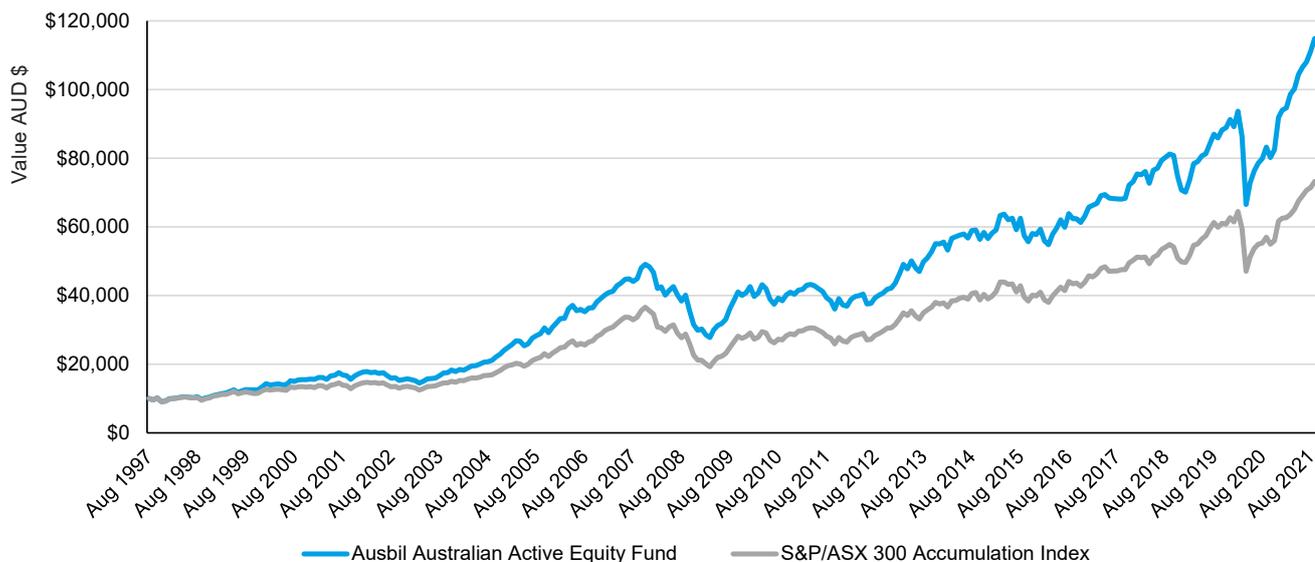
#### Let's take a look at an asset class

The Mercer Australian Large Cap Share Performance Survey for the 20 years to end September 2021 shows that the S&P/ASX 300 (All Ords before 1/4/2000) returned 9.0% pa on a compound basis. The median return of the 30 active strategies in the survey was 10.2% pa, compounding at a very respectable 1.2% pa above the market. The upper quartile compounded at 11.3% pa, beating the market by 2.3% pa. Even the lower quartile mark of 9.8% pa outperformed the broader market. These results do not include the effect of franking and are shown on a before fees basis.

Over a 20-year timeframe, investing \$10,000 at a median return of 10.2% pa produces a balance of \$69,764. If, rather, one invested in an index fund and received a before fees return of 9.0% pa, the final balance would amount to a far lower \$56,044.

The Ausbil Australian Active Equity Fund has delivered a 20-year compound return of 11.3% pa (gross of fees) turning \$10,000 into \$85,094. Since inception in 1997, the same Fund has delivered a compound return of 11.5% pa, an excess return of 3.0% pa (gross of fees).

## Ausbil Australian Active Equity Fund: Value of \$10,000 invested at Inception at 1997 (net of fees)



Compared to the large-cap segment of the market, the small-cap sector of the market is arguably less efficient (lower levels of information), with less broker coverage and therefore affords relatively greater opportunity for alpha generation over the long run. The data bears this out in a stark fashion.

The Mercer Australian Small Cap (ex 100) Share Performance Survey for the 20 years to end September 2021 shows that the S&P/ASX Small Ords returned 7.9% pa on a compound basis. Of the 11 strategies in the survey, all of them beat the market with a median result of 13.8% pa, compounding at a very respectable 5.9% pa above the market. The upper quartile compounded at 15.7% pa, beating the market by 7.8% pa. Even the lower quartile mark of 13.4% pa outperformed the broader market by 5.5% pa.

During the last 10 years in particular, there has been a proliferation of micro-cap strategies that utilise the S&P/ASX Emerging Companies index as their benchmark. For the 10 years ending September 2021, the Mercer Survey indicated a peer group median compound return of 20.7% pa versus 7.5% pa for the benchmark.

### Coping with sequencing risk

Reducing share exposure either after the commencement of a correction or during the period of recovery, will interfere with compound growth and be detrimental to capital accumulation. However, after the worst corrections, history shows that share values may take several years to return to their starting value.

