Do active managers really outperform?

The debate on whether an active or a passive manager can outperform the market is ongoing. **PHIL GRAHAM** looks at some of the evidence.

Despite extensive academic research in the field of market efficiency, there is considerable debate as to whether financial markets are efficient or not. This is a central issue for the ongoing issue of active versus passive management. The proponents of active management argue that markets exhibit inefficiencies that can be systematically exploited. Index managers argue markets are efficient and that investors are better off accepting the market return with very low cost than seeking to outperform the market.

In reality, the level of market efficiency varies from sector to sector. The end result is that the question of whether active managers can consistently outperform index managers has been reduced to an empirical case study of actual results. This article attempts to extend the active versus passive manager debate in two areas:

- it takes another look at the evidence, in the process adjusting active manager performance to ensure comparisons are on a like-with-like basis; and
- it expands the analysis to cover all Australian and international equity classes, and to include enhanced index and low risk active managers.

The evidence

The following figures show InTech data on manager performance across the major equity sectors—large cap overseas equity (unhedged), global small companies, emerging markets, Australian equity and Australian small companies equity.

Figure 1 summarises median active manager performance relative to benchmark across all equity sectors over three, five and seven years; Figure 2 shows the upper quartile, median and lower quartile manager performance relative to benchmark for each sector over five years; Figure 3 shows upper quartile, median and lower quartile performance of the three overseas equity classes on an annual basis since 1997; and Figure 4 shows upper quartile, median and lower quartile performance for the two Australian equity classes on an annual basis since 1997.

The data shows that:

- in overseas large cap equity markets, active managers have generally underperformed the benchmark. The above benchmark result over three years reflects an improved result in 2000, though this followed particularly poor years for active managers in 1998 and 1999. Note that the median index manager in this sector has added a consistent 0.4% per annum above the benchmark over all periods, thereby delivering higher returns to investors over longer periods than the median active manager;
- in the global small companies and emerging market sectors, active managers have posted significant above benchmark returns over all time periods. This is consistent with the less efficient nature of these markets;
- in Australian equity, the median active manager has outperformed the index by 2 to 2.5 % per annum over three, five and seven years. Like their international counterparts, the median Australian index manager has

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FIGURE 1 **MEDIAN ACTIVE MANAGER VALUE ADDED BY EQUITY SECTOR**

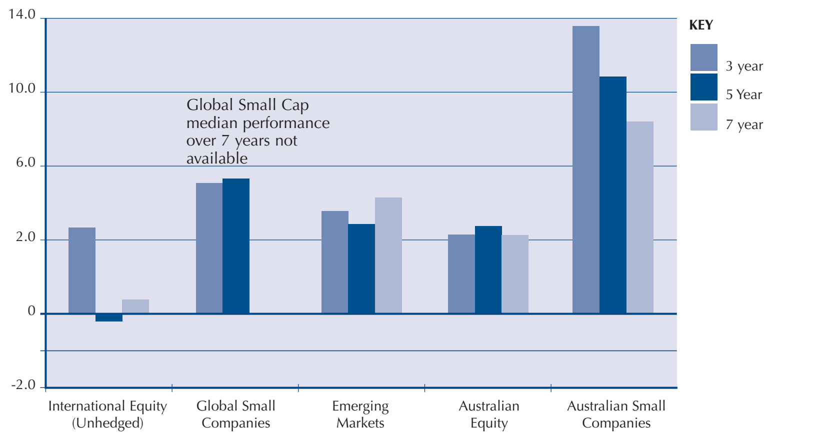
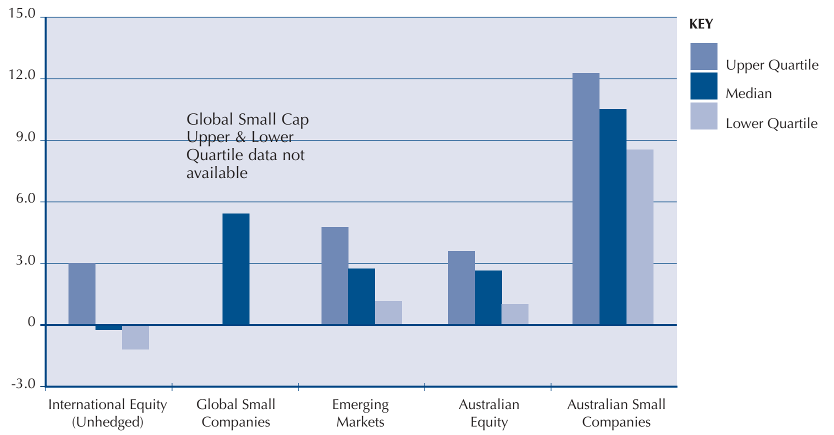


FIGURE 2 **UPPER QUARTILE, MEDIAN AND LOWER QUARTILE VALUE ADDED OF ACTIVE MANAGERS OVER FIVE YEARS, BY EQUITY SECTOR**



returned a consistent 0.4% per annum above benchmark;

- the median manager in the Australian small companies sector has outperformed by over 10% per annum over five years, with even the lower quartile manager outperforming by almost 9% per annum.

