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Australia defying global index funds trend – for now

4 November, 2013 Freya Purnell 0 comments

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Although the rest of the world has moved heavily into index funds in recent years, Australians and Kiwis have to a degree maintained their love affair with an active management investing style, writes Freya Purnell.

Chris Douglas

Across the globe, the growth in passive investments over actively managed offerings has emerged as the most significant development in the worldwide funds industry since the GFC.

Speaking at the Australian Morningstar Investment Conference in May, Morningstar global director of fund research, Scott Burns, said index funds have dominated inflows over the last few years.

In 2007, there was approximately US$220 billion held in index funds, and around US$880 billion in actively managed vehicles.

In 2010, the US$250 billion invested into index funds was more than three times the US$80 billion invested in active funds, and in 2011, over US$200 billion was invested in index funds, while there was a net outflow of about US$100 billion from actively managed funds.

Index funds have also been gaining ground in terms of their share of global managed fund assets. For example, among non-US-domiciled equities funds index vehicles have increased their share of total assets from just under 10 per cent in 2007 to just under 20 per cent in 2013. Except in Australia and New Zealand.

In 2012, Oceania was the only region in the world to experience a small outflow from index funds.

In Asia index funds attracted net flows of US$16 billion in 2012, more than twice the US$7 billion taken by active funds. Similarly, in Europe, index funds took in US$23 billion compared with US$17 billion for active funds, and in the United States, US$259 billion flowed to index funds in 2012 compared with US$203 billion to active funds.

Compared with other world regions, Oceania, with 8 per cent of managed fund assets invested in index strategies, also has a much lower proportion of money being passively managed.

At 31 December 2012, in the US, 24 per cent of managed fund assets were in index strategies, and in Asia, 22 per cent.

So why is Australia and New Zealand lagging behind the rest of the world when it comes to indexing?

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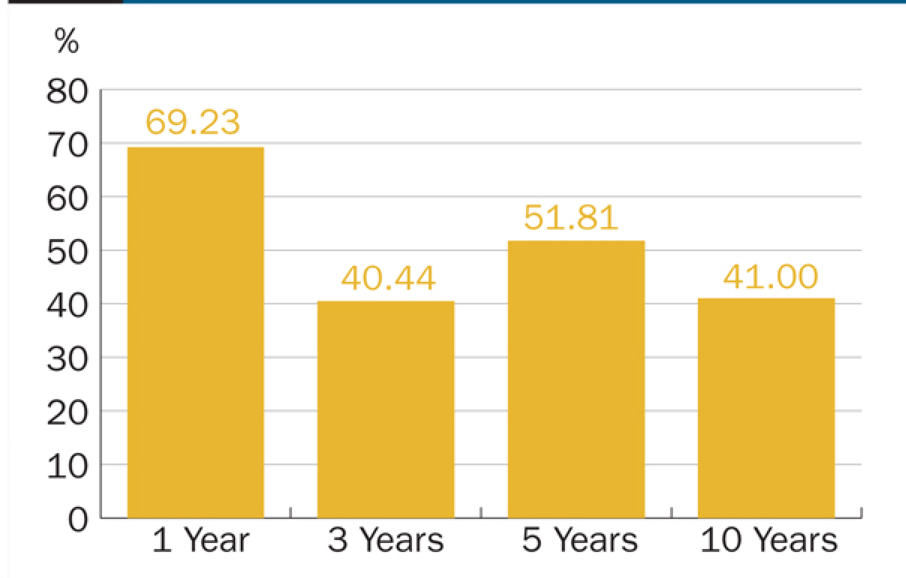
Chris Douglas, co-head of fund research at Morningstar, says the Australian and New Zealand markets have been shown to be less efficient than those in the US and Europe, which means that active managers have more opportunity to actually beat the index.

"It's not always the case, and not for every time period, but certainly the data suggests that fund managers are able to add value in actively managed vehicles," Douglas says.

While data from the US indicates that only 0.4 per cent of active managers can beat the S&P 500 over 10 years, in Australia, the picture is much more mixed.

