Quarterly Investment Newsletter – December 2018

DFS Portfolio Solutions
Lev 3, 179 Queen St Melbourne Vic 3000 Tel: 03 9658 6700 Fax: 03 9670 3988
Corporate Auth Rep 336004

Active v Passive Investing

There is growing debate around whether investors should have their portfolios managed through passive funds and whether active funds are worth the additional costs.

The role of active managers is being questioned following the lacklustre performance over 2018, which was a turbulent year for markets. Historically, active management has delivered strong performance in volatile conditions.

The following paper takes a look at the differences between the two approaches and compares the long-term performance of the actively managed DFS Models against their market benchmarks. Our conclusion is that active managers play an important role. However, DFS is very aware of the undercurrents in markets that favour passive funds and in accordance with our complementary investment approach, we are working to incorporate a greater range of options for clients that wish to integrate passive investments to their portfolios.

Passive Investing (market return)

Passive investing seeks to capture the "market return" by proportionately investing in stocks (or securities) that make up a given market. It has **no regard for "stock-specific" returns**, apart from their marginal contribution to the overall market return. Capital is therefore allocated to stocks based on their proportionate weight within the market index. It requires no fundamental analysis. For example, the largest single allocation for a passive Australian equity fund is CBA as it's the largest listed Australian stock, making up some 7.5% of the ASX200. Whether it represents good or poor value from a fundamental perspective is irrelevant; passive approaches defer to the market composition when allocating capital to the market.

Active Investing (market + stock specific returns)

In contrast, active managers seek to out-perform the market by **capturing stock-specific opportunities**. They generally employ fundamental approaches to analyse the value of stocks, and skew allocations to those that offer the greatest value. In the case of CBA, an active manager will generally allocate more than 7.5% to the stock if it believes the share price is trading meaningfully below its real (intrinsic) value; or it may allocate less (or nil, or sell short) if it believes the stock is expensive. The notion of relative value therefore drives the capital allocation decisions of active managers. Research is required to determine which stocks offer better value, which of course is more costly than a passive process that allocates funds based on the market composition. In order to sustain their strategies, active managers must be able to out-perform the market return, net of fees over the full market cycle.

Market conditions matter

Generally speaking, passive investments tend to perform better under buoyant market conditions when (positive) sentiment is the major driver of returns. As markets become turbulent, active managers are expected to outperform as fundamentals and relative value take over from sentiment as the main driver of returns. Rational investors invest in active managers in the belief that they will outperform the market over the full cycle.

Active managers have struggled to keep up with their passive counterparts in recent years. Markets have generally been buoyant since 2012, so some degree of under-performance is expected and should be tolerated. However, the first and last quarters of 2018 were turbulent, we would have expected active managers to have performed better, given a good part of the year was volatile.

Why isn't active management working well of late?

Equity markets quickly rallied and cemented V-shaped recoveries after experiencing drawdown in Q1/2018 & Q4/2018. Clearly, while turbulence presented, it did not persist. Even so, we question why active managers didn't fare better. A possible explanation lies in the significant growth of passive investing over the last decade. Significant outflows from active managers to passive investing have been observed in recent years; and according to the US based Investment Company Institute, there has been a swing of USD 2 trillion to passive investing from the onset of the GFC to 31 December 2015. Momentum has only intensified, thereafter. The unprecedented growth in passive investing is directing funds to mega-cap stocks and it's this liquidity that is driving asset valuations rather than fundamentals. Capital is being irrationally allocated and leaving active managers unable to perform relative to the market… or so the argument goes?

Some examples

Value-investor Steven Bregman of Horizon Kinetics specifically refers to a bunch of companies (e.g. McDonald's, Coca Cola, Procter & Gamble, etc.) with negligible revenue and earnings growth, much higher gearing and less equity – yet their share prices have risen enormously, entirely due to PE expansion. He asserts … "*the price discovery method has been broken by all of this inflow into passive instruments, which then puts kind of an automatic bid on what turns out to be maybe a few hundred large, highly liquid stocks. Look at something like Exxon Mobil [XOM]. From the beginning of 2012 through to June 2018, Exxon Mobil's revenue per share fell 40%. Its EPS, normalized for the tax-reform benefit, fell 64%. Its long-term debt increased 162%. The price of oil fell 26%. You might think that would have wrought havoc on the company's share price, but you'd be wrong. The share price was exactly the same at the start of 2012 as it was at the end of June 2018.*
Take another mature-company example, McDonald's [MCD]. Its revenue actually decreased from 2008 to 2017 and its net income over that period decreased by about 20%, not even 2% per year. Its long-term debt almost tripled. The share price, however, increased by 175%, as the P/E multiple accorded the stock went from just under 17x to nearly 26x. Can anyone credibly argue that McDonald's growth

prospects are that much better now than they were 10 years ago? We think not and think the higher valuation – and what we consider inefficient pricing – in stocks like this has to do with automatic buying driven by inflows into passive vehicles."

