Wealth Investing

Alpha reaching vanishing point in face of market volatility

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With sharemarket returns expected to drop in coming years with the end of easy money and easy gains, financial experts say superior investment returns will need to come from active funds management, or "alpha", rather than passive management.

But due diligence on active funds is needed, with many struggling to produce the alpha's promise to investors.

Managed funds are broadly defined by two measures, their ability to deliver "beta" or market-linked performance, and "alpha", or the ability to deliver higher-than-market performance resulting from a fund manager's skills.

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Passively managed funds aim to earn beta returns for investors, or returns in line with market benchmarks for investors. But actively managed funds aim to deliver alpha [https://www.afr.com/link/follow-20180101-p5b1v6], or excess market returns, through asset selection to offer investors superior performance, or outperformance of their respective benchmarks.

For their skills, active funds charge higher management fees than passive managers such as exchange-traded funds [https://www.afr.com/link/follow-20180101-p5b1wf] (ETFs). But it is important for investors to check whether the funds in which they are considering an investment have actually delivered alpha returns, matched the market, or in fact, done worse.
That's because over the long-term, most actively managed funds in Australia haven't delivered the alpha they've promised investors. Many have performed

worse than the market, or barely been able to match their benchmarks.

As the central bank liquidity taps are turned off, fundamentals and alpha will become more important, says Simon Doyle, Schroder's chief investment officer, Australia.

The SPIVA Australia Scorecard reports on the performance of Australian active funds against benchmark indices. In 2021, more than one-half of the funds in the Australian equity general and Australian equity mid- and small-cap categories beat their respective benchmarks. That was the good news. Most funds in the international equity category, Australian bonds, and Australian A-REIT categories delivered *lower* returns than their respective benchmarks. In addition, over five and 10-year periods, most active funds underperformed their respective benchmark indices across all asset categories.

Looking forward, Andrew Vallner, chief executive of CPG Research & Advisory, says that in a weaker equities market, such as the present, there is greater potential for alpha to deliver returns to investors due to greater stock dispersion.

"Fundamentals do matter a lot more outside a stock market bubble," he says. "There is real punishment for bad results. The overvalued bubble stocks (like buy now pay later) are destroyed."

Vallner claims that the potential to deliver alpha is greatest in the small companies asset class [https://www.afr.com/link/follow-20180101-p5b58x]. "There is potential for extraordinary alpha in that extremely inefficient market with a lack of broker coverage, and an ability to get informational advantage. There are also discounted placements and convertibles in rapid growth companies, and [there are] more takeovers," says Vallner.

According to Jared Pohl, partner at ECP Asset Management, even with larger companies, it makes sense for fund managers to allocate more capital to growing businesses that do not depend on the overall market conditions for their profitability. Identifying these companies requires the skill of active managers to deviate from the index.

Investors who can distinguish good quality businesses and assets more generally will add value.

— Simon Doyle, Schroders Australia,

"Indexes tend to favour bigger, more mature, companies which are much more dependent on the overall economy for their growth. This approach has served us and our clients well, and we expect it to continue in the current climate," says Pohl.

Ganesh Suntharam, CIO at Redpoint Investment Management, says another area where alpha will be readily available is in assets related to the transition to a net-zero economy [https://www.afr.com/link/follow-20180101-p5akzn], where active stock selection is needed to improve risk and return outcomes in the area.

"In the case of the net-zero transition, stock selection will play a significant role in assessing and vetting investment opportunities that we expect will improve outcomes relative to a broad-based exposure to the thematic," he says.

According to Simon Doyle, chief investment officer at Schroders Australia [https://www.afr.com/link/follow-20180101-p59zdw], as the central bank liquidity taps are turned off, fundamentals and alpha will become more important.

"Investors who can distinguish good quality businesses and assets more generally will add value. This is evident in the strong performance of active managers, particularly in equities since markets have turned down in the face of rising rates and rising inflation," says Doyle.

"This is in some ways the reverse of the situation prevailing in much of the COVID-19 environment where speculation usurped investment fundamentals and skill. Going forward, there is a strong case to be made that fundamentals and skill will usurp speculation," he says.

The debate about active versus investment strategies always crops up during times of volatility, says Duncan Burns, of Vanguard Asia-Pacific.

Hugh Selby-Smith, co-chief investment officer at Talaria Capital, adds that in an environment where equity markets are appreciating at a high level, say 10-per cent-plus, the value then from active management is less material. However, as sharemarket returns move closer to zero or below, this added value or alpha becomes increasingly important.

“As an example, adding 3 per cent return on top of 10 per cent is less important than the same 3 per cent on a zero-market return,” he says.

“Relying less on the market’s beta return and more on strategies able to add value is of particular importance in the current environment,” says Selby-Smith. “While expected future returns may be lower, it does not mean the volatility around those returns will be less: in fact, the likelihood of investors having negative returns is far greater in a lower return environment than one with a much stronger underlying rate of return.

“Active management and strategies that can lower volatility and thus reduce likelihood of adverse outcomes are increasingly valuable.”

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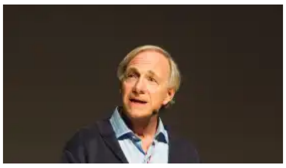

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However, Duncan Burns, chief investment officer, Vanguard Asia-Pacific, says the active versus passive debate always rears its head during periods of market volatility. These discussions inevitably focus on investment style and returns, at the expense of another equally important factor, investment costs.

“Numerous studies show that expense ratio is one of the most reliable predictors of future after-fee performance, with low-cost funds delivering above-average performance relative to their broader peer group,” says Burns.

“This is not to say that investors should dismiss or reject the use of an actively managed investment strategy. A lower cost broadly diversified actively managed fund can be a better alternative to a higher cost index fund. As always, we urge investors to watch their investment costs, because returns erode as costs increase.”

Vanguard’s Burns also makes the point that it doesn’t have to be an either-or choice between the two investment styles of active and passive. “There is a role for both active and index funds in a portfolio and investors should view both styles as complementary components of an overall investment strategy and not look at either in isolation,” he says.