Active fund managers have had a year to forget

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It's been a tough year on the market for active fund managers. Picture: AAP

- 12:00AM AUGUST 17, 2019
- THE AUSTRALIAN

In the year ended June 30, 2019, we have seen 83 per cent of active fund managers underperform their benchmark — some quite dramatically so.

Why have we seen such underperformance in an industry which charges fees to manage more than 500 strategies (many managers have multiple branded strategies), against an index with 200 stocks?

Five factors stand out which drag down the performance of these fund managers.

Not holding certain stocks

When looking at the top 20 stocks, which constitutes 46 per cent of the Australian equity market, if a fund manager didn't hold or was underweight stocks that "went for a run" during the year they would have underperformed. These stocks include Telstra (+53 per cent), Brambles (+49 per cent), CSL (+13 per cent), Woolworths

(+13 per cent), Transurban (+31 per cent) and the big miners BHP (+27 per cent) and Rio Tinto (+31 per cent).

Underperformance by banks

The big four banks performed well post-election but on a full year basis the only major performer was Commonwealth Bank (+20 per cent).

Not being where the action is

Lead performance was in stocks generally “under owned” by fund managers. A lot of underperformance has come from technology stocks such as Afterpay Touch (+162 per cent) and Appen Group (+107 per cent), iron ore producer Fortescue Metals (+134 per cent) and fund manager Magellan Financial (+127 per cent) as examples of where fund managers stood on the sidelines.

Growth vs value

Style has also been a contributor for many. Growth companies performed, therefore the continuation of underperformance from “value” as a style. Many value managers completed a year they would otherwise like to forget.

Momentum vs fundamentals

The stockmarket is also running on momentum and not fundamentals, as lower interest rates are forcing investors to look at risk-based assets to compensate for a decrease in yield from defensive assets.

There is still a large number of fund managers (some say too many) in what is a very small equity market. Indeed, it’s a concern that some are trying to differentiate themselves by taking on too much risk.

Whatever the reasons behind the outcomes, it is this underperformance in a narrow index which has investors frustrated.

Australian Taxation Office data shows self-managed super funds control $747 billion of assets, up $32bn in the last 12 months, with an average allocation to the domestic Australian equity market of 37 per cent.

One of the essential truths about SMSFs is their bias towards yield. The recent examples of the chase for yield will have seen SMSFs with high holdings in yield stocks such as banks and Telstra having outperformed the index for the year to June 30.

While this strategy will have paid off in the past year, it would have underperformed in the previous two years — as it had in the few years before that.

After the yield compression that momentum has given these stocks through this chase for yield, I am not as optimistic about outperformance in this strategy for the next few years.

Finally, I must again highlight one of my favourite topics: fees. The bottom line is that domestic equity management expense ratios are higher than those of international markets. These fees must come down and the argument of paying for conviction doesn’t hold water.

This has certainly been a very tough environment for equity managers in the last year. Unless we see an improvement in performance, we will experience further contraction in what is a very crowded market.

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