Chant West

Research Paper

Active and Passive Management

Australian Super Industry Experience

August 2014

Comparing Apples with Apples.

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Contents

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1. Executive Summary

This report has been prepared as a second round submission to the Financial System Inquiry (the Inquiry).

In its Interim Report (July 2014), the Inquiry makes considerable reference to the Grattan Institute's report on fees in the Australian superannuation system *(Super Sting: April 2014).* The Grattan report claims that Australians pay far too much for superannuation when compared with other countries. The report also claims that high-fee funds do not generate higher gross returns and that low fees are the best guide to subsequent performance. We disagree with these claims.

We believe that fees in Australia are reasonable when we take into account the characteristics of our industry. In particular, compared with the rest of the world, Australia has a high level of investment in equities, which are relatively expensive to manage. We also have a large number of funds, many of which are relatively small in scale. Offsetting these factors are the highly competitive nature of the industry and the number of investment managers competing for business.

In this report, we show that members of high-investment fee funds, where the fee budget has been spent wisely, have been rewarded with higher net investment returns. We believe a move towards low-cost, substantially passive portfolios would have the effect of reducing net investment performance and, as a consequence, be to the detriment of fund members over the long term.

Mandating substantially passive, multi-sector portfolios (as suggested by the Grattan Institute) limits a fund's investments to asset sectors for which there is a market index. It denies funds the flexibility to invest in the wide range of unlisted assets (including unlisted infrastructure, unlisted property, private equity and hedge funds) for which no indices exist.

While unlisted assets tend to be more expensive to invest in than listed assets, they have proven to provide additional sources of return and diversification (risk reduction) over many years. It is the non-profit segment of the superannuation industry that has shown the greatest preparedness to invest meaningful amounts in these more expensive unlisted assets. As a result, these funds tend to have higher investment fees.

In this report we show that, based on past performance, when comparing the largest MySuper products (all of which are non-profit funds) with a passive multi-sector benchmark portfolio, their higher investment fees have been more than justified and members have been rewarded with higher net returns (0.8% per annum higher over the last 15 years, after investment fees and tax).

Numerous academic studies around the world have shown that, in general, retail investors pay higher fees for active management than passive management, but that they receive very little, if any, excess return (referred to as 'alpha'). Essentially, at the retail level, active managers' higher fees cancel out any excess returns they generate.

Australian superannuation funds are in a very different situation. They are wholesale investors and, because of their scale and negotiating power, the fees they pay for active management are much lower than fees paid by retail investors. For example, they pay about 0.3% and 0.5% for actively managed Australian shares and international shares, respectively, which are about the same as retail investors pay for passive management. Since the active fees they pay are substantially lower, Australian superannuation funds have a much greater chance of generating excess returns after fees.

While not all active managers outperform the index, our research shows there are enough managers with the necessary skills to generate excess returns (net of wholesale fees) through active management. While there is clearly a place for passive management in investment portfolios, mandating wholly passive management would be a mistake and would take away an important tool that funds have used to add value for members.

2. Fees and Active Management

2.1 Relationship between fees, asset allocation and management style

The Grattan Institute's report on fees paid by Australian superannuation fund members (*Super Sting: April 2014*) claims that Australians pay far too much for superannuation when compared with other countries (based on OECD data). This is a difficult claim to substantiate. Many industry commentators have noted that comparing fees across countries is problematic because of the differing nature of each country's superannuation system and approach to disclosure.

The Grattan report also claims that (i) high-fee funds do not generate higher gross returns (ii) low fees are the best guide to subsequent performance and (iii) funds incur substantial costs in active management despite strong evidence that passively managed assets perform better in most asset classes. We disagree with all of these claims. Our research shows that, historically, high-investment fee funds in Australia utilise active management well and have generated the best net returns for their members.

The key difference between our analysis and the Grattan report is that we assess investment performance net of investment fees only, whereas the Grattan Institute bases its analysis on total fees paid i.e. the combination of administration fees and investment fees. We believe our methodology is more appropriate when assessing investment performance. Investment fees are the only fees that are relevant in determining the returns that members receive. Administration fees relate to other services and should be considered separately.

In addition, the Grattan report uses APRA fund-level data to calculate returns. This data has limited relevance because, in most cases, it represents the amalgamation of the returns of many different investment options. No members actually receive these returns. On the other hand, we have sourced individual investment option returns from the funds themselves. These are the returns that members actually received.

