THE Frontier Line

Thought leadership and insights from Frontier Advisors

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Active Management in Australian Equities

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $320B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Active management underperformance

In the 2018/19 financial year, active management struggled in most equities sub-asset classes, particularly in Australian equities which saw the worst active management financial year since performance surveys commenced in Australia. This paper discusses active management in Australian equities for the past 12 months.

We then consider this in the context of longer-term active management data. For completeness, we also cover Australian small caps. In a separate paper, to be published shortly, we will look at active management in international equity asset classes.

Table 1 shows the very poor performance of active management in Australian equities in the past 12 months to 30 June 2019. We seek to outline what has driven these very negative active management results in Australian equities.

We know of two common characteristics of Australian equities managers relative to the S&P/ASX 300 Index – active managers tend to be significantly underweight A-REITs and Large Caps (i.e. they favour Mid Caps and Small Caps instead).

Table 2 shows returns data for these segments of the market. The A-REITs underweighting has worked in favour of managers over the long-term as A-REITs have modestly lagged the broader market. It is, however, modest.
A 5% underweighting to A-REITs would have only added only a few basis points per annum. Underweighting the Top 50 stocks in favour of Mid Cap and Small Caps also appears largely insignificant over the long term.

Table 1: Australian Equities Managers Excess Returns vs S&P/ASX 300

	1 Year to 30 June 2019 %
Upper Quartile	-1.0
Median[1]	-2.6
Lower Quartile	-5.0
Observations	55
S&P/ASX 300 Return	11.4

Source: eVestment, Frontier cleansed universe

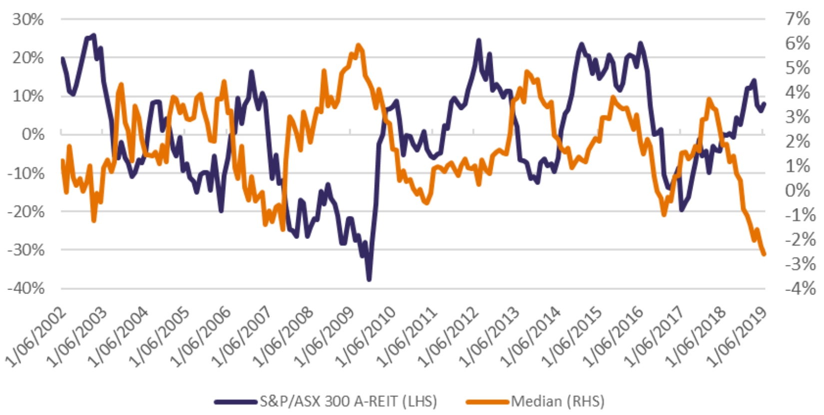
Table 2: Benchmark returns since September 2000

	Sep 2000 – Jun 2019 % p.a.
S&P/ASX 300	8.3
S&P/ASX 300 A-REITs	7.6
S&P/ASX 50	8.3
S&P/ASX MidCap 50	10.4
S&P/ASX Small Ordinaries	5.7

Source: eVestment

[1]We note that the median underperformance in the Mercer survey for Australian equities was -3.4%.
This universe includes multiple products by single managers and multi-manager products.

Chart 1: S&P/ASX 300 A-REITs vs Australian equities median (rolling one year excess return)

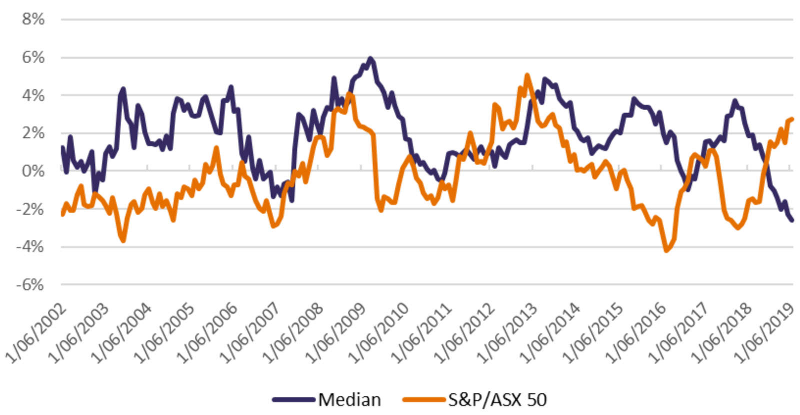


Source: eVestment, Frontier

With regard to A-REITs, this sector represented around 7.7% of the Index as at 30 June 2019, but most active managers either do not own any A-REITs or have a large underweighting. We observe it is typically only quantitative managers (with sector neutral portfolio construction rules) that reliably have close to Index weight in A-REITs.

