Active managers to shine in next decade: UBS

Jonathan Shapiro

Active fund managers are set to flourish over the next decade as ageing Western populations create a drag on stock market returns and increase volatility. That's the conclusion of UBS quantitative analysts that presented their research findings at a gathering of analysts and academics in Sydney on Thursday.

The broker's Asia Pacific head of quantitative analysis, Paul Winter, told the audience that given current stock market valuations, history suggested investors should expect returns of 3.1 per cent a year over the next 10 years.

"Our expectation for pure beta [the market index return] is well below par and in the world where beta won't deliver your required return from equities, you really have no choice but to go active," he said.

Three long-term measures of the broader stock market's valuation – the Shiller price-to-earnings ratio, the Tobin's Q ratio and Warren Buffett's favourite measure, stock market capitalisation to national income – had a consistent message.

"They are telling you the market is sitting at elevated values," Mr Winter said.

That historically meant a sustained period of low stock market returns and increased volatility.

Mr Winter said that above-average market returns in the 30 years heading into the global financial crisis – from 1980 to 2007 – were largely a function of demographics as baby boomers fuelled a period of economic prosperity, but also abundant capital that resulted in lower interest rates.

"The combination of demographics and falling interest rates drove those phenomenal returns and that has conditioned investor expectations about what to expect in the future," he said.

But the outlook for stock market returns will look different when baby boomers retire and he's forecasting a period of higher volatility as a result.

"They will take with them their labour, capital and productivity and leave us in a world with lower growth, and lower interest rates which can't provide any further benefit [because there is no room for interest rates to fall]," he said. Mr Winter also pointed out that there was a strong relationship between short-term interest rates as measured by the Federal Funds Rate and the VIX, a market measure of volatility.

But there was a two-year lagged effect – which meant volatility only picked up two years after short-term rates increased.

This, he said, was a function of the increasing cost of capital for firms of varying degrees of quality coming into effect.

"Large high-quality companies may be able to finance for 30 years but smaller, lower quality ones can only finance on a one-year horizon. The median is actually four years."

"Given half the companies would have refinanced before today and half after the change in the cost of the capital, it [higher rates] will only have impacted half the market. So the average is two years."

The research Mr Winter presented also examined how the stock market had evolved from the 1950s "where long-only mutual fund investors kept the market efficient" to the present where various new players such as hedge funds and high-frequency traders account for a substantial share of trading.

"On a three-year view, 98 per cent of assets are priced based on the views of fundamental investors," he said. "The quants are there, but they are really ironing out … behavioural mispricings."

What batting averages say about funds management

Market minds

Chad Slater

Everyone loves a great performing fund, right? The data say they do – money consistently flows into funds that have recently performed well. They are showered with annual awards and often rated highly by the asset consultants who determine what goes into your superannuation portfolio.

But this week, I want to ask: how much is too much? More specifically, focusing on equity funds, what should one realistically expect from a "good" equity fund in terms of performance?

While there are many mathematical models that pull apart returns into components, there is another simple way to look at returns, irrespective of asset class. For a fund's return for a given period there is a hit rate, gain-to-loss ratio, and weighting. These are like using batting averages and strike rates from sport.

Firstly, one needs to consider the hit rate of the fund. This is the percentage of winners in stock picks. Within equity investing it's been shown that it is difficult to operate with a win rate much higher than 55 per cent through time. Perhaps why so many of the greats are also very humble!

The gain-to-loss ratio is intrinsically linked to the hit rate. This is how much money is made from the winners compared to what is lost on the losers. Think of them as two sides of the same coin. Why? Because a high hit rate often indicates a low gain-to-loss ratio and vice versa.

Selling insurance is a good example to illustrate this. An insurance company could have six years of no disasters, so it's very profitable. Then in one year, three hurricanes hit and wipe out seven years of profit. This shows a high hit rate (6/7 years profitable) but a very poor gain-to-loss ratio. The point here is that a high hit rate doesn't tell you much without knowing the gain-to-loss ratios.

In mainstream equity investing, to outperform the index by 15 per cent to 20 per cent per annum, on average, for winning positions would be considered significant (if the market goes up 6 per cent to 8 per cent on average, it implies that your average winning stocks are up 20 per cent to 30 per cent in absolute terms). Conversely, let's assume on losing ideas the losses are identified early through good risk management and kept to a minimal 15 per cent.

The last input is weighting or position sizing. Generally, funds have more money in their higher conviction investments, the theory being to put the most money in the most likely winners they identified. An alternate strategy is equal-weighted portfolios, which have gained popularity over the last few years and consist in setting all positions to the same size.

Now we can have a go at putting these three variables together. The table shows what a "good" fund could expect. For simplicity, I use an equal-weighted fund here. Take the hit rate, multiply it by the expected pay-off (alpha per winner/loser) and by weighting.