While we believe there is a role for passive management within multi-sector portfolios, we do not believe that investment decisions should be made solely on cost. While the best-performing funds mostly employ active management, many also have a modest exposure to passive management.

Mandating portfolios that are substantially passively managed (as suggested in the Grattan Institute's report) would set an artificial constraint on asset allocation. It would limit investment to those asset sectors for which there is a market index. By doing so, it would deny funds the flexibility to invest in the wide range of unlisted assets (including unlisted infrastructure, unlisted property, private equity and hedge funds) for which no market indices exist.

Many funds, especially in the non-profit sector, have invested meaningful amounts in these unlisted asset sectors over many years. They have done so to provide additional sources of return (i.e. outside traditional asset sectors) and for reasons of diversification (risk reduction). Our research shows that these funds as a whole have exhibited superior performance over the longer term (even after investment fees). In other words, while their investment fees may have been higher than the industry average, this has been outweighed by the additional returns resulting from their wider exposure, and their members have benefited as a result.

2.2 Relative fee levels for active and passive management

In Section 3, we show the benefits of active management in multi-sector portfolios. To do so, we compare the performance of the ten largest MySuper products (based on assets under management) with a passive benchmark portfolio using Vanguard's Growth fund as a proxy. Table 1 provides key data for these funds (all of which are non-profit funds).

We have chosen these ten largest funds, all of which are non-profit funds, for comparison because (i) they have meaningful allocations to unlisted assets (ii) they account for a significant portion of MySuper assets under management (about $360 billion), and (iii) they represent a large proportion of the overall membership (about ten million members). Also, they have been investing in a similar way for a long period of time.

These are sophisticated investors, with experienced internal investment teams, regular input from high quality asset consultants, strong investment governance frameworks, and strong track records of investing in unlisted assets.

Table 1: Key Data for Ten Largest MySuper Products

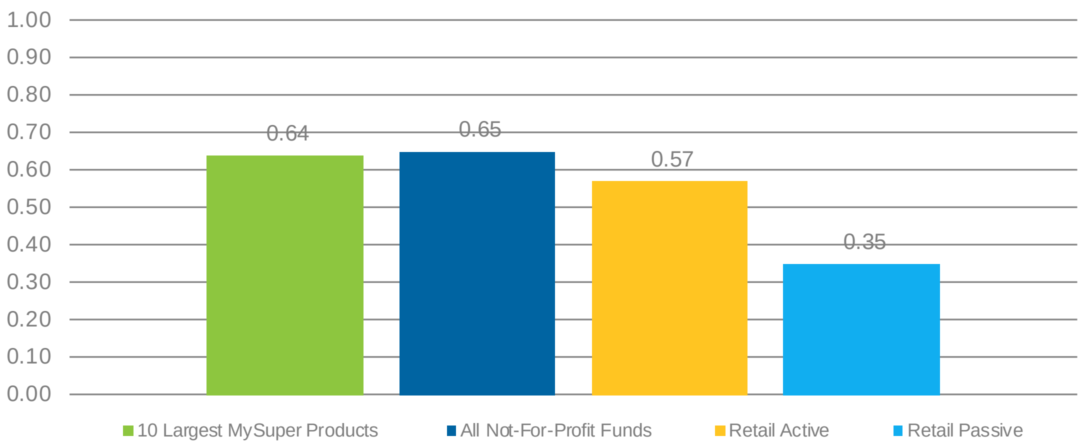
Fund	AUM ($m)	Members ('000)	Unlisted Assets (%)	Passive Management (%)	Investment Fee (%)
AusSuper	78,270	2,089	30	10	0.66
QSuper	51,391	537	21	58	0.36
FSS	46,100	779	10	27	0.41
UniSuper	42,732	471	10	3	0.61
REST	31,267	2,043	18	0	0.63
Sunsuper	29,179	1,058	29	16	0.63
HESTA	27,859	794	30	16	0.80
Cbus	27,163	726	36	13	0.77
Telstra	15,251	103	21	0	0.58
HOSTPLUS	15,213	1,006	33	5	0.96
Total	364,425	9,606	-	-	-
Average	-	-	24	15	0.64

Source: Chant West

The proportion of passive management shown above includes passive and enhanced passive management (we have excluded cash as there is little difference between active and passive cash). Note that of the 15% passive management overall, the bulk resides within the Australian shares (7%) and international shares (4%) sectors.