The performance results suggest that active managers have outperformed in the global small companies, emerging market, Australian large cap and Australian small cap sectors, while international large cap managers have generally underperformed.

In order to compare active manager performance with index and enhanced index managers, however, some adjustments must be made for the following factors:

- **Fees**: the InTech data shown above is based on performance gross of fees and taxes. Active managers charge higher fees, so this needs to be taken into account in any comparison with index managers. Although there are differences introduced by the use of base and performance fees and across sectors, the difference in fees between active and index managers is around 0.4% to 0.6% per annum;
- **Tax and other costs**: active managers have higher turnover than index or enhanced index managers, which leads to increased capital gains tax and higher custodian costs. The impact of this effect is more difficult to estimate, given different turnover rates across managers. A paper[1] presented to a recent conference in Australia suggested that the tax effect was in the order of 0.25% per annum.
- **Survivorship Bias**: a final issue relates to the inherent bias in the survey data, reflecting what has been termed "survivorship bias"—the fact that poor performing managers are either not included in the survey or have gone out of business due to poor performance. A recent study by Macquarie Investment Management[2] estimated that this effect could account for 0.5% of the median manager's outperformance in Australian equity.

Based on these figures, a total estimated cost impact of 1.25% per annum (.5% for fees, .25% for taxes and .5% for survivorship bias) is a reasonable adjustment to bring active manager performance back in line with index managers.

In addition, index managers have typically earned on average 0.4 to 0.5% above the benchmark, increasing the adjustment to 1.75%. Adjusting the five year median active manager outperformance therefore reduces active manager outperformance (per annum) to minus 2% for developed international equity, 3.25% for global small company managers, 1% for emerging market managers, .5% in Australian equity and 9% in the Australian small companies sector.

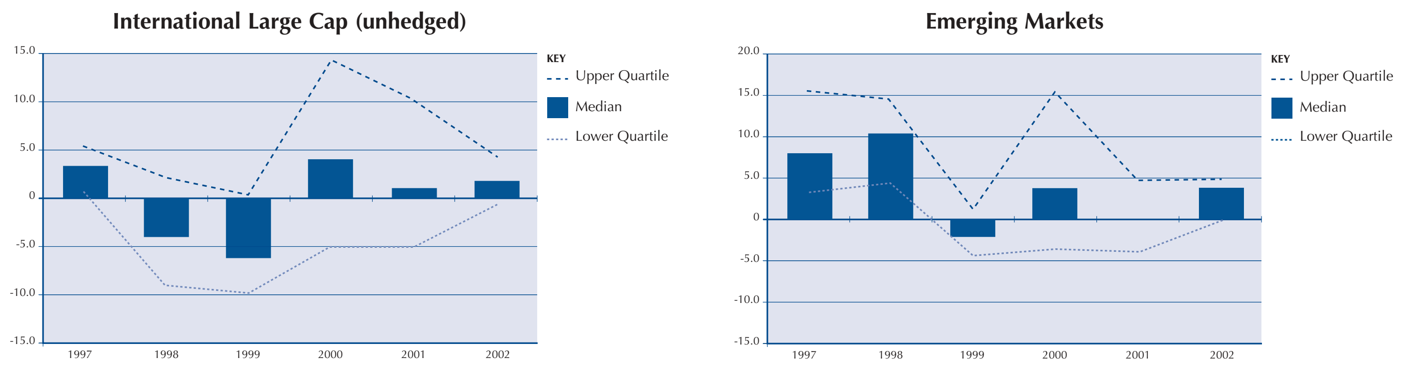
Further issues in the Australian context

In the Australian context, the above results suggest that Australian equity managers modestly outperform and that Australian small company managers have posted massive outperformance.