Morningstar figures show that over 10 years to 31 July 2013, the proportion of actively managed large-cap Australian share funds outperforming the index was only 41 per cent, but for five years, this was 51.85 per cent, and for one year, it was 69.23 per cent.



Source: Morningstar

Another factor diluting the attraction of indexing is the limited choice of low-cost index funds locally.

While Vanguard has built its presence in the Australian market over a number of years, the concept of passive investment has really only been given a boost by players such as Black Rock and State Street pushing more into the ETFs market.

"There hasn't been a big movement coming through from the product providers to actually take products into the space," Douglas says.

Australians have also had something of a love affair with active management, and of course, the structure of the industry, dominated by large institutions, may have encouraged advisers to focus on some investment types more than others.

Change is in the air

But there are signs things are starting to change. While a focus on cost and value has been evident amongst investors since the GFC, this push is gaining momentum due to the imposition of the Future of Financial Advice (FOFA) regulations.

"We have actually seen a pick-up in Australia [in interest in passive funds]. A lot of that, from what we see and hear anecdotally, is really driven by the regulatory changes that we're seeing, and the drive to seek a low-cost proposition for clients to invest into in a post-FOFA regulatory world," Douglas says.

Vanguard Investments Australia head of distribution Michael Lovett agrees, saying advisers are far more receptive to the indexing message than there were five years ago.

"I think the pressure FOFA is putting on the value chain is leading to people being more and more

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open to including index as part of their portfolio," Lovett says.

"Even though FOFA was not designed to lower costs to clients, it is an outcome of it, and advisers are much more fee conscious as a result. By dropping the cost of investment management, you can actually lower the cost to the client, and keep [adviser] fees at the same level."

Vanguard has invested considerable time in educating advisers about how index funds can be used to create 'adviser's alpha' – a concept which is resonating well in the marketplace, according to Lovett.

"That's all about focusing on what you can control – you can't control markets," Lovett says.

"You should be spending time on strategy and asset allocation, because if you look at all the research, asset allocation is the biggest determinant of performance.

"So by actually spending less time on fund manager selection, you can really control what you're providing to the client as a better outcome."

Managed funds regaining ground

As investors, feeling more buoyant, have started to pull out of term deposits and invest back into the market, active fund managers have also posted some impressive 12-month returns.

"Prior to that, there were a few lean years where active managers didn't actually add a lot of value, so I think a lot of advisers started to wonder if there was a lot of value that could come from choosing an active manager," Douglas says.

"Whenever things like that happen, you tend to see a turnaround in performance, and obviously in the last 12 months, we saw active managers really come to the fore and actually on average do very well against the index."

While index funds should benefit from the overall shift back into managed funds in terms of higher inflows, Investment Trends research shows index managers shouldn't necessarily expect to also grow market share.

According to Investment Trends senior analyst Recep Peker, back in October 2010, planners began investing much more into listed investments – driven by pressure on fees and the need to lower costs – and a little more in cash and term deposits, with flows into managed funds shrinking from 64 per cent to 52 per cent.

As market volatility grew, so did the proportion of funds being directed to term deposits and cash. This trend peaked in September 2012, with planners putting 31 per cent of new client money into cash and term deposits, up from 16 per cent in October 2010.

Flows of new client money into managed funds decreased further to 41 per cent. By May this year, the trend had reversed in favour of growth assets, with cash and term deposits receiving 19 per cent of new client money, and managed funds 44 per cent.

But throughout this rollercoaster away from managed funds and back again, the proportion of client funds being directed to index managers has stayed remarkably stable at around 11-12 per cent.

"I think one of the reasons index funds have been relatively immune to the fall out of favour of active managed funds is because they are lower cost, so at a time of price sensitivity, it was not an issue," Peker says.

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In terms of planner intentions over the next few years, it doesn't look like index funds will be gaining ground – with listed investments much more popular as a growth area for planning businesses.