The Passive Position

Proponents of passive investing assert that a market based approach to investing reduces costs and vastly improves portfolio efficiency; and that active management detracts from value as market efficiency inhibits managers from generating value (after fees) against the market return. They further believe that long term asset valuations can be justified and sustained through passive investing. The notion of any meaningfully market distortion is rejected. Passive investing has received broad academic support over the last several decades.

DFSPS Position

We believe that active and passive investing can perfectly co-exist; and this is probably what we are currently observing. If there's easy money to be made over and above passive investing, capital will surely find a way to exploit it.

The environment in recent years has been unfavourable for active management because of the volume of money following liquidity (i.e. sentiment) rather than fundamentals. There's no telling when that trend will break; but it will break. "Fundamentals" is just a big word for the best estimate of a security's future outcomes. When that future arrives, we can expect the money following the fundamentals to be rewarded and the money simply following "the other money" to get punished.

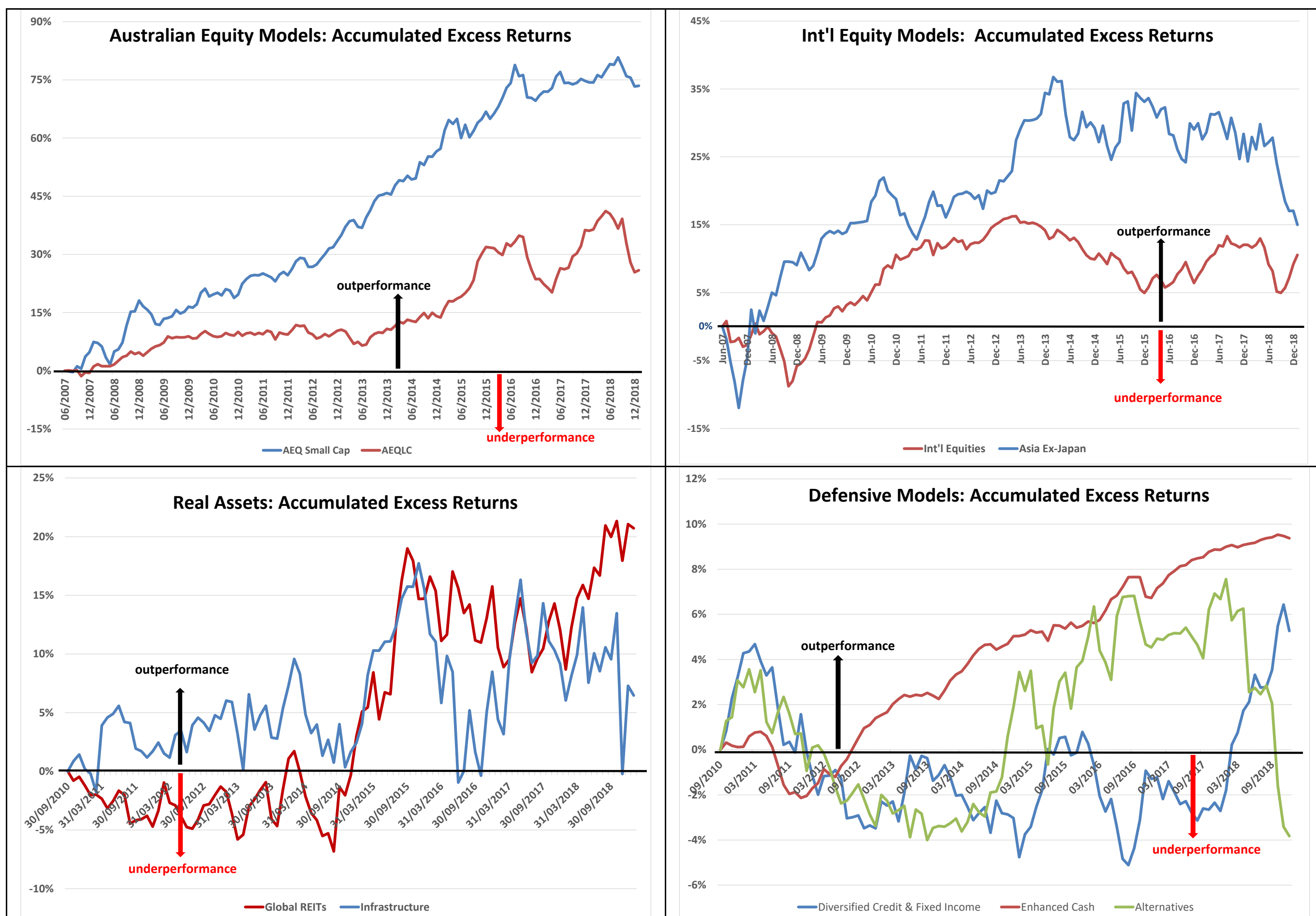
To put it another way, markets can go through periods where passive investment outperforms active; but equally, there are periods where active does better. Another such period will arrive sooner or later. In fact, the more the market moves away from fundamentals, the greater the potential gains when it finally does correct.

