

Lonsec Active Funds Outperform and The Passive v Active Debate

Lonsec Releases Aussie Equities Sector Review

The latest review of Australian equities by research house and ratings company Lonsec has found its actively managed funds have clearly outperformed index funds in all recent major time frames.

According to its Australian Equities Sector Review, Lonsec found the 137 active managed funds it provides investment ratings for have outperformed their corresponding index by an average of 1.54 per cent on an after fee basis during the past three years but also across other significant comparison periods.

Table 1. Lonsec Active Managed Fund universe* (average annual returns, after fees)

	1 YEAR	3 YEAR	5 YEAR	7 YEAR
ACTIVE MANAGERS	5.45%	16.24%	7.34%	2.95%
S&P/ASX300 ACC	5.30%	14.70%	6.48%	2.02%
OUTPERFORMANCE	0.15%	1.54%	0.86%	0.93%

Source: Lonsec Research

“The findings are very topical given the ongoing debate about the ability of active funds to outperform passive or index funds,” Lonsec senior investment analyst Peter Green said.

“The results from the active managers within our peer group clearly shows the benefit of careful selection of fund managers,” Mr Green said.

“The case for supporting active management is evident across most time frames and these results highlight that it can be worthwhile paying for active professional large cap stock pickers,” he said.

Lonsec remains agnostic in the wider debate about active versus passive funds and lets the results stand on their own merit; however, it does have a view as to what constitutes a ‘highly recommended’ active manager.

“In a crowded market place, the difficulty is how to sort the good from the mediocre. For our research and ratings purposes we have carefully investigated what it takes to stand out from the pack,” Mr Green said.

Lonsec’s approach to assessing fund managers may also prove a useful check list for all investors, which we briefly summarise as follows:

1. The Firm: Is the organisation financially stable and viable? What is the ownership and staff culture, is there good quality stewardship and a culture of excellence?
2. The People: Are the key investors experienced, talented and passionate? Do they have the courage to have a different view and not just follow the herd and, importantly, do they have the humility to correct a mistake?
3. The Philosophy: Does the firm have a clear and well-articulated investment philosophy about how it will add value? Is the team aligned to this philosophy?
4. The Process: Does the firm’s investment process give it a competitive research advantage that helps it meet its investment objectives? Is this process repeatable over an investment cycle? Are there any constraints to this process?
5. The Portfolio: Are historical portfolio holdings and characteristics in line with the manager’s philosophy and process? Is risk managed effectively?
6. The Performance: Is there a logical reason for historical performance, i.e. does it match with the firm’s approach? Are the drivers of returns sustainable over the long term?

The case for passive management

- Lower costs: full replication index funds tend to be much cheaper which can help them provide more efficient exposure to market indices.
- Transparency: index funds provide investors with a high degree of transparency of the underlying investments. This contrasts with active managers who tend to be more opaque with their stock holdings, as often they believe this information is intellectual property.
- Greater certainty of outcome: many passive managers have been successful in achieving their investment objectives of closely matching an index, regardless of market conditions. This contrasts with many active funds which tend to experience underperformance from year to year, even if they have a successful track record of meeting long term objectives.

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- Tax efficiency: Index funds tend to have low turnover within their portfolios which can lead to greater tax efficiency and reduce trading costs.

The case for active management

- Professional management: professional managers tend to have superior investing skills.
- Less concentration risk: The highly concentrated Australian market can create unnecessary risk from certain highly represented companies and sectors. Active funds can better manage this risk.
- Flexibility: Active managers are better able to adapt to market conditions which can be critical during key market turning points.

Head to head

"The Australian equity market is significantly concentrated with almost two-thirds of the market allocated between resource and financial stocks. In addition the 'top 50' stocks also account for nearly 70 per cent of capitalisation of the S&P/ASX200 Acc Index, with the majority of this in the 'top 20' largest stocks," Mr Green said.

"As a result, a majority of large cap stocks are heavily researched, meaning it is difficult for fund managers to get an information advantage over their peers", Mr Green said.

"Fund managers who are not prepared to take meaningful under or over-weight positions against these top stocks, or who do not dig deeper for strategies outside the top stocks, will struggle to consistently outperform the market."

Despite the strong performance by the Lonsec managers, generally active managers are under performing passive funds in Australia. According to the SPIVA Australia Scorecard the majority of large-cap equity funds again under performed the index during the 2014 calendar year and for the three and five year periods. Lonsec fund managers are clearly an exception.

Table 2 Percentage of funds that under performed the index @ December 2014

CATEGORY	INDEX	1 YEAR	3 YEAR	5 YEAR
AUST EQUITY GENERAL	S&P/ASX200	61.44%	63.14%	77.56

Source: S&P Dow Jones Indices LLC, Morningstar'

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Note: * Lonsec wider universe of Australian equity funds total 170 capabilities, of which 152 are deemed 'active' and 18 'passive'. The active universe presented in this analysis has been reduced to 137 managed fund equity products, after stripping out active Exchange Traded Funds and Separately Managed Accounts.

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