"Planners say in three years' time they'll only be putting 41 per cent of new client money into managed funds, which includes 11 per cent into index managers. So they still see a purpose for it, but they're really pushing hard on the listed investment side," Peker says.

Weighing up the risk/return equation

With the industry becoming increasingly fee-sensitive, a key benefit of index funds is the low cost, with most carrying low MERs. Another important benefit is tax-effectiveness.

"With the traditional passive funds that we've seen, they're very low turnover by nature, and that means typically you're paying much lower capital gains tax than what you're getting from a high turnover actively managed product as well," says Douglas.

Lovett believes there is not enough emphasis placed on after-tax returns across the industry.

"It's such a big factor in the end return to the investor. Our Australian share fund has a very low turnover of close to 3 per cent. Compare that to many active funds, it's very different," Lovett says.

The simplicity of index funds might also be attractive for investors or advisers who are looking for pure, low-cost market exposure and have a reasonable degree of confidence in the outlook.

Traditional passive options perform well when there is less volatility in the market, for example, during the middle of the 2000s when resources were doing well and the market was going up.

"But we have more uncertain economic conditions, and we have more volatile markets that might play into the hands of an active manager because they can appropriately position the portfolio," Douglas says.

"With the end of the resources boom and the impact it's had on the market, the ability of active managers to actually significantly decrease the exposure to resource companies is one reason why looking active can also have benefits as well."

Though there is no doubt certain active managers can deliver the goods for their investors, providing returns well over the benchmark, the question that always remains is whether advisers can choose the right manager at the right time.

"Is someone going to get that call right or wrong? It's not always easy to be able to find those managers who are going to be able to effectively position the portfolio for the right thematics away from the areas you don't want to have exposure to," Douglas says.

For some, that risk is too high. Employing a core/satellite strategy can help to get the best of both worlds, using an index fund at the core, with higher risk, higher cost managed funds as the satellites.

"We're a believer in using both passive and active in an appropriate proportion to reduce the risk and lower the cost of your portfolio," Lovett says.

ETFs: friend or foe?

In the US, Europe and Asia, exchange-traded funds (ETFs) have grown massively over the last 10 years, and this has been a strong driver of indexing around the world.

Australia has been slow to get on the ETF bandwagon, but over the last 12 months, assets under management in ETFs have grown more than 50 per cent from $6.4 billion to $8.9 billion, according to BetaShares' Australian ETF Review for September.

While the growth of ETFs certainly helps to focus attention on passive investment, ironically, the popularity of index funds' listed cousins could also pose their greatest threat. Competition in the market has already driven down fees for some index funds.

ETFs offer similar benefits to index funds – low cost, transparency and simplicity – in a listed package, which is highly desirable for some investors.

“Investment Trends research shows that more SMSFs are wanting to own direct securities. By adding those ETFs into your portfolio, you can still own those direct securities but you can increase the diversification massively.

"That’s something advisers and even SMSFs understand more and more, so we think that will be a really big catalyst for ETFs to grow, which is largely going to be a growth factor for indexing,” Lovett says.

As a listed vehicle, ETFs offer advisers some advantages in terms of accessibility, as they can be transacted through the ASX, rather than requiring platform approval like traditional funds, says BetaShares managing director Alex Vynokur.

He says the key difference between ETFs and unlisted index funds is that ETFs can be used to access significantly more diversified asset classes.

“With traditional index funds, you can buy a broad Aussie equities index fund or a board MSCI World Index fund, but if you look at the ETFs market you can go significantly beyond that to access asset classes such as commodities or currency,” says Vynokur.

ETFs also provide an opportunity to be more tactical, by investing in particular sectors of the ASX, for example, or with asset allocation. Even as money begins to move back into managed funds, Vynokur believes investors will use a mix of active funds and ETFs to obtain beta exposure.

“But also very importantly, a significant number of investors, whether they are financial planners or self-directed investors such as SMSFs, are using ETFs to generate alpha in their own portfolios, whether through asset allocation decisions or through rebalancing or portfolio completions – for example, accessing gold or emerging markets,” Vynokur says.

