FINANCIAL REVIEW

Fund managers spill the beans on returns

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The boss of a $2 billion hedge fund quips with a cryptic smile: "You can't outperform without underperforming, mate."

His seemingly contradictory statement rattles through my brain for days and raises profound questions. What do we mean by "underperformance"? Is it relative to asset-class indices or the "absolute returns" one expects to earn? And what should savers building portfolios focus on: indices or absolute return targets? More fundamentally, is there a case for active management or should we rely on cheap index funds that replicate the "market portfolio" associated with any investment class? (For my sins, I had to debate an 800-page dissertation I wrote on this subject with academics at Harvard, Yale and New York University.)

Finally, if you buy into the view that active managers have a role to play, what do we do when they disappoint?

To address these questions I interviewed a range of top "asset-allocators". These are individuals who have dedicated their careers to figuring out how to generate returns that satisfy client needs using both active and passive strategies.

So let's begin with the issue of "absolute" as opposed to "relative" return targets.

Stefano Cavaglia, head of unlisted investments at Philo Capital Advisers, which has more than $4 billion in assets under advice, says, "Joe taxi driver's 'target' rate of return should be implied by his goals, circumstances and willingness to bear risk to achieve those goals".

Every "Joe" requires a customised benchmark against which to evaluate their investments, Cavaglia says. This should reflect "the cash flow stream he requires to retire and the risk he is willing to bear to achieve it".

This "objectives-based" portfolio construction approach is echoed by other researchers. Michael Furey, managing director of the asset consultant Delta Research, says savers need to "determine their desired retirement income, the capital required to produce that income, and what contributions they can make during their lifetime which will then allow them to calculate an annual return target".

Rule of thumb

"A simple rule of thumb is that long-run government interest rates are around 3.5 per cent to 4 per cent annually. Global equities have outperformed cash and bonds by about 3 per cent to 5 per cent. Put them together and you're looking at 'low-risk' return targets of around 4 per cent and 'high-risk' targets closer to 9 per cent over any period of 10 years or more."

Ross Endres, the chief investment officer of the $450 million MAP super fund, agrees that "all investors should have a 'goal-based' absolute return target no matter their sophistication – if only to provide a trigger point for discussions when realised returns do not coincide with it".

"Over the last two decades the average super fund has returned circa 7 per cent after fees," Endres says. "The double-digit returns in recent years should give investors pause to consider whether they are durable."

With a return target resolved, how should one think about evaluating actual investment outcomes?

Morningstar's director of manager research, Tim Murphy, says "the performance of any investment should be assessed relative to a relevant benchmark over an appropriate time frame, which will vary depending on the type of investment in question".

Philo Capital's Cavaglia uses benchmarks to decompose a fund manager's deviation from the market into its "style" and "panache" components. Equities managers, for example, often focus on specific "value", "growth" or "small companies" styles that give their portfolios systematic sector risks that can yield additional returns beyond the wider market. "Identifying these risks and how they play out in different cycles then becomes the challenge of what we call 'style management,'" Cavaglia says.

"Less commonly, a manager might have some unusual skill that other participants are hard pressed to replicate. We call it 'panache', which is rare." How much a manager depends on structurally embedded "style" (which may be more commodity-like) compared with unique "panache" determines the fees Philo is prepared to pay them and the allocations the solution gets in client portfolios.

Adjust for risk

MAP's Endres agrees that "returns have to be risk-adjusted" but warns the techniques used to do so, like "Sharpe Ratios", which subtract a "risk-free" rate (e.g. cash) from a fund's returns and then divide that excess return by the fund's volatility, are "meaningless" to punters. More nuanced, "regression-based" performance evaluation techniques, cited by all the researchers, are even harder for mums and dads to understand. This is why there is value in distilled metrics like asset consultant ratings.

Endres is critical of active managers asking for performance fees above a zero-return benchmark without an appropriate risk premium. "When I look at hedge funds I use a return target of cash plus 6 per cent because I can get that return from passive equities for next to nothing over long horizons," he says,

So should investors use active managers as a complement or substitute for passive index funds?

Andrew Aylward, director of research at Pitcher Partners Investment Services, believes "there is definitely a case for active management in the more inefficient asset-classes". This is a perspective shared by most asset-allocators.

"The key is identifying those managers [who] can consistently beat the market and understanding the environments in which they are likely to outperform," Aylward says. One problem here is investor behaviour. "Investors tend to chase the outperforming managers and sell the underperforming ones, often at the wrong times, thereby ensuring that their own portfolio will underperform."

"As Warren Buffet has pointed out, the average investor is often better off adopting a mix of passive investments in index funds, especially if they do not have the time or access to qualified financial advice, and if they plan to leave their investments untouched for the long term."

Kelvin Boyd, chief investment officer at financial advice firm Whittle & Skok, says, "whether the 'average' manager can add value is debateable in most areas except for Australian small companies". "We believe there are good managers out there that can add value through active management in most of the asset classes over the long term, but they are certainly in a minority."

All researchers agree the ability of active managers to persistently identify mispriced assets depends on the efficiency and liquidity of the investment universe in question.

"The case for active versus passive varies by asset class," Morningstar's Murphy says. "Australian small-cap equities is an example of where active managers have consistently outperformed passive indices while large-cap US equities would be an example of the opposite.

Delta's Furey thinks that "active management is definitely more important in less liquid and less analysed markets including some bonds, private equity, and certain real estate markets."

Beating the negatives

Once you have allocated to an active solution, how do you then respond to periods of sub-par or negative performance?

"It is inevitable any one strategy or any one manager will underperform the benchmark," Philo's Cavaglia says.

"The key is to understand the source of underperformance. Managers with a 'quality bias' can outperform when the market falls and underperform when it rises."

Divergences may be attributable to conditions being temporarily unfavourable to a manager's style, a more permanent erosion of their "edge" or "panache", and/or one-off mistakes that could in theory make them superior investors in the future.

Morningstar's Murphy concludes that "underperformance over a matter of months is not something that generally concerns us too much". "If it persists for years, then we thoroughly re-test our original thesis, determine if something has changed or is broken, and make a call accordingly." That's sound advice.

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