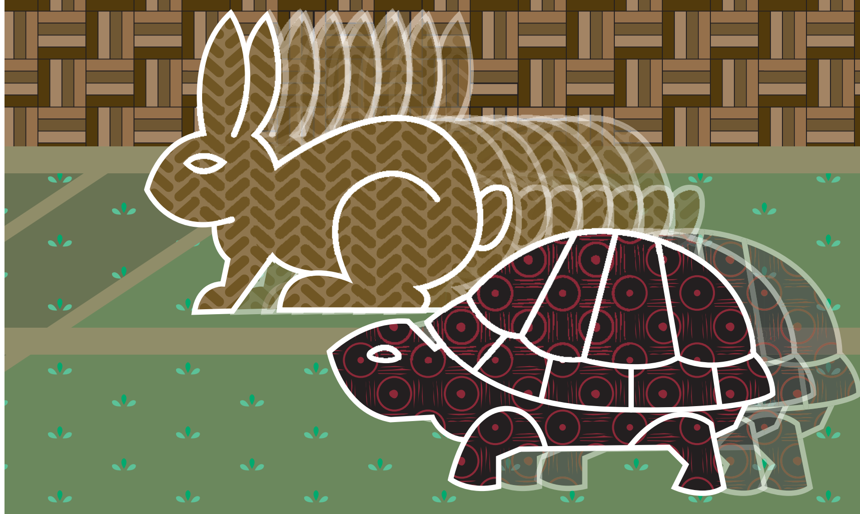
Can fund managers BEAT the index?

Many investment studies in the US say it's an uphill task for fund managers. Elaine Boey examines how local fund managers score.



IN 1994, A stockbrokerage based in France made international news when one of its chartists decided to pick shares for the firm's annual investment competition by throwing darts at the share-listing pages of a financial newspaper. As random as his stock selection may have seemed, Phillipe Cartoux was said to be confident of beating most of his colleagues. For someone who makes a living advising investors on which stocks to buy, his act triggered a debate among the investing community around the world that has yet to reach a conclusion: Are fund managers, who can demand fees of up to 1.75% annually, really worth the money? Or are investors better off leaving decisions to a computer program that operates an investment vehicle that simply mirrors the performance of a specific index?

In the US, historical data favours index investing. In a study published in the *Journal of Financial Planning*, Thomas P McGuigan, president of Beyond Tomorrow Strategic Advisors LLC in Guilford, Connecticut, examined the performance of actively-managed large and mid-cap domestic stock funds against a passive strategy during a 20-year period, 1983-2003. The study found that the number and percentage of individual, actively-managed funds that had outperformed the passive approach was low: 55% of large-cap funds did better than an index fund over the five-year period (The study did not take into account sales or surrender charges); only a quarter of the funds managed to outperform the index over the 10-year period; but only 10.59% of funds outperformed the index fund over the 20-year period. A recent Forbes article reported that of the 355 equity funds that existed in 1970, only 169 remain today. Nine of them have outperformed the S&P 500.

What local statistics say

At home, one argument for the active investing is that our market is not as efficient as the US. "Investment literature point out that the majority of actively managed funds do not beat the market index. And this is the case for an efficient market. But the Malaysian market may not be efficient," says Kenneth Koh, head of research (Asia ex-Japan) for Lipper Asia Ltd. The efficient market hypothesis asserts that financial markets are "informationally efficient" and that prices already reflect all known information.

In an inefficient market, a skilful fund manager with a supportive investment process can add value. There are top-performing equity funds that have consistently produced

ILLUSTRATION: LEE WAN YEE/THE EDGE

returns that far exceeded the benchmark index.

"As the performance of a fund is highly dependent on the skill and experience of the fund manager, the average performance of all equity funds could be skewed. Top performers will beat their benchmark," says David Ng, chief investment officer for Hwang-DBS Investment Management Bhd. "For example, since its inception to March 31, 2007, Hwang's DBS Select Opportunity Fund has made 246.46% and outperformed its benchmark, the Kuala Lumpur Composite Index (KLCI). As such, those who wish to invest in an actively managed fund should evaluate the fund's prospectus and manager carefully to ensure confidence and conviction in their investment."

While an actively managed fund with a capable fund manager and supporting processes can outperform the KLCI, here are the real questions — how many fund managers can do this and can retail investors pick the right fund every time? Over the long term, actively managed funds that are thought to have the best chances of beating the broad market are those that focus on obscure niches such as companies operating in newer industries, but these areas are typically under-researched and this makes it hard for managers to identify winners that escape the notice of their peers.

To get an inkling of how local fund managers have performed against the KLCI in the past, consider historical returns of actively managed equity funds against the performance of the index. This comparison is not all-conclusive as many factors such as the fund's mandate is not taken into account, funds that fall into this category may not be benchmarked against the broad market and that the KLCI is assumed to be a theoretical portfolio that does not incur trading cost.

Over the three-year period ended Dec 31, 2006, 24.2% of funds in the equity category outperformed the KLCI. Over the longer periods of five and ten years, the ratio improved to 43.9% and 64.7%. Upon examining the averages, a mixed picture emerges. The KLCI far surpasses the average performance of actively managed funds over the three- and five-year period ended Dec 31, 2006, but the loss made by the benchmark index over the longer ten-year period of 36.6% is far more than the average loss of 1.6% made by equity funds during the same period (see Table 1).

