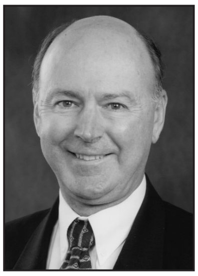
In praise of inefficiency

Is the EMH really just a theory of mediocre returns?

An article in the Autumn 2000 issue of JASSA, "EMH is Alive and Well", has drawn this response in rebuttal of the contention that the Australian equity market is unequivocally efficient. REUB HAYES says the evidence clearly shows that active management of domestic equity portfolios has added substantial value over the past decade and that the magnitude of the value added has accelerated.



REUB HAYES FSIA, chief executive officer of Ausbil Dexia Limited, has 35 years' experience as an active equity analyst, equity research manager, investment strategist, CIO and CEO in the Australian institutional market.

The *JASSA* article "EMH is Alive and Well" (Summer 2000), prompts this response which demonstrates that the Australian market is anything but efficient.

As an active investment manager, the central tenet of one's investment philosophy is the belief that markets are not perfectly efficient. Differing interpretations of market information and investment potential of specific securities lead to market inefficiencies that persist for varying periods. Active managers benefit from these interim inefficiencies as they yield opportunities that can be exploited though rigorous qualitative and quantitative research.

Having spent the past 30 years or so as an active participant in the Australian institutional equity markets, I am often amused by the ongoing debate of "active" versus "passive" and "efficient" versus "non-efficient" market theory. It is like arguing politics and religion — no-one ever wins but everyone has strong convictions. Notwithstanding this, I could not let the most recent article go unchallenged as its conclusions are based on dubious data which lack some degree of credibility.

It is not proposed to provide a comprehensive critique of the methodology used in the article's conclusion, other than to say it is comparing apples with oranges. The major flaw is the use of "retail" funds data as the active manager performance proxy. Retail fund unit prices include full management expense ratios (MERs), usually in the vicinity of 2% or more per annum. MERs are management and administrative charges which have no relevance to the managers' ability to outperform the index. MERs also vary significantly depending on the size and the nature of the fund (retail or wholesale). Such a methodology also ignores the fact that most superannuation assets are wholesale mandates where expense ratios are a fraction of those of retail unitised products. Notwithstanding this, the conventional industry standard for assessing a manager's performance, be it passive or active, is based on raw data before fees and expenses. This is then compared with the benchmark on which the mandate has been granted. That is, apples are compared with apples.

Thorough domestic equity performance analysis has been undertaken by Australia's leading asset consultants over the past 20 years. Mercers, Towers Perrin, InTech, Frank Russell Group and many other global asset consulting houses have comprehensive and sophisticated performance measurement software which is based on empirical data provided monthly by active Australian equity managers. The work complies with world standards for performance measurement.

These accredited surveys show a completely different outcome to the conclusions drawn from the EMH article published in *JASSA*.

The simple facts are that the Australian equity market is not perfectly efficient and active managers have been effectively exploiting these inefficiencies consistently over the past 20 years. Because of "survivor bias" there is not a lot of credibility in using current performance survey data for more than five to seven years. Industry rationalisation and merger-and-acquisition activity has significantly depleted the number of managers who can claim a continuity of process and style for longer than this. However, the pattern of active managers outperforming the index has been demonstrated consistently from these surveys on rolling five-year periods over the past 20 years. The magnitude of value added (alpha) over the past seven years has been significant and benchmark outperformance by active managers has been further amplified during recent years as the structure and behaviour of the Australian equity markets demonstrates less efficiency. Table 1 demonstrate this phenomenon.

A simple analysis of these wholesale survey results provides the following empirical conclusions:

- The Australian equity market is often less than efficient and Australian active managers have consistently added alpha value by successfully exploiting inefficiencies.
- The "average" active specialist wholesale manager has consistently outperformed the index by between 2.3% and 2.9% per annum over the past five to seven years.
- The magnitude of benchmark outperformance has increased over the past three years during which period the average active manager equity benchmark value added has increased from 3.1% per annum to 7.0% per annum.

The most significant feature of this data is the consistency in the number of active managers who have outperformed. Over every period of this analysis even the lower-quartile-ranked managers have consistently beaten the index. In addition, on average, over the four periods analysed from one to five years, 93% of active specialist managers have outperformed the benchmark index. This is depicted in Table 2.

TABLE 1 Performance survey results, Australian shares (specialists), 31 March 2001

	1 year	2 years	3 years	5 years	7 years	10 years
Benchmark						
ASX All Ordinaries Accumulation Index % pa (S&P ASX 500 from 1.4.00)	2.3	5.8	7.9	10.9	10.2	12.1
Manager returns % pa						
Average manager return	9.3	9.2	11.0	13.8	12.5	15.1
Upper quartile	11.8	10.6	12.3	15.4	13.6	16.8
Low quartile	6.3	7.1	9.4	12.3	11.4	13.5
Excess average return vs benchmark % pa	7.0	3.4	3.1	2.9	2.3	3.0

Source: InTech DeskTop Consultant Software

TABLE 2 Performance vs benchmark, Australian shares (specialists), 31 March 2001

	1 year	2 years	3 years	5 years
Benchmark return % pa* and survey rank	2.3 (56/60)	5.8 (47/50)	7.9 (47/50)	10.9 (22/24)
% of active managers outperforming benchmark	93	94	94	92

Source: InTech DeskTop Consultant Software
** Benchmark ASX All-Ords Accumulation Index (S&P ASX 500 after 1 April 2000)*

How anyone could conclude that the Australian market is "efficient" when this information is readily available through several globally accredited asset and actuarial consultant sources is hard to comprehend. The Australian equity market is less than efficient and the inefficiency continues to be exploited by active equity managers in a very effective manner.

While conceding that the Australian sharemarket may be generally effective in valuing companies over the *long* term, it is not perfect and inefficiencies arise from differing shorter-term interpretations of market information. As a consequence, a company's share price at any point of time does not always represent its "true" or inherent business value. This facilitates an active manager to achieve outperformance to the benchmark, by overweighting (holding more than the index) in undervalued companies, and by underweighting (holding less than the index) in overvalued companies. Therefore, the manager's interpretation of the available information decides the appropriate weighting of a stock, depending on the prevailing stock price plus the assumption of "fair value". That is what active equity funds management is about and is the prime catalyst which has enabled most active managers to provide consistent outperformance over the past decade.

Understanding the dynamics of all portfolio management theories is an important part of the educational process. However, if tomorrow's fund managers are being taught by our graduate schools that the Australian markets are "purely efficient" and that active management cannot add value within the Australian equity market, they are in for a very rude shock when they join the factual world of funds management. J