Chart 1 shows the historical inverse relationship between the median manager excess returns and the outperformance of A-REITs – a pattern we would expect given the manager positioning we typically observe.

Chart 2: S&P/ASX 50 rolling one year excess returns versus Australian equities median rolling one year excess return



Source: eVestment, Frontier

With regard to Large Caps, given the S&P/ASX 300 Index is capitalisation weighted, the Index is heavily skewed to the largest stocks (the top ten stocks often comprise between 40% and 50% of the Index). As a result of this heavily skewed benchmark, active managers typically seek greater diversification and are consistently underweight the Large Caps. Chart 2 shows the relationship between the median manager excess returns and the outperformance of the S&P/ASX 50.

An inverse relationship between the median manager excess returns and the outperformance of the Top 50 stocks is evident at times but not others. It is not as stark as for A-REITs.

These two effects have meaningfully impacted active returns over the past 12 months as A-REITs significantly outperformed the broader market and Large Caps significantly outperformed Mid Caps and Small Caps. Analysing the past year's returns, we can decompose these two effects. We suspect the active manager returns generated over the past 12 months have been driven by this positioning. This is shown in Table 3.

As an illustration, a 5% underweighting to A-REITs detracted around -0.4% in the past financial year, while a 5% underweighting to Large Caps in favour of Mid Caps/Small Caps would have detracted an estimated -0.6%.

Table 3: Australian equities managers and index excess returns vs S&P/ASX 300

	Year to 30 June 2019 %
Upper Quartile	-1.0
Median[1]	-2.6
Lower Quartile	-5.0
Observations	55
S&P/ASX 300 A-REITs	+8.0
S&P/ASX 50	+2.7
S&P/ASX MidCap 50	-7.7
S&P/ASX Small Ordinaries	-9.5

Source: eVestment

The A-REITs and Large Cap effects are not the only explanatory factors. We believe the following factors also contributed to the under-performance (noting that some of these are inter-related to the A-REITs and Large Cap effects):

- Telstra performed very strongly (up 60%) and is a typical underweighting;
- The iron ore price almost doubled in the past financial year and managers were mostly underweight to this theme (via underweighting the collective of BHP, Rio Tinto and Fortescue which returned 38%, 40% and 154% respectively);
- With interest rates moving downwards, bond proxies performed well and managers were largely underweight this thematic. The bond proxy segment includes the outperforming A-REITs and also infrastructure stocks like Transurban and Sydney Airports which performed particularly well (up 31% and 18% respectively);
- Active Australian equities managers often hold little exposure to the IT sector in Australian equities, which is dominated by fledgling businesses currently generating little profit. While this has historically had a low index weighting, with such outsized returns by some small but fast growing stocks (examples such as Afterpay and Wisetech which returned 168% and 77% respectively), not owning these stocks was a detractor; and
- Cash holdings detracted from performance in the rising market. A 5% cash holding, on average, would have detracted an estimated -0.5%.

Breaking the year down into quarters, it is evident from Table 4 that active managers did not outperform in any of the four quarters. The two worst quarters were the December 2018 and June 2019 quarters and these were largely responsible for the poor result over the financial year. In both of these quarters, there was significant outperformance by Large Caps over Mid Caps and Small Caps. In addition, A-REITs outperformed substantially in the December 2018 quarter, meaning both common positions (underweight A-REITs and underweight Large Caps) were simultaneously unfavourable. This resulted in the December 2018 quarter being the worst active management quarter since performance surveys commenced in Australia.

Table 4: Australian equities managers and index excess returns vs S&P/ASX 300

	Jun 2019 qtr (%)	Mar 2019 qtr (%)	Dec 2018 qtr (%)	Sep 2018 qtr (%)
Upper Quartile	0.0	+0.6	-0.7	+0.7
Median	-0.9	-0.1	-1.2	-0.2
Lower Quartile	-2.0	-0.8	-3.0	-1.0
S&P/ASX 300 A-REITs	-3.9	+3.5	+6.7	+0.5
S&P/ASX 50	+1.1	-0.1	+1.6	-0.3
S&P/ASX Mid Cap 50	-3.1	-1.1	-4.7	+2.1
S&P/ASX Small Ords.	-4.3	+1.7	-5.3	-0.4

Source: eVestment

[2]We note that the median underperformance in the Mercer survey for Australian equities was –3.4%.