"Fund managers may have invested in small-cap stocks or made tactical bets that would have caused periods of underperformance and outperformance against the broad market," says Lipper's Koh.

Funds that do not outperform the broad market don't necessarily reflect the poor skills of their fund managers. "This underperformance can be due to the fund management company's investment process. There is a tendency for managers to react to market trends instead of predicting where the market is going to go. This can be a result of time constraints to do their own research or a lack of organisational effectiveness whereby information is not assimilated quickly throughout the team," says Puah Ser Sze, investment consulting practice leader for Watson Wyatt (Malaysia) Sdn Bhd.

Koh: The Malaysian market may not be efficient

Puah: There is a tendency for managers to react to market trends instead of predicting where the market is going to go

Fund managers paid to outperform

In actively managed funds, you pay fund managers a management fee (which can reach 1.75% per annum)

Table 1: Longer-term returns of equity funds (as at Dec 31, 2006)

	THREE YEAR (%)	FIVE YEAR (%)	TEN YEAR (%)
Category average	0.73	1.83	-1.6
KLCI	48.72	69.64	-36.6
Funds that beat KLCI	16 out of 66 (24.2%)	25 out of 57 (43.9%)	22 out of 34 (64.7%)

SOURCE: MORNINGSTAR ASIA LTD

Table 2: Time-weighted rates of return of equity funds (as at March 31, 2007)

	ONE YEAR (%)	THREE YEAR (%)	FIVE YEAR (%)
Category median*	32.6	7.7	9.6
Underperformed their relative benchmark by:	-0.5	-2.9	-0.6

**Based on funds included in Watson Wyatt Measurement of Investment Performance Survey, 1Q 2007*

SOURCE: WATSON WYATT (MALAYSIA) SDN BHD

PHOTO: KOH (SUHAIMI YUSUF/THE EDGE), PUAH (PATRICK GOH/THE EDGE)

to outperform the index, but are you getting your money's worth? Funds that attempt to beat the index can end up underperforming and outperforming the index. But there are also fund managers who manoeuvre defensively to ensure they do not do worse than their respective benchmarks — this can lead to the lacklustre returns when compared against the market. This behaviour is known as "closet indexing", which is understandable given penalties such as redemptions by investors for a poor short-term performance.

Results from Watson Wyatt's Measurement of Investment Performance seem to demonstrate this practice (unlike comparisons made between equity funds and the KLCI earlier, this survey measures funds against their respective benchmarks). As at the end of the first quarter of the year, the median of all institutional funds in the country and some retail funds (which contributed up to 8% of all funds in the survey) did not beat their benchmarks in the past one-, three- and five-year periods ended March 31, 2007. But although the median returns of the funds in the survey did not outperform their benchmark, neither did they differ by a large quantum (see Table 2).

However, these figures do not have sufficient historical data to provide statistical evidence on a fund manager's ability. "At least 13 years of data is required to make a statistically-backed decision whether a fund manager is truly skilful or not. It is very hard to make this analysis because not many funds have been around for this duration or managed by the same manager," says Puah.

The impact of costs

These performance figures in Table 1, as demonstrated by Morningstar, however, represent returns made by the funds and do not include the effects of upfront costs. Investors may find their individual returns lagging behind their fund's reported returns due to the cost required to invest in an actively managed equity fund, which ranges from 5% to 7% of net asset value.

Once these expenses are considered, the majority of actively managed funds in the market will not beat the index, says Puah. "The funds in the Watson Wyatt survey do not require upfront fees from institutional investors and they are not outperforming their benchmark. Since the retail market has higher fees, it would make it even harder for an investor with an actively managed fund to make returns that outperform the market," says Puah.

With cost in the picture, the argument for a passive investment that follows an index is even more persuasive. A passive investment via an exchange-traded fund (ETF) requires only transactional costs that are exactly the same as when trading a share (0.6% via brokerage) and ETFs charge much lower management fees. Index funds can also be options but such funds currently offered in the market behave more like actively managed funds and can impose similar fees with their actively managed fund counterparts (see story above). ■

Index funds and ETFs

UNTIL RECENTLY, THE easiest way to ensure that your portfolio's performance matches an index is to invest in an index fund. Theoretically, the fund should mimic a chosen index by investing in almost the exact constituents of stocks that make up the index. A classic index fund should be broadly diversified, operating with minimal expenses and have an extremely small portfolio turnover. The first two points are the main advantages of investing in an index fund.

However, most of the index funds currently available in the country do not behave as the quintessential index fund. "With a small tracking error, the fund's under- and overperformance compared to the benchmark is acceptable. However, top-performing index funds made quite a bit more than the benchmark Kuala Lumpur Composite Index last year. This means that a portion of its portfolio is based on the fund manager's discretion," says Dinesh Virik, executive director of Perkasa Normandy Advisers Sdn Bhd.

Virik: With a small tracking error, the fund's under- and overperformance compared to the benchmark is acceptable

Equity exchange-traded funds (ETFs) have fast gained popularity among hedge funds and investors around the world as a cheap and easy way to invest in an index. In early June, the first ETF was listed on the Main Board of Bursa Malaysia. Known as the FBM30etf, its objective is to mimic the performance of the FTSE Bursa Malaysia Large 30 Index (see story on Page 10). The only other ETF in the country is the Asian Bond Fund Malaysia Bond Index Fund, which listed two years ago. "More ETFs are required before investors, who want to invest passively [in an index], are able to construct their overall portfolio in accordance to their risk profile and objectives," says Virik. ■

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