Passive is best

May 2015

For a manager to achieve above average returns, they must have above average skill, or a lot of luck. If they have genuine skill, you would expect a pattern of returns where they consistently "shine" relative to other managers. The evidence is that this does not happen. The logical conclusion is that a low cost, low turnover, highly diversified approach, probably results in better outcomes for most investors.

Assume there is no skill

Take 32 managers wanting to invest your money in Australasian shares. Without any insight into the specific managers, you would expect after 1 year, half (16) would be above average (strictly above the medium) and half (the other 16) below.

After two years, of the 16 with above average returns in the first year, half (8) should also be above average in the second year i.e. they will have two above average years out of two.

Therefore, assuming no manager has any skill advantage, after 5 years, statistically, you would expect one manager to have performed above average each year and therefore over the 5 years. The 32 total managers go to 16, after year 1, then to 8, to 4, to 2 and finally 1, after 5 years.

Therefore, if we look back at the last 5 years, we would not be surprised to find one manager with a track record of above average returns each year. In fact, we would be surprised if there wasn't, as it would mean that all managers have negative skill, or that they were just very unlucky. If some manages have skill, we would expect to see more managers with consistent above average returns – more than one in the example.

NZ experience

NZ data is limited as managers come and go and mandates change. Therefore any analysis based on historical data must be highly qualified. The data below is from the AON Hewitt performance survey to 30 June 2014 for the Australasian equity sectors. This is the sector with most data/managers. In terms of the 25 managers/funds in the survey, 19 have a 5 year track record. The returns of the 19 managers are shown in table 1 over the page.

With a starting level of 19 managers, if there was no skill, statistically you would still expect one to have above average returns in each of the five conservative years and therefore more than one to have 5 above average years, if there was a skill advantage.

You can observe

- Only one manager performed above average each year. The implication is the managers do not have above average skill or, if they do, they were just unlucky.
- Many of the managers will have got their relative positions due to policy decisions (particularly the exposure levels to Australia, inclusion of smaller companies etc) and what happened in the markets, as opposed to skill. This is particularly relevant over the five year period where the NZ market (NZX50) for the 5 years was 14.4% p.a. of the Australian market (ASX200) was 8.0% p.a.

There are some obvious high profile managers missing from the analysis (e.g. Harbour and Russell). This is because they do not have an Australasian share fund in the survey for the full 5 year period. Whether, with the passage of time, these managers will demonstrate skill is unknown, but it is probably best to wait to find out than rush in, only to later discover that they do not. The evidence, based on their limited track record is that they would not be above average each year.

What matters most

Of course what really matters is the return to the investor and you cannot tell this from the survey, as the survey is pre-fees and pre-tax. What you can tell is that it is hard to get above average returns each year and actual returns would have been lower than shown, because of fees (and tax).

Also, does the 1-year return matter? The answer, in most cases, is no. What matters is the net of costs long-term average return. What really matters therefore is to be with a manager that efficiently captures the market return and does not charge a lot for this. It is probably better to be passive.

Table 1.	Above average (✓) or below average (x) in the year to 30 June					
Manager	**2014**	**2013**	**2012**	**2011**	**2010**	**No. of above average years**
AMP Capital	✓	x	✓	✓	✓	3
AMP Capital – strategic	✓	x	x	x	x	1
ANZ - Australasian	✓	✓	✓	✓	x	4
ANZ – Australian only	x	x	x	✓	✓	2
ANZ - ESF	✓	x	✓	✓	x	3
ANZ - NZ	✓	✓	✓	✓	x	4
Devon - NZ	✓	✓	x	x	✓	3
Devon Trans Tasman	✓	x	x	x	✓	2
Fisher Funds	x	✓	✓	x	✓	3
Milford – Active Growth	x	x	✓	x	✓	2
Milford - NZ	✓	✓	✓	✓	x	4
Milford – Trans Tasman	x	x	✓	✓	✓	3
Mint	✓	✓	✓	✓	✓	5
Salt - NZ	✓	✓	x	✓	✓	4
Salt – NZ Focus	✓	✓	x	✓	x	3
Salt – NZ Plus Share	✓	x	x	✓	x	2
Tyndall - Aggressive	x	x	x	✓	x	1
Tyndall - Core	x	✓	x	x	x	1
Tyndall Small Companies	x	x	x	x	✓	1

Source: AON Hewitt International update/July 2014