A reversal in active management outcomes?

On A-REITs, it appears the especially strong A-REITs performance has been driven by a yield gap over decreasing Australian interest rates. This would seem the key rationalisation for the strength seen in A-REITs. However, Chart 3 shows that the yield gap is still wide, so we should not assume a swift reversal in A-REITs will occur.

With the official Australian interest rate down as low as 1% and bond yields also low, there is, however, a limit on A-REITs rallying based on yield gap.

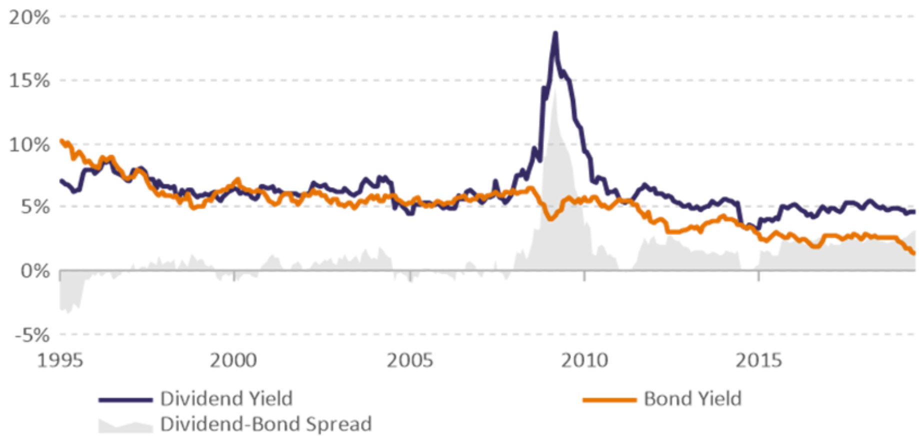
We also consider the Price/NTA (Net Tangible Assets) of A-REITs when thinking about the future potential returns of A-REITs. Chart 4 shows that A-REITs are trading at a significant premium to NTA and the last time this occurred, it eventually proved unsustainable. Weighing this up, our considered opinion is that it is unlikely that low growth, income-generating assets such as A-REITs would repeat the high double digit returns that we have seen in the past financial year. For this to continue, it would require the Price/NTA to keep widening.

Looking forward, we expect active managers to maintain their current underweight stance on A-REITs. This position largely exists as managers expect they can generate greater upside from investing in more dynamic businesses.

There is little reason to think active managers will start thinking about A-REITs in a different manner. When considering the Price/NTA of A-REITs, retaining this position may be a favourable feature for active Australian equities managers in future. However, given the presence of the yield gap, it may take time for the underweight to reap future gains.

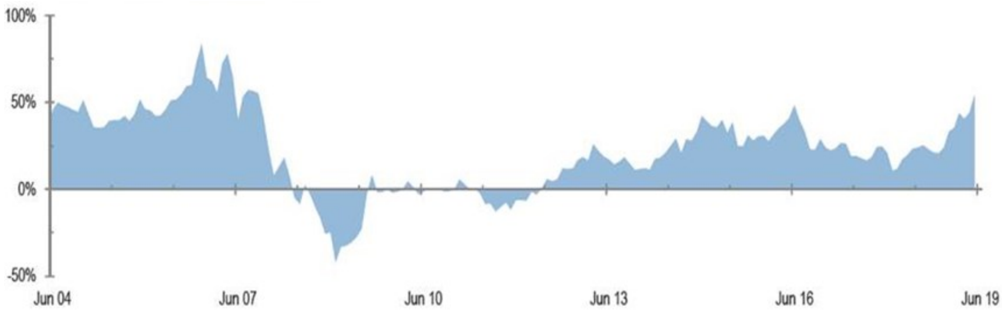
With regards to the Large Caps underweighting, we expect this will also be retained. Active Australian equities managers typically do not manage active Australian equities portfolios with the same Large Cap concentration as the S&P/ASX 300 Index (which has 40-50% in the top ten holdings at most times). We like that active Australian equities managers have more balance in their portfolios than the S&P/ASX 300 Index, but unlike the A-REITs stance, we do not have a strong view on whether this Large Cap underweighting will prove favourable or unfavourable going forward. Despite the recent outperformance by Large Caps, we note that, as at 30 June 2019, Mid Caps and Small Caps remain on higher Price/Earnings ratios than Large Caps (21.6 and 19.7 for Mid Caps and Small Caps respectively versus 17.8 for Large Caps). While this is not extreme, it does not support the idea that a near term reversal is imminent.