The average investment fee for this group is 0.64% per annum. Chart 1 shows this fee is higher than the average investment fees for retail active funds (0.57%) and retail passive funds (0.35%). Note that we define retail passive funds as those that have 65% or more in passive management.

Chart 1: Average Fees (% pa)



The higher fee levels of these MySuper products is as expected, since they have a much higher exposure to the more expensive unlisted asset sectors (about 24%) than retail funds (about 4%). In the next section, we show that, based on past performance, the higher investment fees paid by funds with a meaningful exposure to unlisted assets is justified.

3. Multi-Sector Performance

Table 2 shows the performance of the ten largest MySuper products over several periods to June 2014. Performance is shown net of investment fees and tax (gross of administration fees). The passive benchmark performance is based on a proxy managed by Vanguard, specifically the Growth PST until August 2010 when it was closed and since then the equivalent distributing trust, applying an 8% effective tax rate.

Table 2: Performance of Ten Largest MySuper Products (% pa)

	5 Years	7 Years	10 Years	15 Years
Median	9.8	4.2	7.5	7.2
Upper Quartile	10.1	4.6	7.6	7.3
Lower Quartile	9.7	4.1	7.2	7.0
Number of Options	10	10	10	9
Passive Benchmark	10.0	3.8	6.9	6.4
Median Outperformance	-0.2	0.4	0.6	0.8

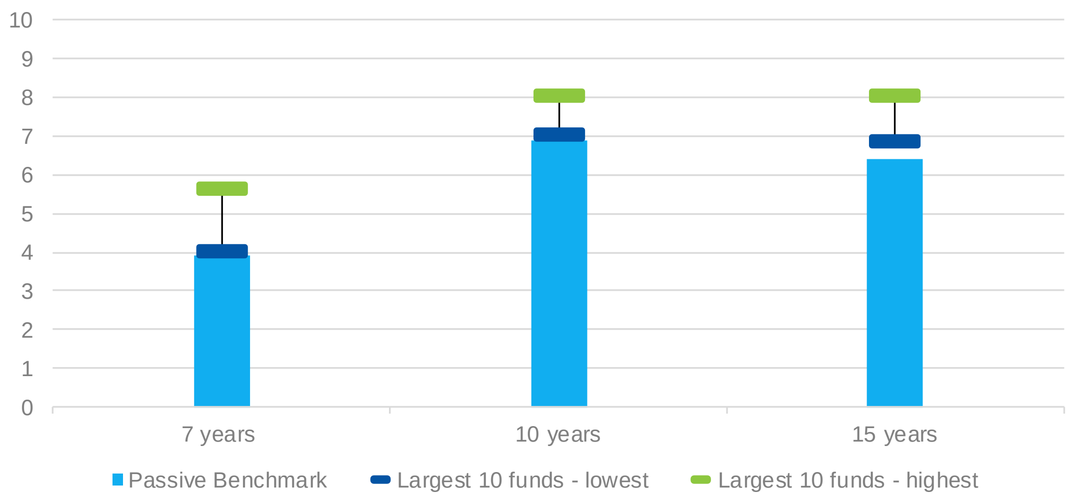
Source: Chant West

The performance of the ten largest MySuper products has been strong. As a group, they have outperformed the passive benchmark by 0.4%, 0.6% and 0.8% per annum over the 7, 10 and 15 years to June 2014, respectively. To put this in some perspective, the 0.8% per annum outperformance over 15 years translates to a cumulative outperformance of about 20%. For a fund member, that represents a substantial difference in their superannuation nest egg – and it has been achieved net of all investment fees. This outperformance stems from two main sources: asset allocation and active manager selection (also referred to as 'stock selection').

The underperformance of the group over five years is expected given the strong post-GFC rally in listed markets where they have a lower allocation relative to the passive benchmark.

Chart 2 shows the range of returns of the ten funds. Note that all of the 10 largest MySuper products outperformed the passive benchmark over 7, 10 and 15 years.

Chart 2: Performance of Ten Largest MySuper products (% pa) – to June 2014



The average investment fee of the ten largest MySuper products is 0.64% per annum. The fee for the passively-managed benchmark portfolio is 0.36% per annum. Significantly, the ten largest MySuper products have not only made up the fee differential of 0.28% but have also delivered an additional 0.8% per annum over 15 years. This clearly demonstrates that the higher investment fees incurred by these funds have been more than justified.

When considering relative performance, it is also important to consider rolling periods because this is how funds typically frame their performance objectives. Charts 3, 4 and 5 compare rolling 5, 7and 10 year median returns of the ten funds with those of the passive benchmark since September 1998 (we only have return history for the passive benchmark since then).