Active managers tend to do better at managing risk. A market cap-weighted index is fully exposed in the event of a market crash. Skilled active managers can favour less exposed securities, or indeed increase cash balances, to reduce losses. Further: if an index becomes dominated by a small number of stocks or a particular sector or such like, its diversification can suffer. The poor performance of Australian banks is a recent reminder which has adversely impacted index returns. Active managers have scope to maintain better diversified portfolios.

Our active Models have been exposed to these broad trends over many years as highlighted below.

Performance of Active DFS Models

DFSPS manages nine (9) active Models, which have a track record of at least 8 years. Each Model with the exception of the Alternatives Model has out-performed its benchmark, net of fees. The models have generated periods of relatively strong performance and sub-par performance against their benchmarks, as highlighted in the following charts:



Excludes return enhancements generated through preferred pricing negotiated with active managers

***Reading the charts**: the above charts show the Models accumulated excess returns against their respective markets benchmarks. The Australian Equity Models chart, for example shows the excess returns of the Large Cap Model (red line) and Small Cap Model (blue line) against their respective market benchmarks (denoted by the black line, which crosses the 0% threshold). When the Models are above (below) the 0% threshold, they are outperforming (underperforming) the market benchmark. Moreover, when the excess returns trend upward (downward), it means the Models outperformance is increasing (decreasing). While the charts clearly show there are protracted periods where the active Models underperform, there are periods where active Models do much better.*

We note that while only four (4) of our nine (9) active Models managed to out-perform their benchmarks in recent years, the charts highlight that the overall long term performance has been positive. The active DFS Models continue to outperform their benchmarks over the long term, with exception of the Alternatives Model, which recently reversed its outperformance. The Alternatives Model is "most active" and has certainly fell out of favour over the last 12 months. However, we do not expect this trend to persist, indefinitely.

The recent underperformance has given us reason for some concern as the leakage from active management is becoming more significant. We reiterate that this experience is not limited to DFS Models, but rather active management in general. Many are under-performing ***before fees***, which is increasingly becoming an untenable position for some investors.

What is DFS doing about the recent underperformance?

No one appreciates underperformance, particularly when a substantial premium is being paid. Notwithstanding the recent bout of under-performance, DFS has no intention of disengaging from active management. We believe that it plays a very important role, especially during periods of heightened risk where fundamentals matter a great deal.
That said, we have incorporated measures to cater for the impact of passive investments. We note the following initiatives and enhancements that we look forward to sharing with you shortly.

1) **Preferred Pricing**
DFS has been communicating with its existing active managers extensively, with the objective of securing meaningful reductions in base management fees. On average, active equity managers charge base fees of around 1%p.a. and some charge performance fees subject to benchmark outperformance.
We will shortly announce the outcome of our Preferred Pricing project, which better aligns the interests of consumers and fund managers through lower base fees.

2) **Complementary Approach**
We further highlight that our Risk Profile Models (RPM) clients generally hold both passive and active exposures. These accounts are managed using a Dynamic Asset Allocation (DAA) approach, which meaningfully tilts to passive investments when markets are buoyant; and rotates away from passive investments when they become volatile. Further, we have a stop-loss process to guard against equity market crashes.

Our process combines active and passive investments as complementary construction tools. We appoint active managers that we expect to outperform their benchmarks over the long term. We are confident in the value of all these levers, but we don't expect any of them to outperform all the time. Having multiple return-drivers provides diversification benefits. For instance, when our risk management is struggling, our active managers might do well (and vice versa). If we were to take away our active management, our portfolios would be more reliant on just the dynamic management levers, and we would be more exposed to market cycles.

3) **Indexed Investment Options**
For clients that have a strong preference for passive investing, our DAA Models can be implemented through passive investments and largely omit active managers. The advantages & disadvantages of this approach can be discussed with your adviser at your subsequent review meeting.

4) **Customised Service**
Clients in our Customised Portfolio Service generally have portfolios that follow a Strategic Asset Allocation (SAA) approach and are implemented through active DFS Models. The option of incorporating passive investments to your portfolio will be discussed with you in your subsequent review meeting.