Chart 3: A-REITs dividend yield vs 10 year bond yield



Source: Thomson Reuters Datastream, Frontier

Chart 4: A-REITs premium/discount to NTA



Source: J.P. Morgan

Long-term data on active management in Australian equities

This section delves into the long-term data on active management in Australian equities.

Chart 5 shows the median Australian equities managers rolling one-year excess return versus the S&P/ASX 300. The cyclical nature of alpha within Australian equities is evident in the chart. There is no evidence that negative structural change has occurred in active management in Australian equities. It is clear that the past 12 months has been the worst year for active management over the past two decades with the median active manager underperforming by around 2.6%.

Table 5 shows non-overlapping five year periods spanning the past 15 years. It is our contention that there is a lack of strong evidence for a structural decline in alpha for the median manager based on this data. There is a slight decline in the median excess return and a minor narrowing of the range between upper and lower quartile outcomes. However, these do not appear significant and the excess return of the median manager has remained above 1% p.a. (before fees) in the most recent five year period, even when including the last financial year.

Chart 5: Australian equities median rolling one year excess return vs S&P/ASX 300

Source: eVestment, Frontier

Table 5: Australian equities managers excess return vs S&P/ASX 300

	5 Years to June 2019 % p.a.	**5 Years to June 2014 % p.a.**	**5 Years to June 2009 % p.a.**
Upper Quartile	+2.5	+3.9	+4.4
Median	+1.3	+1.5	+2.4
Lower Quartile	-0.1	+0.6	+1.2
Observations	54	50	30
S&P/ASX 300 Return	8.9	11.0	6.8

Source: eVestment

We can also break down the past five years of data into two periods – the very poor past year for active management and the four prior years to 30 June 2018 – to see the impact of the two main effects (underweight A-REITs and underweight Large Caps) over a longer period. This is shown in Table 6.

Both effects detracted significantly in the one year to 30 June 2019. However, over the most recent five year period, underweighting A-REITs was a negative contributor while underweighting Large Caps was actually favourable.

While we have a belief that these two effects are a leading explanation of the underperformance of the past year, we also consider whether, over the longer term, there have been changes in Australian equities that have structurally reduced the outperformance expectations of institutional investors. The following are some of the main changes in the Australian stock market that we have observed in the past two decades that may have impacted outperformance potential.

- Considerable money flow into Australian equities with the continued growth of the Australian superannuation market;
- Increased short-selling of stocks;
- Greater investment by quantitatively driven investment approaches;
- The rise of high frequency traders and other very short -term investors using algorithms to trade;
- An increase in passive investment;
- The creation of ETFs; and
- A continued increase in the numbers of institutional investors in Australian equities.

In aggregate, we think these may have had a modest impact on the efficiency of the Australian equities market, but they do not seem so significant to change expectations greatly around the scope for active manager outperformance.

Frontier's view is that there are inefficiencies that have existed historically in Australian equities and these still remain entrenched today. We think these enduring inefficiencies in Australian equities come about because:

- Despite declining as a percentage over time, there remains considerable retail investment in the Australian market (around 15% of the market according to data sourced from the ASX and Morgan Stanley) and this cohort underperforms the market. Australia remains above most developed markets in terms of retail investment in the local stock market;
- There remains considerable international investment in Australian equities (particularly in Large Caps) and this cohort does not get the benefit of franking credits, so contributes to inefficient pricing of many dividend paying Australian stocks; and
- There remain opportunities for outperformance from Australian small caps that are often misunderstood and lowly represented in indices.

In addition, the decline in the stock broking industry in Australian equities may reduce stock market efficiency going forward. From our discussions with managers, it is clear to them that stockbroker coverage is declining (both in terms of numbers of firms covering stocks and the experience level of the stockbroking analysts).