A number of reasons have been put forward to help explain the persistent outperformance of Australian large cap managers:

- in world terms, the Australian market is small (around 1.25% of world market capitalisation). For most global fund managers, Australia is a small part of the universe, which warrants only cursory attention. In most part, global managers only look

FIGURE 3 ACTIVE OVERSEAS EQUITY MANAGER VALUE ADDED OVER SIX YEARS



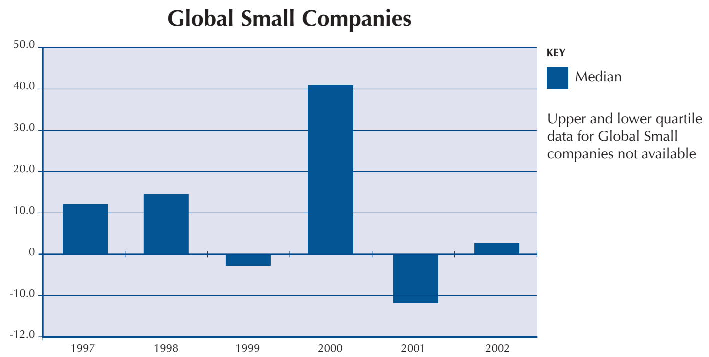


TABLE 1 PERFORMANCE OF ACTIVE FUND MANAGERS BY COUNTRY

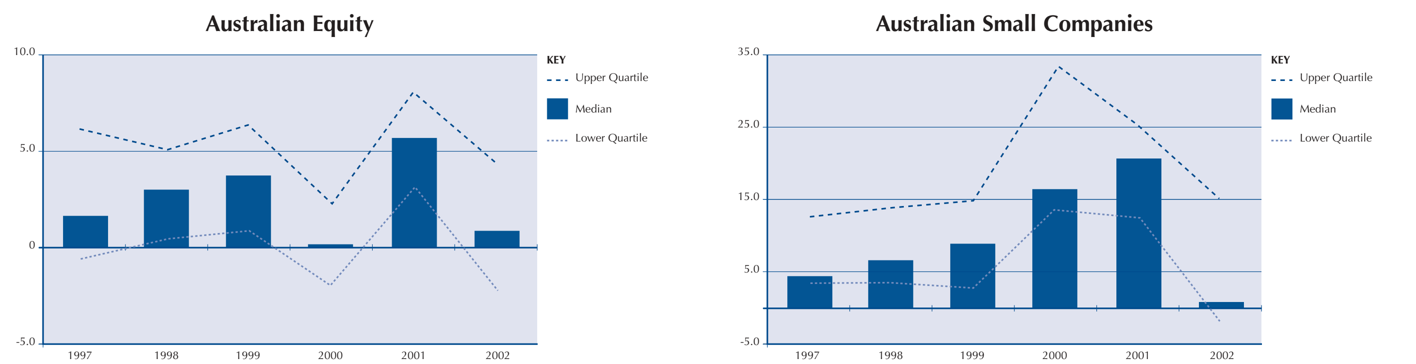
	Periods to 30 June 2001		
	5 Years	7 Years	10 Years
Australia	3.3	2.3	2.2
Canada	3.3	2.3	1.5
Hong Kong	4.7	5.1	5.0
New Zealand	5.4	3.6	2.6
United Kingdom	0.4	0.0	0.1
United States	0.6	0.2	1.2

Source: WestAM.

to Australia for very large cap exposure, often based more on global macro trends rather than domestic factors. Specialist Australian managers may be able to take advantage of a foreign investor's moves;

- the strong performance of managers in the Australian small company sector has almost certainly provided a significant fillip to average large cap equity manager performance. This is discussed further below; and
- over the last five years active Australian equity managers have had a number of performance 'free-kicks', some of which are unlikely to be repeated in the next decade. These include:
  - privatisations at below fair value, such as the Commonwealth Bank and Telstra I, in which active managers could add easy value;
  - a number of 'easy' stock selection picks, such as underweighting the so-called 'entrepreneurs', following the share market crash of 1987 and

FIGURE 4 ACTIVE AUSTRALIAN EQUITY MANAGER VALUE ADDED OVER SIX YEARS



in the early 1990s, and avoiding the stocks which were part of the tech bubble, and which were sold off when the bubble burst in April 2000.

One point which bears further exploration is the argument that the outperformance of active Australian equity managers is a common finding in small country equity markets. Table 1 presents some figures based on data from William M. Mercer[3] which support this contention. While results such as these are indicative rather than conclusive, there appears to be a positive relationship between the efficiency and size of equity markets.

