

CHASING GREAT: SHOULD WE EXPECT LOCAL EQUITY MANAGERS TO OUTPERFORM?

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A reasonably common, if not universal, belief is that New Zealand represents a favourable sharemarket for employing active management. Much of the theory and some of the statistics tend to back this up, although not all the data is definitive. Bearing in mind that the use of a research-based stock-picking approach can be more expensive than a passive alternative and has its own risks, in this article we revisit the case for active management and identify key issues that investors should factor into their decision process.

WHY MIGHT OUR MARKET BE FERTILE FOR ACTIVE MANAGEMENT?

Few would argue that all markets are 100% efficient. Critically, however, the actual level varies dependent on the unique features of each market. There are a number of features of the NZ market that suggest it could be inefficient enough to allow focused investors to profit.

VARYING INVESTOR OBJECTIVES

By international standards NZ is a small, less-developed market. It is multi-tier in nature in the sense that offshore investors including Australian fund managers, who value liquidity highly, have a significant influence on prices amongst the largest 10-15 stocks. Meanwhile the prices of smaller stocks tend to be determined largely by domestic fund managers and private investors.

The degree of inefficiency in the local market is influenced by the fact that some investors hold stocks for reasons other than to add value to a conventional benchmark such as the S&P/NZX 50 Index. Retail “mum and dad” investors typically hold a narrow range of stocks for the long-term, attracted by dividend income. They tend to undertake limited sophisticated analysis and pay little attention to day-to-day market action. Meanwhile global fund managers are often driven by a wish to gain country, currency or theme exposure through an allocation to a select group of stocks, or they may follow an alternative benchmark such as the MSCI New Zealand Index. In some cases, global investors value stocks on the basis of international comparisons rather than company-specific factors. Further, their trading activity may be affected by specific tax implications.

INFLUENCE OF OFFSHORE FLOWS

Local fund managers are hence “competing” with offshore investors who may have a less detailed understanding of our market or no desire to wring the last basis point of performance from their limited NZ holdings. These investors (who collectively account for nearly half of NZX free-float) choose not to be well-informed on a material portion of the market, and at the same time may be acting logically in accordance with their perceived self-interests.

Capital flows in and out of the domestic market have been bolstered in recent years by the popularity of offshore-domiciled Exchange Traded Funds (ETFs). These funds often invest in accordance with pre-defined rules – a quest for high dividend yields being a notable recent example. In doing so they can generate “liquidity events” which temporarily push stock prices away from recent trading levels, even in larger cap stocks. Offshore players are used to trading in bigger volumes and in shorter timeframes than the NZ market allows. Local investors in tune with this dynamic can capitalise on the resulting short-term price imbalances.

GAPS IN BROKER RESEARCH

When it comes to broker research on listed companies, this tends to be focused on the top 20 NZX stocks. Coverage below this level is patchy, particularly outside of the top 50 stocks, and is sometimes conducted by a broker’s offshore office. The trend over the years has been toward less rather than more extensive stock coverage by brokers. This provides opportunities for fund managers to undertake proprietary research to secure an informational advantage versus the wider market.

LINKED-IN MANAGERS

Local fund managers can also add incremental value by virtue of being well-networked with company management, industry competitors or supply chain members, and the broking community. This gives insights into the prospects for corporate funding activity including rights issues, new capital issuance and initial public offerings (IPOs). Where such activity is anticipated or (as is often the case) influenced, fund managers are well-positioned to take advantage of attractive offerings compared to other investors, or opt to sell out of a stock before these events take place.

MODERATE STOCK CORRELATION

The correlation of returns over time between stocks on the NZX – especially outside the top 10 companies – is relatively low compared to some overseas markets. This is positive from an active management perspective because it means prices are reacting more to company-specific information than macro or political developments (although those factors still matter). Where correlation is high, stock prices tend to move in synch with one another which allows little scope for relative out-performance.

STANDARD OF INVESTMENT PERSONNEL

Finally, the quality of staff in investment teams is relevant. While not a guaranteed recipe for superior returns, our general observation is that the capability and experience of key individuals within NZ institutional funds management teams is strong. The total number of firms operating in the sector has not grown materially over an extended time period. The competition for analyst and portfolio management roles is hence keen, including from offshore, and this puts a floor on the base level of talent required.

AND WHY MIGHT OUR MARKET NOT BE SO FERTILE?

