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The Case for Actively Managed Funds

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The lost decade

During the 1997 Asian Financial Crisis, Western equities skyrocketed while Asian equities crashed, leading to the introduction of global equity investing. Financial advisors reinforced this idea by highlighting the advantages of diversification through the construction of global portfolios. Unfortunately, over the next decade between 2000 and 2010, global equity investing was a huge disappointment as the MSCI World Free Index lost 34%. On the other hand, the MSCI Asia Ex Japan Index gained 30%, and the MSCI Emerging Market Index gained 66.91%. How did the concept of global investing fail investors?

The problem with benchmark investing

While active fund managers claim to be 'actively' managing funds, many global funds track the MSCI World Index, which had a large allocation in excess of 70% to developed markets like the US and Europe. After a decade, on 30 June 2010, both the S&P 500 and MSCI Europe lost 43%. Gains attributed by Asia and emerging market equities did little to offset the losses of developed markets.

Why then did global equity funds have such a small allocation to Asia and emerging markets? This is due to the 'benchmark-hugging' obsession by the fund management industry. As most benchmarks are market-weighted indexes, they focus on the largest market capitalized stocks rather than those with the best potential for capital gains. Benchmark-hugging funds would end up accumulating more of a stock as its price rises, and reducing holdings of cheap stocks.

Even fund managers with exceptional stock-picking skills will see their alpha returns limited and diluted by their beta exposure. As a bull market cycle matures and peaks, value stocks could become a rare commodity over time as they become expensive growth stocks and ultimately create asset bubbles. When global stock markets crash, a large stock price drawdown would be distinct. This was evident in the technology and internet crash in 2000, when half of global benchmarks were made up of overpriced stocks. Value picks were not spared.

'Bread & Butter' issues

Why then do fund managers bother with benchmarks? We can pin the blame on fund-rating agencies. Rather than focusing on longer-term results, the agencies track fund managers' performances in the short term. Underperforming a benchmark could cost a fund manager his job.

Benchmark-focused managers work on avoiding high 'tracking error', i.e. deviation from their adopted benchmark, as that is perceived by fund rating agencies and the financial industry at large as taking on higher risk.

In addition, having a high portfolio turnover, which increases the expenses ratio, is also deemed bad by the cost-sensitive fund rating agencies. Such thinking would limit shorter term trading skills of a fund manager, which can come in handy during volatile and non-trending market conditions.

Over the past ten years, global equities have been through two bear market cycles where the MSCI World Index twice saw drawdowns of between 40% and 50%. Unfortunately, most funds are not mandated to apply short strategies and have to stay invested with a maximum level of cash holdings at 10%, which leaves their capital unprotected. Moreover, traditional funds also hedge neither their equity nor currency exposure. While investors expect fund managers to be altruistic and treat their money as their own, it can't happen.

With these unnecessary business and psychological pressures on a fund manager, the amount of actual 'active' work they do is put to question. It's no wonder, then, that many fund managers do not beat their respective benchmark. To start with, they were never really active managers.

The rise of ETFs

According to Strategy Insight, net sales of exchange-traded funds in the first 11 months of 2008 saw net sales of US$215 billion ($291 billion) compared with a net outflow of US$205 billion. As of 2010, the number of ETFs listed is Singapore alone has increased to 70, with a turnover of $5 billion. Does this mark the demise of the active fund management industry? Should investors abandon actively managed funds for ETFs?

While it is commonly said that 80% of actively managed funds in America do not beat their benchmark, it is not so in Asia. A quick observation made at GYC Financial Advisory revealed that in a five and ten year period, more than 70% of onshore Asia Pacific Ex Japan (SGD) beat the index. Funds that have beaten the benchmark by the widest margins are the non benchmark-huggers.

With the threat of ETFs on the rise and a volatile market, investors can expect to see a rise of absolute return equity funds that can shift to 100% fixed income and have short equity positions to protect capital. These funds can also invest in any country, sector or asset class unhindered by benchmark. The first of such a fund was recently launched by UOB Asset Management, with GYC Financial Advisory as the investment advisor, and more will come in the months ahead.

While an ETF is a cost effective instrument that can be used for beta exposure or market timing strategies, it should not replace active management. An ETF will suffer as long as the index it is tracking does badly, and the same applies to a sub active benchmark-hugging fund.

As the great Benjamin Graham once said, "To beat Mr Market, do not follow Mr Market".

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