Another issue that needs to be considered is the practical problem of actually achieving the median outcome. As the saying goes: “you can’t buy past performance”. History shows that last year’s outperforming manager has a high likelihood of underperforming in the period ahead. To a large extent this reflects the fact that many managers have a ‘style bias’—they follow either a growth or value approach to stock selection—and style trends move in cycles. To assess this issue, Table 2 reviews the performance table of active managers in the twelve months to 31 March for each of the last six years.

Over the six years shown, there are 30 possible top and bottom five positions which were occupied by 19 and 23 different managers, respectively. Given the number of managers in the surveys (an average of 46 each year), there was substantial churning of both the top five and bottom five managers. Indeed, the churn rate was such that there is a surprising commonality in names included in both the upper and lower panels of this table. That is, top outperformers in one year are frequently among the top underperformers in a following year, and vice versa.

- Merrill Lynch Special Situations was in the top five three years in a row and the bottom five the next year;
- Maple Brown Abbott was a bottom five performer for two years and a top five performer in one year;
- Tyndall is in the top five three times and the bottom five twice; and
- Bankers Trust was in the top five once and the bottom five twice;

Three managers have been in the top five more than once and not appeared in the bottom five: ANZ, Dimensional and Perpetual. Of these, the ANZ Australian equities team left to join Jardine Fleming and was bottom of the rankings in 2002, while Dimensional has only a two year track record.

One way to combat the churn rate of top performing managers is to appoint a number of managers with differing style, but this is costly in both performance terms (due to rebalancing costs in coordinating a number of managers) and in management time. Alternatively, this aspect could be managed by using an implemented consulting approach. A recent survey[4] reviewed the performance of the seven

TABLE 2 **TOP AND BOTTOM FIVE ACTIVE MANAGERS BY YEAR BASED ON PERFORMANCE IN TWELVE MONTHS TO 31 MARCH OF YEAR SHOWN**

1997	1998	1999	2000	2001	2002
Top 5 managers (best at top):					
Tyndall Value	Merrill Lynch Special Situations	Bankers Trust	Wallara	Dimensional	Tyndall Value
BNP Paribas	ING	Merrill Lynch Special Situations	Alpha	Maple Brown Abbott	Perennial Value
Merrill Lynch Special Situations	Credit Suisse	ANZ	AMP–Capital	Investors Mutual	Lazard
Colonial First State	AM Corp	Colonial First State	AUSBIL	Perpetual	Dimensional
Perpetual	ANZ	Merrill Lynch	BNP Paribas	Tyndall Value	Investors Mutual
Bottom 5 managers (worst at bottom):					
Maple Brown Abbott	Rothschild	MLC	ING	Credit Suisse	BNP Paribas
HSBC	MLC	Citigroup	Citigroup	Aberdeen	Bankers Trust
Cwlth Investment Management	AMP Quant	AM Corp	Merrill Lynch Special Situations	Colonial First State	Bell
Norwich	Portfolio Partners	Maple Brown Abbott	Investors Mutual	BNP Paribas	Credit Suisse
Schroders	United	Tyndall Value	Tyndall Value	Bankers Trust	Jardine Fleming
Number of managers in survey:					
33	41	44	48	54	57

Source: InTech Survey, March 2002.

implemented consulting approaches on offer in Australia: results are shown in Table 3.

The average return over three years *(sample size: 5) was 2.3% per annum ahead of benchmark, which compares to the median manager outperformance of 2.1% per annum over the same period. The extra 0.20% per annum of outperformance does not change the earlier analysis using the median manager returns. On the positive side, the extra return may be more stable, particularly in terms of reducing/eliminating style movements, and therefore could (arguably) have a higher probability of being sustained.

Additionally, there may be cost savings in terms of rebalancing.

Australian small cap manager outperformance

The large outperformance of active Australian small company managers deserves further examination. The most simple explanation is that the Australian small company market is significantly less efficient. Certainly, it is very likely that the small company sector is less efficient than the large cap sector. There are a number of elements to this state of play:

- the relatively small size of the Australian market, such that the global and regional small company benchmark indices include very few Australian stocks;
- the significantly lower level of research coverage, a situation which may have been exacerbated by the consolidation of stockbroking firms over recent years. As an offset, the number of managers running small company funds has increased over recent years (the number in the InTech survey has increased from 7 to 12, and there are also a number of boutique managers not included in this sample), all of whom have their own analysts; and,
- the lower level of liquidity in the sector, which makes implementation a more important issue. In this regard, managers with smaller amounts of funds under management are in a better position than larger managers (as they have less market impact).