This discussion so far suggests there is scope for at least some inefficiency in the NZ market. However, we need to acknowledge that there are a sizeable number of well-informed market participants who are seeking to capitalise on any inefficiency and hence contribute to its lessening or demise over time. Further, market liquidity is required for trading ideas to be converted to actual portfolio positions in a timely manner (particularly in smaller stocks), and this is not a strong feature of the local bourse.

Another issue is that the NZX is a less concentrated market than in years gone by. There were periods when certain large companies demonstrated chronic under-performance, and many fund managers were able to deliver returns above benchmark by picking up on this thematic. Nowadays, while seven or eight companies feature very prominently in our market, the capitalisation is more dispersed and the scope for relatively “easy” active management gains is less evident.

AUSTRALIAN STOCK EXPOSURE

A discussion on the NZ equities sector requires mention of the fact that many fund managers include a component of Australian stocks in their domestic equity portfolio – commonly in the range of 10% to 30% but this range is variable. Effectively, the portfolio is a NZ equity portfolio in that it attempts to add value to a domestic equity benchmark (usually the S&P/NZX 50 Index). However, the range of stocks that a fund manager can select is not limited to those companies listed on the NZ exchange.

This “Australasian” approach has become common as a means of bolstering portfolio diversification and allowing selective access to potentially well-performing companies in a geographically proximate market. As we discuss below, we need to take account of this feature when considering the full universe of products which can be broadly classified as domestic equity.

WHAT DO PAST PERFORMANCE NUMBERS TELL US?

“Noble intentions should be checked periodically against facts”

– Warren Buffett

Mercer has been compiling data on fund manager performance for many years. There are currently 32 products in the Mercer “Australasian Shares” survey category. Just under half of these adopt the S&P/NZX 50 Index as benchmark and hence, as a group, provide a consistent basis for examining fund manager performance. The remainder of the products adopt a range of other benchmarks which reflect their style or geographic biases.

EVIDENCE OF ADDED VALUE

One way to assess active management over time is to consider outcomes achieved over five-year periods to the end of 2006, 2011 and 2016 respectively (which helps reduce product survivorship bias), as per figure 1. The returns shown are gross of fees and tax and include imputation credits.

Actual fees paid will vary widely depending on whether the client is a sizeable wholesale institution or a retail investor.

FIGURE 1. EXCESS RETURNS FROM ACTIVE NZ MANAGERS OVER 5-YEAR PERIODS

	FIVE YEARS TO DECEMBER...		
	2006	2011	2016
S&P/NZX50 Index	16.5% pa	-2.7% pa	17.5% pa
Median Manager	17.5% pa	-0.6% pa	18.0% pa
Value Added	+1.0% pa	+2.1% pa	+0.5% pa

Excess returns from NZ managers have varied over time, but despite a challenging last five years, have been positive over all periods.