Adviser perspectives

Among advisers, there are very different perspectives on index funds, which perhaps explains the stability of index funds’ market share in Australia – there is a clear split between index believers and sceptics.

Albert Kuris, managing director of Prospaerum Financial Planning, says although index funds can provide a low-cost, low-maintenance product for clients, the lower returns can be a downside, so he would prefer to recommend a model portfolio created from single or multi-manager funds.

However with the introduction of MySuper funds, he expects to see more interest in index funds.

“For somebody who is basically looking for something that is quite competitive in terms of costs and will offer a reasonable variety of investment options, then an index fund would be the way to go,” Kuris says.

“The difficulty is that a lot of the time when we are looking at an index fund, we are comparing it directly against an industry fund – which are very cost-competitive, they typically offer types of index funds within their offering, and they are pretty much a one-stop-shop.”

Joe Stephan CFP of Stephan Strategic is at the opposite end of the spectrum, with his practice moving five years ago to only place clients in passive investment vehicles.

They decided to make the change after realising that although their message to clients was that they should buy and hold over the long term, and that their investments, once set up, strategically shouldn’t change, in reality, manager changes would force their hand, they were paying higher fees, and sometimes making mistakes in manager selection.

“Having researched it, we are finding that just capturing the market return at lower cost can actually put your clients in a better position over a longer period of time,” Stephan says.

The practice positioned the change with clients as bringing greater diversity in the companies held in their Australian share portfolios, and that it would be a lower cost approach with fewer tax implications.

While this rationale gave clients a degree of comfort with the change, Stephan admits the recent change in the fortunes of active managers will put their upfront client education to the test. But overall, they have seen the benefits of such a bold move.

"Our clients have become less focused on purely investment performance, because they know that the markets will do what they do. Instead what they are focused on is contributions and getting the right structures, which ultimately is what makes the biggest difference on the outcomes for the client," Stephan says.

While he concedes that "index funds are just not sexy", their strategic advice is more important than the factors outside their control, "such as a great fund manager coming into play and being able to ride that dream with them. You don't place your clients' critical capital on the hopes and dreams of a manager".

The rise of 'smart beta'

Institutional investors have long been involved in indexing, particularly industry super funds looking to offer cost-effective investment options.

An emerging trend in the institutional market is the rise of 'smart beta' – strategies to get more out of equities and bonds by moving beyond investing according to traditional market capitalisation indices, into alternative approaches.

"Smart beta describes an index-like strategy which provides the ability to effectively add value to or outperform the general market-weight indices," Vynokur says.

Superannuation funds, for example, are looking to take advantage of these more progressive strategies to ensure they meet their wealth creation and protection objectives in a more volatile, changing market.

AXA Investment Management director of Australia and New Zealand, Craig Hurt, says that since the company launched its global SmartBeta equity strategy six months ago, "significant interest has been shown by local investors looking for cheap diversified global equity exposures which provides a more sophisticated and efficient way of capturing equity market beta than traditional approaches".

In the same way that the retail market has followed instos into indexing, investors are now also seeking to take advantage of smart beta strategies.

BetaShares recently launched a smart beta product, the BetaShares FTSE RAFI Australia 200 ETF, which tracks the performance of the FTSE RAFI Australia 200 Index.

The fundamental index methodology looks at the economic footprint of companies as opposed to their market cap, taking into consideration factors such as cashflow generation, dividend sales and book value, to improve on the limitations of market cap-based methodologies, while still maintaining the benefits of passive investment.

"ETFs are starting to deliver not just the traditional market-weighted index investing but now also allowing people to express some of those smart beta implementation possibilities in a way that is very simple for people to access and traditionally it would be in the realm of the institutional investors only," Vynokur says.

"From a financial planner's perspective, it allows us to access all of the benefits of indexing – low cost and transparency, at the same time as the ability for a differentiated outcome, and quite often a superior outcome to the traditional market-weighted approach."

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