Indexing – the cheap middle ground

Professional development programs are one of the Securities Institute's most important contributions to the finance and investment community. Here JASSA presents a sample of the content of three recent PD seminars.

Despite the financial community's occasional lapses into blind faith, it remains a truism of investment that for every winner there will be a loser. This fact keeps investment strategists busy behind the scenes, devising ways to best exploit the laws of risk and return.

One result of this considerable activity is the long-lasting debate about the relative merits of active and passive investment. Indexing, the most talked-about form of the latter, drew spirited support at a Securities Institute seminar in Sydney on 27 April titled "To Index or Not to Index?"

Indexing is "going for the middle ground", according to Eric Smith of Vanguard Investment Australia. Explaining the increasing appeal of index funds, Smith said their popularity was driven by their competitive costs — not only in investment and administration fees but in lower capital gains tax liability resulting from a buy-and-hold strategy. He warned, however, of the danger of relaxing this strategy and trading within an index portfolio: "Moving in and out kills one of the key cost advantages of indexing over active trading."

Indexing should be the core element of a portfolio, Smith said — "Lock it in, keep it there, and if you must trade, trade in the active part of your portfolio."

Greg Liddell from Mercer Investment Consulting agreed that costs were a major contributor to the popularity of index managers. He cited cost models showing a differential of 35 basis points to eight in favour of index investments.

Fees for active management were higher, relative to excess returns, in most asset sectors.

A third speaker, Gus Fleites from State Street Global Advisors, defended exchange-traded funds (ETFs), the "dreaded products characterised as funds for speculators". In fact, he said, they protected the interests of the long-term investor better than traditional index funds.

"In a traditional index fund, you have no idea what the price will be when you subscribe for units," he said. "With an ETF you have full control of the execution. ETFs had "democratised" the market by providing a new way to trade a basket of securities quickly — provided there was strong liquidity in the underlying securities."

Hot property

A PD seminar on 8 May, on whether property trusts had reached their limit, brought an emphatically negative response from speakers. However, there were diverse views when they discussed direct property investment relative to listed property trusts (LPTs).

Tim Stringer, from AMP Henderson Global Investors, said that although each performed differently at stages of the business cycle, AMP's view was that LPTs did not offer comparable long-term returns. Over 16 years, direct property had shown dramatically lower volatility than other asset classes. LPTs, on the other hand, were highly correlated to bonds and equities and provided lower diversification benefits.

Combining direct and listed property in a portfolio was likely to produce better risk-adjusted returns than investments restricted to one or the other. Both had a bright future. J.B. Were's Nick Vrondas described LPTs as institutions' preferred method of exposure to real estate. He said there was considerable scope for growth in the sector considering that in Australia, 45% of major enclosed shopping centres were owned by LPTs, as well as 35% of office accommodation and perhaps 25% of industrial property.

Capital appreciation

At another PD seminar on 27 June, two senior risk analysis executives from the Australian Prudential Regulation Authority (APRA) explained proposed changes to the Basel Accord on capital adequacy. Wayne Byres and Guy Eastwood, admitted that they were dealing with complex concepts and outlined the implications of revisions to risk assessment methods used by banks and other financial institutions.

Australia, through APRA, had suggested modifications to the Basel Committee's proposals, which are due for implementation in 2005. The overriding objective was "no change on average", but new advanced approaches to weighting risk meant that some institutions would finish up with higher capital requirements.

Byres emphasised that institutions would need to "gear up now" for the 2005 deadline. They would have to develop new skills in implementing sophisticated risk assessment frameworks and invest heavily in infrastructure, people and information systems.

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