Table 6: Australian equities managers excess return vs S&P/ASX 300

	5 Years to June 2019 % p.a.	1 Year to June 2019 %	4 Years to June 2018 % p.a.
Upper Quartile	+2.5	-1.0	+3.9
Median	+1.3	-2.6	+2.2
Lower Quartile	-0.1	-5.1	+0.6
S&P/ASX 300 Return	8.9	11.4	8.3
S&P/ASX 300 A-REITs Return	13.8	19.4	12.5
S&P/ASX 50 Return	8.4	14.1	7.0
S&P/ASX MidCap 50 Return	12.8	3.7	15.2
S&P/ASX Small Ords. Return	9.3	1.9	11.2

Source: eVestment

Australian equities small caps

Frontier's recommended high allocation to active Australian small caps is built on the premise that active Australian small caps managers can deliver excess returns versus the S&P/ASX Small Ordinaries Index, but also the broader market (S&P/ASX 300 Index).

We firstly show the active management history versus the S&P/ASX Small Ordinaries Index. The outperformance level generated by the median Australian small cap manager in the past five years to 30 June 2019 has been lower than prior periods. This is illustrated in Table 7 and Chart 6.

We note that the median Australian small caps manager has long-term outperformance versus the S&P/ASX Small Ordinaries, but importantly there is also long-term outperformance versus the S&P/ASX 300 Index (i.e. investing in active small caps assists a Portfolio in achieving a higher return than the broader Australian equities index).

Table 7: Australian small caps managers excess return vs S&P/ASX small ordinaries

	5 Years to June 2019 % p.a.	5 Years to June 2014 % p.a.	5 Years to June 2009 % p.a.
Upper Quartile	+4.0	+13.2	+5.6
Median	+1.7	+11.4	+3.2
Lower Quartile	-0.4	+9.8	+0.9
Observations	23	25	19
S&P/ASX Small Ords. Return	9.3	3.4	5.6
S&P/ASX 300 Return	8.9	11.0	6.8

Source: eVestment

Chart 6: Australian equities small cap median rolling five year excess return

Source: eVestment, Frontier

There are various explanations why active management in Australian Small Caps versus the S&P/ASX Small Ordinaries Index fluctuates significantly.

Firstly, part of the explanation of the large historical outperformance appears driven by the S&P/ASX Small Ordinaries Index and its own construction issues. In effect, part of what we interpret to be outperformance arguably comes from misrepresentation of the true Small Caps beta. This Index has often performed poorly, making small caps managers look like they are highly alpha generative. The construction issues can be broken down into the following.

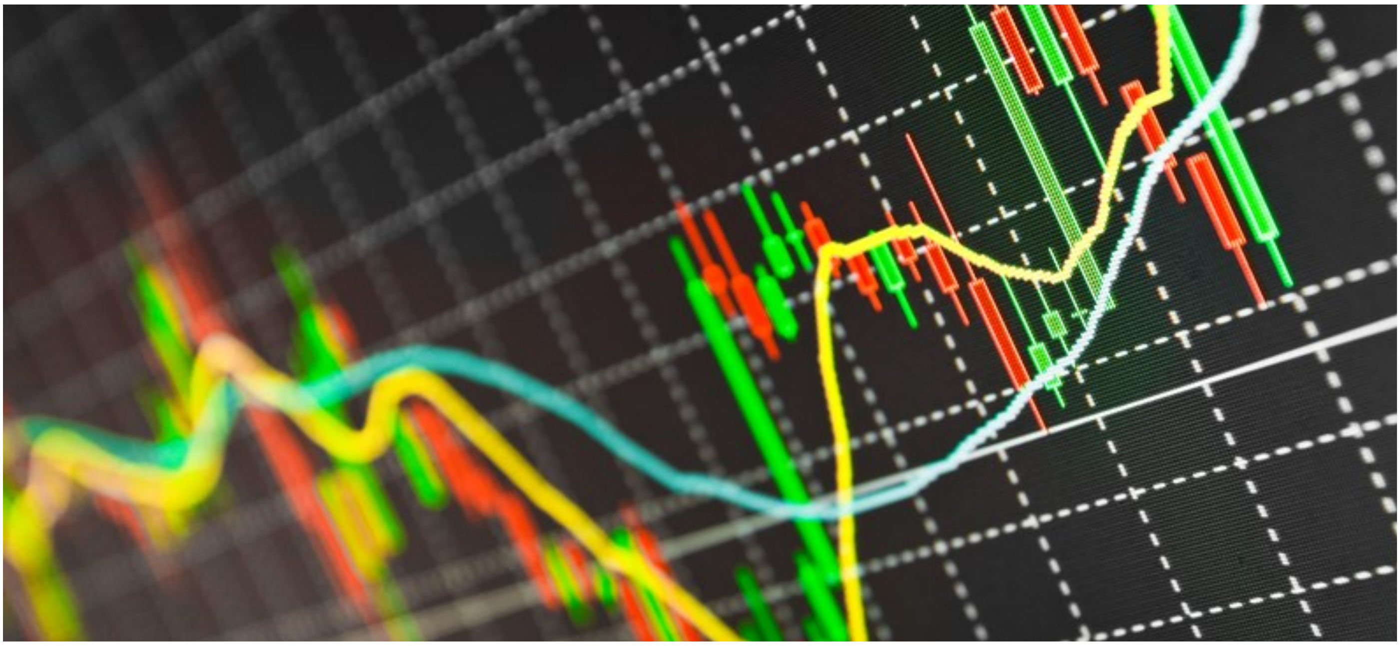
- This Index has its strong performers elevate into the Top 100 and it inherits poor performers that fall out of the Top 100 (and naturally these stocks get assigned the largest weights as they enter the S&P/ASX Small Ordinaries Index). Managers typically benefit from underweighting these stocks that are often in secular decline.
- At the bottom-end, stocks are added to the S&P/ASX Small Ordinaries Index when there is a cyclical boom. For example, booms in gold, other metals and technology have all resulted in new stocks being added into the Index during their final stages, often later to be reversed. As one such example, during the resources boom, mining stocks were steadily added to the Index and reached around 45% in 2011. Small caps managers benefitted significantly from not owning the newly added stocks, effectively underweighting the cyclical boom as it unwound. As an illustration, as at 30 June 2019, resources were less than 20% in the S&P/ASX Small Ordinaries Index.