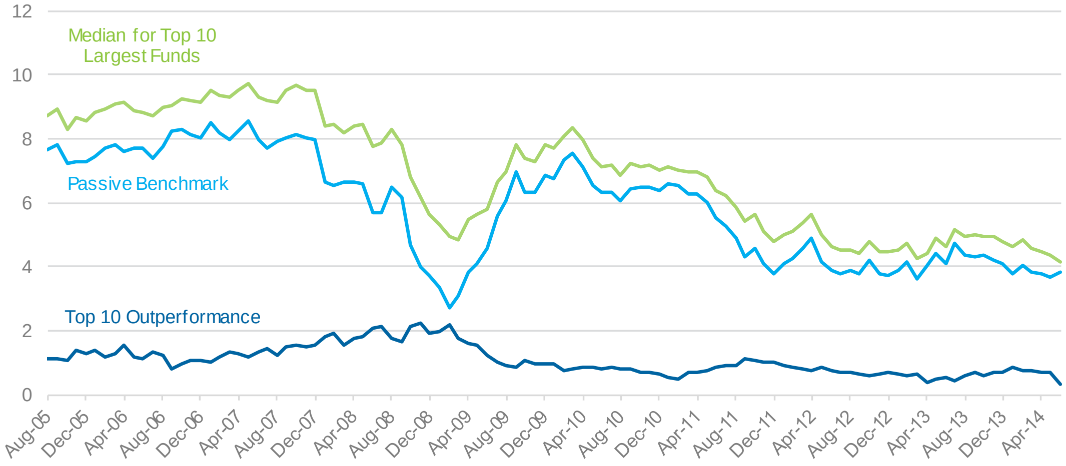
Chart 3 shows that the rolling five year median return for the ten funds was ahead of the passive benchmark for the great majority of the 16 year period. It is only recently that, due to the strong performance of listed shares and property since the GFC low point in February 2009, they have fallen back due to their lower allocations to these sectors.

Charts 4 and 5 show that the rolling seven and ten year median returns have been ahead of the passive benchmark over the entire period considered. Note that these returns are all net of investment fees and tax.

Chart 3: Rolling 5 Year Performance of Ten Largest MySuper Products (% pa)

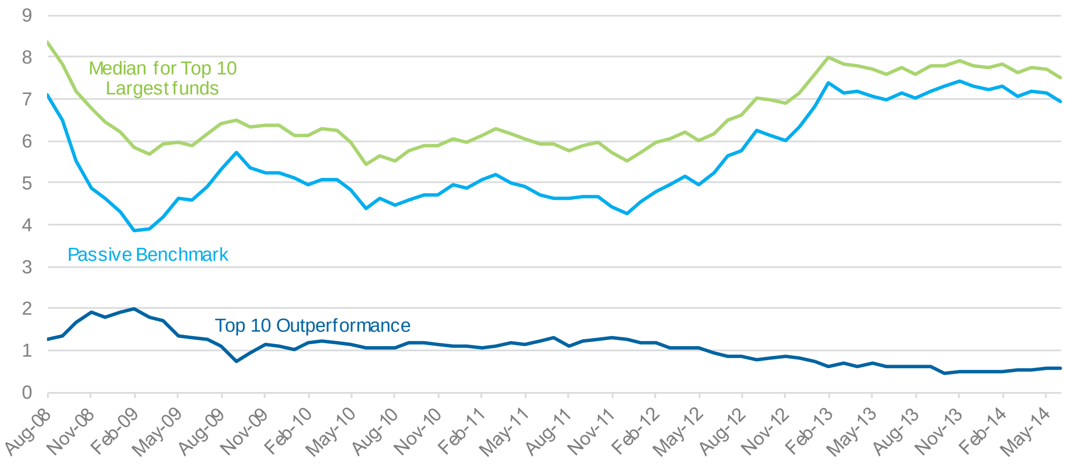
Source: Chant West

Chart 4: Rolling 7 Year Performance of Ten Largest MySuper Products (% pa)



Source: Chant West

Chart 5: Rolling 10 Year Performance of Ten Largest MySuper Products (% pa)



Source: Chant West

In addition to outperforming the passive benchmark over the longer term, the ten largest MySuper products have also performed strongly when compared with the broader growth fund universe in the Chant West Manager-Manager Performance Survey.