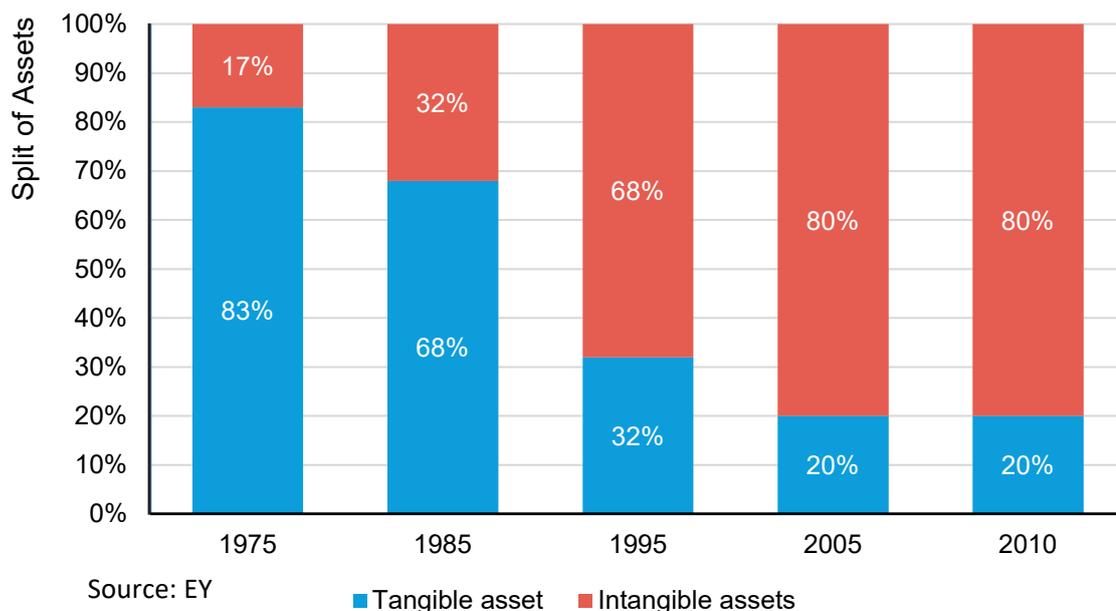
During the famous stock market crash of 1987, the S&P 500 collapsed by 28.5% and took 398 trading days to recover. The global financial crisis that extended across the second half of 2007 and 2008 caused the S&P 500 to depreciate by 56.8% and recovery took 1,022 trading days.

So, while an 80% to 100% exposure to equities will make sense for many investors, the retiree is in different circumstances given the absence of working income, the reliance on investment income and the consequent vulnerability to so called sequencing risk. It will therefore make sense to retain at least 3 to 5 years of income in defensive assets so as to allow growth assets to recover after substantial downside movements. Further, low volatility and absolute return equity strategies may be utilised alongside traditional, long only shares to moderate this downside risk.

### ESG: an additional source of active investment returns

Fundamental, proprietary research of course provides the insights that allow active managers to create a capital return beyond the return of the market sector in which they invest. The effort is 24/7 and is conducted by qualified, dedicated professionals. This research is both qualitative and quantitative and, traditionally, has focused on the financial aspects of corporate performance. It is now increasingly common for the same managers to also investigate the target companies approach to the environment, society and corporate governance (ESG), alongside its financial aspects, for a fuller view of the earnings risks and opportunities. The fuller the view, the greater the likelihood of excess returns on a risk-adjusted basis over time. Proper ESG integration will also insist on extensive engagement and advocacy with the interaction between fund manager and company manager encouraging corporate behaviour that is both responsible and sustainable. Issues such as climate change and modern slavery are topical. An index or index tracker is unable to do this work. As is the case with valuations, the index is 'blind', without any ability to use thoughtfulness and intellect to produce superior outcomes over time, or to actively reduce risks obvious or not.

## Share of Intangible Assets: S&P 500



### The effect of fees

Given the vast array of available investment strategies and vehicles it is difficult to generalise about the average level of investment management fees and what level is and isn't reasonable. Investors though should remain considered in this area because the compounding effect of fees can genuinely interfere with long-term growth objectives. It is also important to distinguish between investment, administration and advice fees. Only investment management fees should be attributed to investment portfolios and included in net fee calculations. To enjoy the benefits of an active approach, investors should ensure that excess returns are expected to well exceed fees on a rolling long term basis.

### "Patience is bitter, but its fruit is sweet."

Recent developments are troubling. The government has now implemented the "Your Super, Your Future" reforms and MySuper products are subject to an annual performance test based on a comparison with conventional market indices. Underperforming funds are listed as underperforming on the YourSuper comparison tool until their performance improves. The reforms present the real risk that super fund trustees will minimise their exposure to active investing rather than suffer the potential for public ignominy during those inevitable periods when the fund return profile and relevant indices depart from one another. Einstein is reputed to have claimed that, "Compound interest is the eighth wonder of the world. He who understands it, earns it...he who doesn't...pays it". Whether government legislation, regulation, advice or investor behaviour, any cause for impatience around access to capital or the lengthy incubation period necessary to produce valuable active returns, will only serve to interfere with our industry's capacity to deliver that which our customers desire most – the ability to develop an independent financial confidence that will go the distance. After 45 years across a typical working career, who would deny them?

#### A short notice on the COVID-19 public health event, and how it can impact investments

Given the currently evolving issues around the Coronavirus (or Covid-19) globally, which has officially been designated a pandemic by the World Health Organisation, we wish to notify that, as with many firms, business may be disrupted. A public health crisis, pandemic, epidemic or outbreak of a contagious disease, such as the recent outbreak of Coronavirus (or Covid-19) in Australia, Italy, China, South Korea, the United States and other countries, could have an adverse impact on global, national and local economies, which in turn could negatively impact investment returns in any of Ausbil Investment Management Limited's registered managed investment schemes (the Funds). Disruptions to commercial activity relating to the imposition of quarantines or travel restrictions (or more generally, an inability on behalf of authorities to contain this pandemic) may adversely impact any investment, including by delaying or causing supply chain disruptions or by causing staffing shortages. The outbreak of Coronavirus has contributed to, and may continue to contribute to, volatility in financial markets. The impact of a public health crisis such as the Coronavirus (or any future pandemic, epidemic or outbreak of a contagious disease) is difficult to predict, which presents material uncertainty and risk with respect to any investment or fund performance.

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