



# "A" is for Australia, Active, Anomaly, ...

JACK GRAY considers the value of active investment management and why Australia is the anomaly.

A debate of ancient lineage continues to stir passions around the globe: Does active management add value net of costs? To the irritation of those of us with a theoretical bent, in both listed equities and asset allocation Australia is an active anomaly.

## LISTED EQUITIES

In the US, which has the longest record, the highest quality data, and armies of academics, the almost conclusive evidence, based largely on mutual fund data, shows that almost no active equity managers consistently outperform the passive index net of costs. And that is to be expected. The S&P500 is closest to the ideal efficient market in which all information is instantly and correctly impounded in the price thus ensuring, in theory, that no active manager can add net value through skill.

In practice, the pickings are slim. In the US, the equity managers 'are' (close to) the market in that their combined holdings are (close to) those of the entire market. That means that the median manager's performance before costs must be that of the index, so after the roughly one percent cost of playing the active game, we should expect that manager to underperform by about one percent after costs, a prediction in-line with observations.

Necessarily, some managers do outperform the market (at the expense of others underperforming). But around 40 years of data are needed before we can, with any confidence, decide which of skill or luck best explains outperformance. In addition, market and institutional forces conspire against even skilled managers. On the market side, if a manager's investment style (value, growth, etc) drives outperformance, it will likely dissipate when the market is no longer "sympathetic" to that style.

Meanwhile, success triggers competitive replication of ideas and processes that ineluctably erodes 'alpha'. On the

institutional side, investment management firms have incentives to grow Assets Under Management (AUM), which creates diseconomies of scale that also erode performance. Even if the firm has imposed capacity constraints, successful portfolio managers are often poached or, worse still, are promoted to become (unsuccessful) business managers.

On balance, we should expect consistent net outperformance to be extremely difficult and extremely rare.

So shouldn't we all be fully indexed? No, because active managers provide a valuable public good by facilitating effective price discovery and liquidity. Were we all passive, investments would flock to increasingly expensive stocks, pushing their price further from fair value. Stocks with strong, but unrecognised fundamentals, would struggle to gain access to capital at a reasonable price. The economic consequences of total indexing could be severe.

The broad US conclusions also hold in other developed countries, Australia being an anomaly. Compared to other countries, active managers here have a better chance of outperforming the index net of costs and with some degree of consistency.

For instance, unlike most countries, an Oz manager that has been in the top quartile over three years has a relatively strong 60 percent chance of being above median over the next three years. The largely untested explanation for our anomaly is that only around 40 percent of stock is held by domestic managers ('smart money'), with 40 percent held by retail investors and 20 percent by international managers ('dumb money'). Those supposed 'smarts' give domestic managers a significant performance edge.

Whatever the explanation, and whatever the public good, it beggars belief that Australia has over 80 active equity managers.

## ACTIVE ALLOCATION

The second irritating anomaly arises in active asset allocation, which ironically, is fast becoming fashionable after the crisis. Because of globalisation, it is not unreasonable to assume that all countries should have the same long-term expected return, a view that makes overweighting specific countries hard to justify, especially an overweight to Australia. Australia represents a miniscule two percent of the world and has a highly concentrated, undiversified listed market of mining companies and (regulated) banks. Yet that overly optimistic overweight bet on Australia has worked wonderfully over the past 10-20 years and over the entire 20th century.

In 1900, optimistic investors (all three of them) who ploughed funds into Australia were amply rewarded over the century with a substantial real return, second only to Sweden out of 16 developed countries. Yet in 1900, Australia had a highly concentrated, undiversified listed market of mining companies and (regulated) banks. In retrospect, investors were not so optimistic; they were simply value investors. Australia then was cheap, outrageously cheap, probably because no-one gave a toss about us. In 1900, value rationally justified an overweight to Australia (not that anyone thought that way then).

The last 20 years of handsome rewards to an active overweight to Australia require a different argument. This time not valuation but growth is the post-hoc justification, growth that comes from being a province of China, a state of affairs that may continue for a generation until the single Chinese child becomes a single Chinese retiree. Then we'll appreciate that "A" is not for Always. **SF**

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