Table 3 shows the rankings based on performance over several periods to June 2014. Over 7, 10 and 15 years, each of the ten funds has outperformed the median, with the majority of them delivering upper second quartile performance over those periods. Note that in these periods the highest ranked funds were non-profit funds with a meaningful exposure to unlisted assets.

Table 3: Performance Rankings of Ten Largest MySuper Products – to June 2014

Fund	5 Years (Out of 64)	7 Years (Out of 58)	10 Years (Out of 54)	15 Years (Out of 35)
AusSuper	17	20	9	7
QSuper	13	7	12	17
FSS	49	14	20	-
UniSuper	24	8	11	8
REST	5	1	1	2
Sunsuper	46	22	19	13
HESTA	26	16	17	9
Cbus	28	11	10	12
Telstra	3	10	5	10
HOSTPLUS	31	12	14	3

Source: Chant West

Table 4 shows that, while the ten largest MySuper products have performed particularly strongly, when we consider the broader non-profit universe in our Multi-Manager Performance Survey we still find the median outperformed the passive benchmark over 15 years. Again this is largely due to their meaningful allocation to unlisted assets (22% on average). However, the results over 5, 7 and 10 years are not as compelling.

Table 4: Performance of All Non-Profit Funds (% pa) – to June 2014

	5 Years	7 Years	10 Years	15 Years
Median	9.6	4.0	7.0	6.9
Highest	11.2	5.6	8.0	8.1
Upper Quartile	10.0	4.2	7.5	7.3
Lower Quartile	9.2	3.2	6.7	6.2
Lowest	6.0	-0.2	4.8	5.4
Number of Options	43	41	39	26
Passive Benchmark	10.0	3.8	6.9	6.4
Median Outperformance	-0.4	0.2	0.1	0.5

Source: Chant West

Finally, we note that retail multi-manager funds were unable to outperform the passive benchmark over the periods considered, notwithstanding their lower investment fees.

4. Sector Performance

MySuper options, on average, have allocations to Australian and international shares of 28% and 25%, respectively. Given their importance in a MySuper portfolio, we also consider how active Australian and international multi-manager share portfolios fared against their relevant market indices using our Multi-Manager Performance Survey. Performance is shown gross of investment fees and tax. It should be noted that some of these portfolios contain an element of passive management. Most participants in our sector survey are retail multi-manager providers as many large non-profit funds do not report gross returns.

Table 5 shows that the performance of active, multi-manager Australian share portfolios has been strong. The median outperformed the S&P/ASX 300 Accumulation Index by 0.4%, 1.0%, 0.7% and 0.9% per annum over 5, 7, 10 and 15 years to June 2014, respectively. This outperformance is before investment fees have been deducted.

The typical premium (fee differential) for actively managed Australian shares is about 0.30% per annum. Large superannuation funds are able to negotiate even lower fees with investment managers giving a smaller fee differential. Clearly, the premium for active management has been justified, suggesting that there are enough managers with the appropriate skills to have a reasonable likelihood of adding value through active management.

Table 5: Performance of Active Australian Share Portfolios (% pa) – to June 2014

	5 Years	7 Years	10 Years	15 Years
Median	11.4	3.1	9.6	9.3
Upper Quartile	11.9	3.3	9.9	9.4
Lower Quartile	11.0	2.6	9.0	8.8
Number of Funds	25	25	19	9
S&P/ASX 300 Accum. Index	11.0	2.1	8.9	8.4
Outperformance	0.4	1.0	0.7	0.9

Source: Chant West

Table 6 shows that, while the relative performance of active, multi-manager international share portfolios has not been as strong as in Australian shares, the median has still outperformed the MSCI World Ex Australia Index by 0.6% per annum over the 15 years to June 2014.

The typical premium for actively managed international shares is about 0.4%. Again, the larger funds are able to negotiate even lower fees with investment managers. After fees, the median active manager has slightly outperformed over 15 years. Over shorter periods the benefits of active management are less obvious, although some larger funds would still have outperformed over 5 and 10 years.

Table 6: Performance of Active International Share Portfolios (% pa) – To June 2014

	5 Years	7 Years	10 Years	15 Years
Median	11.9	1.7	4.3	2.2
Upper Quartile	12.1	2.3	4.7	2.4
Lower Quartile	11.5	0.5	3.8	2.1
Number of Funds	20	20	13	8
MSCI World Ex-Australia	11.5	1.8	3.9	1.6
Outperformance	0.4	-0.1	0.4	0.6

Source: Chant West