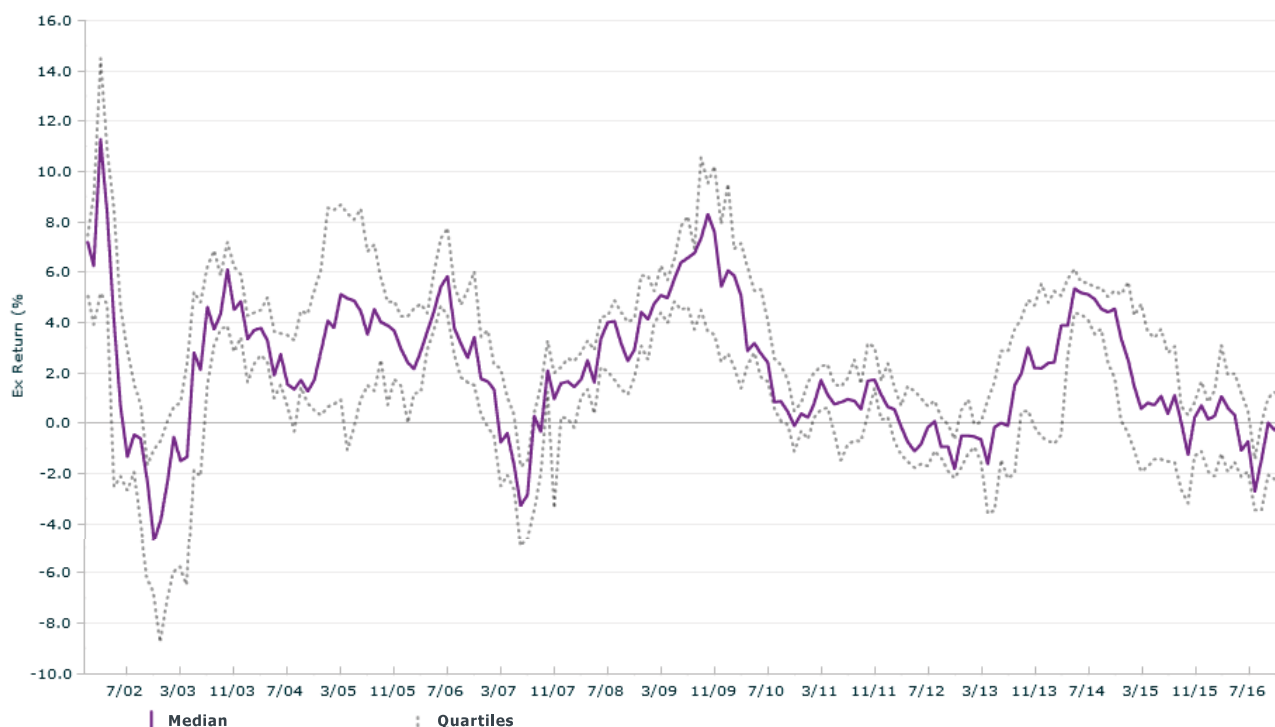
We can observe that the median manager has struggled to “earn their keep” over the latest five-year period. After fees are deducted, close to half of managers may have delivered a return below benchmark, and certainly below a frequently adopted out-performance target of 2.5% per annum. The five-year period to the end of 2011 was significantly more fruitful. Meanwhile the five-year period to the end of 2006 was somewhat favourable, yet below what most investors would consider an acceptable incremental return from an active approach.

We illustrate active management outcomes over time in figure 2 which shows the rolling one-year excess return versus benchmark of the median manager (solid line) and upper and lower quartile (dotted lines) managers. Returns above the horizontal axis represent out-performance.

Figure 2 indicates that the median active manager has been able to add value versus the S&P/NZX50 Index over a reasonable proportion of time periods, including after allowing for active management fees (although there have been some lean patches). The upper quartile manager has significantly exceeded the benchmark over almost all periods. Meanwhile the lower quartile manager has failed to improve on the benchmark return with any consistency.

The outcomes tell us that a typical out-performance target in the order of 2.5% per annum has been ambitious in recent years albeit that, over the long-term, such a margin is a reasonable expectation to justify an active approach.

FIGURE 2. ROLLING 1-YEAR EXCESS RETURN VERSUS S&P/NZX 50 INDEX
(15 YEARS TO DECEMBER 2016)



Picking the right manager can be the difference between experiencing frequent or only occasional portfolio alpha.

IS THE INCLUSION OF AUSTRALIAN STOCKS IN PORTFOLIOS A “FREE RIDE”?

A lengthy discussion could be had as to what may be influencing fund manager value-add outcomes over time, including market conditions (bull or bear markets) and prevailing themes. One aspect worth touching on is whether the relative performance of the Australian sharemarket is a material factor given that, as noted, most managers in practice allocate a portion of portfolios to that market. By allocating in such a way, are NZ equity managers simply buying market “beta” or are they creating “alpha” on an opportunistic basis? If Australian market movements are heavily influencing portfolio performance, we would expect to see a high correlation between the excess performance of the median manager versus the S&P/NZX50, and the S&P/ASX200 (in AUD or unhedged to NZD) versus the S&P/NZX50.

We have undertaken analysis covering the past 10 years which finds that, while there is some connection, Australian market performance is not a heavy driver of alpha for the median manager in the Survey.

There have been a number of periods where the Australian market has underperformed the NZ market but the median manager has still outperformed the benchmark. In saying this we note that, given the varied investment approaches adopted by different firms, such analysis is most usefully conducted on an individual portfolio basis (and include an assessment of what other factors or style-related themes may be influencing return outcomes).

SO IS ACTIVE MANAGEMENT THE BEST APPROACH?

We have seen that the **theoretical** basis for successful active management in NZ is fairly compelling. The **empirical** evidence seems to suggest that market inefficiency has been converted into benchmark outperformance by a reasonable proportion of surveyed managers (and that not all excess returns are generated from the inclusion of Australian stocks), albeit not consistently in every year.