It is interesting to note that large cap manager outperformance can be completely explained by the small cap effect. In the research above, Macquarie Investment Management noted that the average market weight of the small cap sector in the ASX/S&P300 index over five years was

TABLE 3 **IMPLEMENTING CONSULTING VERSUS MEDIAN MANAGER PERFORMANCE**

	Periods to 31 March 2001		
	1 Years	**2 Years**	**3 Years**
Return			
Average Implemented Consultant	12.7	11.4	10.8
Median Manager	13.1	10.9	10.6
Benchmark (ASX 300)	12.2	8.0	8.5
Outperformance			
Average Implemented Consultant	0.5	3.4	2.3
Median Manager	0.9	2.9	2.2

Source: Investor Weekly and InTech Survey, March 2002.

11%. Based on the 10% average outperformance of small cap managers over the same period, exposure to the small cap sector will have contributed 1% per annum to large cap outperformance. At face value this more than explains a significant amount of the Australian equity outperformance (of .5%) noted above.

Enhanced index and low risk active managers versus active management

A final dimension to this debate is to include enhanced index or low risk active managers (rather than index) as the alternative to active management. These options are only available in the larger sectors, such as developed international equity and Australian equity.

The key differences between enhanced index, low risk active and active management are:

- while enhanced index and active managers both focus on stock selection, the philosophies of the two approaches are very different, with active managers using fundamental-based stock picking, while enhanced index managers use a wide range of strategies which target pockets of market inefficiency, and aim to add a large number of small amounts of added value; and,
- active managers typically have a style bias, while enhanced index is style neutral.

Both enhanced index and low risk active approaches are relatively new and are only offered by the largest fund managers in the large cap sectors. This makes obtaining data difficult. Using Access Economics' own data base of enhanced index and low risk active managers in international equity, the average enhanced index manager has outperformed by 1% per annum and the average low risk active manager has outperformed by 1.5% per annum, both over five years.

Against that outperformance, enhanced index manager fees (using performance-based approach) are around 0.15% above index manager fees, while low risk active fees (also performance-based) are about 0.30% higher. Other fees (such as custodian) and taxes for enhanced index/low risk active managers are likely to be higher than index managers, but not significantly so. After allowance for the fact that index managers generally outperform by 0.40% per annum, this suggests that enhanced index managers are likely to outperform index managers by around .5% per annum, and low risk active managers by .75% per annum.

In summary, the relatively poor performance of international large cap active managers makes enhanced index or low risk active a clearly attractive option. Lack of data makes comparison in the Australian large cap sector more difficult, but, on the basis of the international results, enhanced index and low risk active managers are likely to provide competitive results against Australian active managers.

A final point is that the outperformance noted above has been achieved at considerably lower risk than traditional active measures, so the information ratio (the return per unit of risk) for enhanced index and low risk active managers is noticeably higher than for traditional active managers.

Conclusions

This analysis finds that, after adjustment for necessary costs and data issues:

- active international large cap managers have been unable to outperform index managers, while enhanced index and low risk active managers have shown an ability to outperform;
- active global small company and emerging market managers have continued to post returns above the benchmark return;
- active Australian large cap and small cap equity managers have added consistent value over recent years. However the outperformance of large cap Australian equity managers is more than explained by the small cap sector performance, and the problem of finding one or two managers that persistently outperform remains a major problem. Australian enhanced index and low risk active managers have shown a similar ability to outperform with considerably lower risk.

This suggests that active managers can add value in the less efficient sectors of global small companies, emerging markets and Australian small companies. However, active management has underperformed in large cap international equity. In Australian large cap equity, the apparent outperformance can be fully explained by data issues and the contribution of the small cap sector to total performance.

The newly emerging areas of enhanced index and low risk active management are clearly preferred in international large cap equity, and would appear to be viable alternatives in Australian large cap equity.

NOTES

1 How big is too big?, presentation by Greg Vaughan, Chief Investment Officer, WestAM, to WestAM Round Table, 11 April 2002.

2 Recent performance of active Australian share managers, Macquarie Investment Management, August 2001. Also reported in Summer 2001 edition of *JASSA*: Rating the performance of active equity managers, by Phillip Dolan, Patrick Hodgens and Geoff Wells .

3 Inefficiencies in the Australian equity market, presentation by Don Russell, Head of Global Business Development, WestAM, to ACT Branch of the Australian Superannuation Funds Association, May 2002.

4 *Investor Weekly*, 13-19 May 2002. J