These construction issues have not been as evident in the last five years. Instead, the S&P/ASX Small Ordinaries Index has outperformed the Top 50 over that period, when historically this Index has struggled to keep up with the S&P/ASX 50 Index. It is therefore less surprising that outperformance has been muted in Small Caps.

Secondly, the A-REITs effect outlined in broad cap Australian equities has also been impacting Australian Small Caps (A-REITs were 11.6% of the Small Ordinaries Index as at 30 June 2019). Once again, it is common for small caps managers to be underweight A-REITs and seek greater upside from more dynamic businesses instead.

Thirdly, we also note that the past five years has seen some outsized returns by a small collective of stocks – the WAAAX stocks (Wisetech, Afterpay, Appen, Altium and Xero) which have risen in multiples. These are owned by a small cluster of active small caps managers, while the majority of managers have been underweight these stocks as their weights in the Index rapidly rose.

Overall, we think that the last five years of active management in Australian Small Caps (and prior periods) can be explained. In our view, Australian small caps remains a good place for active management and we note a newer condition supporting this view. There has been a significant decline of the stock broking industry in Australia and this is having its most pronounced effect on Australian Small Caps. The level of coverage of Australian Small Caps has been steadily in decline and, where there is coverage, the experience of those covering Small Caps is less than before. This adds grounds to believe that there will be continued inefficiency in Australian Small Caps going forward.



The final word...

Despite the active management failure of the 2018/19 financial year, we believe that Australian equities remains a good asset class for active management. Frontier's view is that inefficiencies have existed historically in Australian equities. We also think these same inefficiencies remain within Australian equities, creating opportunity for active managers to generate outperformance.

We note that Australian equities has just experienced its worst 12 month period for active management. Our key conclusion is that this one year period has been an outlier. It has been driven by two key effects that have had a larger impact than previously – active managers are consistently heavily underweight A-REITs (which outperformed significantly) and active managers are consistently underweight Large Caps (which significantly outperformed Mid Caps and Small Caps). These are regular portfolio composition differences between active managers and the S&P/ASX 300 Index that work at times, but not at others. We do not believe there is a meaningful payoff from either position, but expect these tilts to remain and impact active management outcomes.

With regard to Australian small caps, we note that it has not delivered the large outperformance that many became accustomed to in the 2000s and early part of this decade. We think this can also be explained.

We think construction issues with the S&P/ASX Small Ordinaries Index remain, but they have not been a meaningful factor in Small Caps active management results of the past five years. We also believe that consistent tilts (such as underweighting A-REITs) have also impacted Small Caps managers. In our view, Australian Small Caps remains a good place for active management relative to the S&P/ASX Small Ordinaries Index (and broader market), but caution is required around interpreting the magnitude of active management results against the Small Caps benchmark.

In a follow up paper to be published shortly, we will examine active management in international equity classes.

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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