Brent Sheather's
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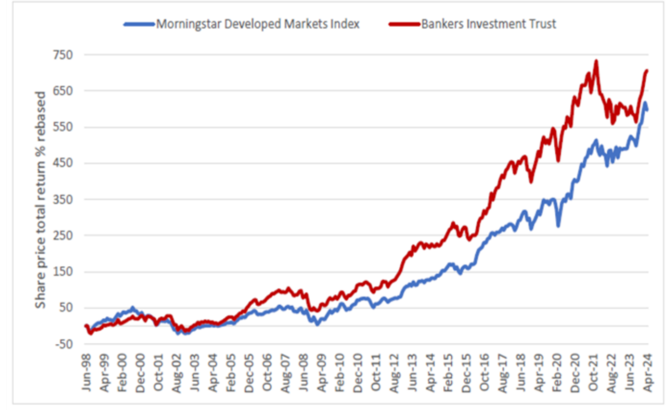
Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

SPIVA COMES TO TOWN – PART 4

The last column looked at some lessons that the SPIVA paper, and the rationale for indexing generally, has for retail investors, most of whom can't afford too many big investment mistakes. As index funds have low fees and many are widely diversified, thereby addressing the "skewness" issue, they have inherent advantages over active funds. So, to paraphrase a favourite episode of Father Ted, the question is "Should we all be index investors Father?" Whilst that's the obvious conclusion just owning an index fund is not optimal for everyone, especially society as a whole.

Despite the attractions of indexing most institutional investors, and coincidentally my firm, use active managers alongside a core of passive funds. Why? The first reason for including some active in portfolios relates to the degree of underperformance of active funds and their fee levels: The SPIVA research concludes that active funds underperform but the devil is in the detail: if they underperform by 2% per year on average that's a deal breaker however, if the underperformance is minimal maybe it isn't such an issue. The SPIVA database shows that in the global equity category, before fees, about 2/3 rds of the funds underperformed in the 10 years ended December 2022. Whilst the SPIVA analysis shows that 66% of these funds underperformed the index the degree of underperformance, at just 0.23% per annum, isn't material. Note that the 9.1% average fund return is before fees but this is a reasonable comparison if one is using UK based international generalist closed end funds, trading at discounts to the value of their assets and with low fees. For example, Bankers Trust, listed on the NZ and UK Stock Exchanges has a management fee of 0.42% per annum but it is trading at a 12% discount to the value of its share portfolio. A simple way of understanding the significance of the discount is to look at the underlying dividend yield of the portfolio which is about 3%. A 12% discount means you are getting an extra 0.36% pa in dividend which roughly offsets the annual fee. So how has that fund done versus the index over the long term? I contacted Nick Britton at the Association of Investment Trust Companies in London and he was able to provide me with some long term data as detailed in the graph below. Bankers has been going since 1888



Source: AIC/Morningstar and Private Asset Management

and the data "only" relates to the last 27 years but it does show that not only has Bankers done as well as the Morningstar Developed Markets Index it has usefully outperformed, illustrating the fact that active investing doesn't have to be a Loser's Game.

A second, and perhaps the most important, reason is that some people enjoy owning a few different investments as long as they are measured bets and the impact of "having fun" won't materially impact the achievement of their objectives. This strategy acknowledges that for people who are interested in investing owning a number of investments is more enjoyable than just one balanced index fund.
That brings us to the third reason for including an exposure to actively managed funds and that is that when closed end funds go out of fashion they

can often trade at large discounts to the value of their share portfolios. For example, back in the early 90s, the UK government had embarked on a programme of privatising government-owned companies like BP, British Airways, British Telecom etc. UK retail investors had been conditioned to believe that that programme represented a foolproof "get rich quick" scheme and assumed that the European governments would follow the lead of the UK and sell their power, telecom and railways companies cheaply too. Mercury Asset Management saw an opportunity to add significantly to its funds under management and floated an investment trust on the London Stock Exchange to capitalize on the forthcoming privatisation bargain boom. The fund, Mercury European Privatisation Trust, was hugely popular raising about £500m. Unfortunately, the privatisation mania never took off in Europe. After the fund decided to invest more widely in European stocks it went out of favour and its price dropped to a 20% discount to the value of its investments. Investors who resisted the hype at the time but bought in when it had gone out of fashion could thus buy a blue chip share portfolio of European stocks at 80 cents in the dollar. The strategy of buying discounts doesn't always work but it provides, in Warren Buffet's words, "a margin of safety" and it's definitely fun getting something for nothing.

The final reason involves ethics; all investors have a responsibility to pay for the price discovery function that allows capitalist economies to allocate resources efficiently and, it must be said, allow passive funds to work. People who only own passive funds are a bit like a hitchhiker who stares at you as you're getting into your car. When you feel guilty and pick them up they then ask you to tell them where they are going. As you are providing the free taxi service they boast about all the money they are saving by not owning a car. The twin ironies implicit in the "Go 100% passive" decision, are firstly that many of these freeloaders also see themselves as being "ethical" investors and secondly many of the financial advisors who exhort the low fee attractions of passive do so primarily because it allows them to keep overall fees low whilst continuing to extract high annual management fees from their clients for themselves. In the USA a majority of the 100% passive financial advisor cheerleaders trumpet the low fees of passive whilst at the same time levying a 1% pa or higher annual fee for themselves.

Readers will be pleased to know that that's it for coverage of active versus passive for a while. Whilst passive funds have lots going for them, a 100% passive portfolio definitely doesn't suit everyone and its certainly not ethical. Note though that investors pursuing a more active and interesting approach need to be sure that their advisor correctly benchmarks their performance, both for the overall portfolio and by asset class, so that you get important feedback as regards the extent of the cost or benefit of "having fun". Last month I read the March quarter report by an advisor at one of NZ's largest stockbroking firms running a highly active portfolio. The advisor patted himself on the back for producing a 4% return in the quarter. What he hadn't told the client is that a representative benchmark returned 6.3%.