LIMITED PASSIVE OPTIONS

Helping tilt the balance to an active approach is that cost-effective options for passive management in NZ are hard to come by, particularly for institutional investors. By international standards, the scope for passive fees to fall is readily apparent. Also of note is that successful passive management has its own implementation challenges. Full replication is made difficult by the subdued liquidity of smaller stocks on the NZX. Meanwhile a stratified sampling approach (that is, replicating the index by focusing on a smaller number of representative stocks), while commonly used in offshore markets, can be difficult to implement in our market due to its lack of breadth and fairly low inter-stock correlations.

We conclude that active management within NZ equities is worth considering by most investors. This is not a “slam dunk” finding and we note that the case is most strong where investors are well placed to select the better-performing fund managers (see next section). It is also a stance that should be kept under review over time. A continuation of Survey outcomes witnessed in the last few years would call into question whether the active funds management community is delivering adequate return outcomes for clients, and hence, potentially turn the tides towards a passive approach.

IN SEARCH OF EXCELLENCE

In order for investors to raise the probability of a successful active management experience, we recommend there be a focus on the selection of a fund manager which demonstrates the following features:

Clear signs of an edge. Achievement of consistent outperformance needs to be underpinned by an investment philosophy which identifies distinct opportunities in the market, and which can be captured by appropriate resourcing and discipline. Relying on good fortune will not deliver outcomes above passive management in the long-run.

Strong alignment. There should be evidence of incentive structures at the fund manager which ensure that, by acting in their own interest, this also produces outcomes which are in the best interests of clients.

Strong alignment helps motivate the investment team to ‘go the extra mile’ to eke out additional returns and manage risk, and fosters an atmosphere where there is reduced client skepticism as to what is driving manager decision-making.¹

Not constrained by size. An investor should have confidence that their funds can be put to work in a truly actively-managed fashion. There is substantial evidence that active investment processes cannot be replicated at an ever-increasing scale without impacting on returns above benchmark (for example, via reduced trading nimbleness). Capacity limitations remain a prominent issue in NZ, reflecting our market’s generally subdued liquidity. Some managers have “soft closed” their products to new mandates, while arguably some others have cause to consider their position more closely.²

Accountability for adding value. For most investors, the sole or at least primary reason for paying higher management fees is to obtain a return significantly above the benchmark. Fund managers similarly need to be keenly aware of this as an imperative. Retail, not just institutional, investors should not hold back in expecting transparency around what value has or has not been added.

In our experience, by no means do all fund managers clearly embody all of the above characteristics.

Of note is that the emergence of new well-credentialed managers has moderated in recent years, partly influenced by the hurdles of a more stringent regulatory environment. Our perception is that there is room for more major players which, amongst other things, will encourage a more dynamic market and trading environment.


1. For more detail see Mercer paper *Align By Design: Steps For Success in Fund Manager Engagement*, May 2016.

2. For more detail see Mercer paper *Keep Your Eyes on the Size: Fund Manager Capacity and Why It Matters*, March 2013.

ACTIVE MANAGEMENT CAN ADD VALUE, BUT SECURING IT IS NOT STRAIGHTFORWARD

In summary, we can say the following:

- An assessment of the NZ equity market and its characteristics suggests the ground is relatively fertile for active management opportunities.
- Historical returns indicate that a reasonable proportion of fund managers have been able to outperform the benchmark, albeit at times by a margin which is below target levels.
- Achieving consistent superior performance is far from easy. Average fund managers will deliver average returns. For active management to be most fruitful, an investor needs to narrow-in on the most compelling product providers – those who possess the talent, are energised and are strongly outcomes-focused. In short – “**chasing great**”.



“When I consider what hard work is, it’s easy to work hard most of the time, but it’s all of the time, and to be able to be consistent. And when there’s that day when you go, ‘I could get away with not doing this or that’, it’s actually doing it. That’s the bit that actually makes the difference, and it takes a hell of a lot of energy to be able to do”.

– Richie McCaw

CONTACT

David Scobie, Auckland

Tel: +61 9 928 3231

Email: david.scobie@mercer.com



David is a Principal in Mercer’s Wealth business. He advises institutional clients on their investment policies, structures and fund manager selection, linking in with Mercer’s global research capability.

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