I'm guessing you didn't think it would be that low (and this is pre-fees). Note that changing stock numbers doesn't change the outcome. To change the outcome you need to increase the hit rate or the skew (make more on winners than losers) and that shows why concentrated funds are not a panacea unless it improves a manager's hit rate.

One way to cross-check these numbers is to look at equity market neutral funds (EMN). These are funds that take out the market exposure to leave pure alpha. The return for the US EMN industry averages out around 3.5 per cent per annum (and this includes leverage).

My simple study above has been done on a much larger scale by O'Shaughnessy Asset Management in the US on real managers, as these three variables are easily analysed. What is interesting is that the weakest area for managers is weighting. Fund managers really aren't great at knowing what their high-conviction calls should be. For readers, this implies that if the pros aren't good at it with all their resources, then readers should consider just equally weighting their own stock portfolio.

"Hang on," you say, "I've seen lots of funds do better than those numbers you quote above." The answer is that it isn't alpha in the stock sense. To quote a cynical colleague, "most alpha ain't nothing but basis and leverage".

What they mean is that there are things apart from stock picking leading to a non-apples to apples comparison. It could be using a benchmark that is wrong – for example, a growth investor who only buys growth stocks but compares to a regular benchmark (known as basis risk). Or it could be using highly volatile stocks that create a hidden form of leverage. On the positive side, it could be the use of cash to protect the downside in falling markets. This is one of the tools we use at Morphic to enhance returns on top of stock picking.

So the next time you read about some great stock-picking performance, a dose of scepticism may help. This is not to say there can't be outperformance – just beware of fundies bearing (lots of) alpha.

Chad Slater is the joint chief investment officer of Morphic Asset Management.

Scoreboard

Theoretical alpha calculator

	Base case "very good" theoretical fund	Whats needed for "Buffett"
Funds under management	100%	100%
Number of stocks	50	50
Stock weighting	2%	2%
Hit rate	55%	60%
Loss rate	45%	40%
Alpha for winners (excess return)	20%	25%
Alpha for losers	-15%	-15%
Number of winning stocks	28	30
Winners Alpha	11%	15%
Number of losing stocks	23	20
Losers Alpha	-7%	-6%
Total alpha pre fees	4.3%	9.0%

SOURCE: MORPHIC

It is difficult to operate with a win rate much higher than 55 per cent.

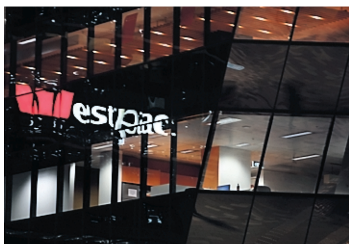
Westpac defends discount mortgages

Jessica Gardner

Westpac has rejected criticism that a cut price mortgage product on offer to new customers is an example of an aggressive pursuit of market share that the Productivity Commission said penalised loyal, existing bank customers.

The Australian Financial Review reported on Wednesday that Westpac was offering loans to new borrowers that lock in a discount of 80 basis points, against the standard variable rate, for the life of the loan.

The offer is for Westpac's most basic home loan product that excludes some features that many customers demand such as mortgage offset accounts. The offer replaces the existing two-year introductory discounts with a life of loan discount for principal and interest and interest-only borrowers.



The Westpac offer to new borrowers locks in a discount of 80 basis points.

A 14 basis point lift in Westpac's standard variable rate also came into effect on Wednesday (and was also applied to the basic product).

In August the Productivity Commission's report into bank competition chastised lenders for exploiting customers' loyalty and made special mention of the banks offering discounted rates to new mortgage borrowers to chase market share.

A Westpac spokesman on Thursday emphasised that the basic mortgage product was not a new attempt to pursue market share.

"The basic mortgage … has always been a cheaper alternative than many other mortgage products as it does not include features such as offset accounts," he said in a statement.

"What we have done for the Westpac Basic mortgage is remove the two year introductory rate for new customers.

"As a result of the changes announced yesterday [Wednesday] a Westpac Basic mortgage customer (owner occupier, principal and interest) applying today will now get a variable rate of 3.98 per cent per annum.

"There is no two-year introductory rate. We believe this is more transparent and gives customers more certainty."

Australian Government
Department of Infrastructure, Regional Development and Cities

Seeking biodiversity credits for Western Sydney Airport

Expressions of Interest are sought by the Department of Infrastructure, Regional Development and Cities (Infrastructure) from vendors of biodiversity credits to form part of a package of measures to offset the biodiversity impacts of construction of Stage 1 of the Western Sydney Airport. This package is funded by the Australian Government.

Credits are required for plant communities and species associated with Cumberland Plain Woodland. The volume of offsets has been calculated using the BioBanking Assessment Methodology (BBAM) under the *Threatened Species Conservation Act 1995* (NSW) (from August 2017, repealed and replaced by the *Biodiversity Conservation Act 2017*).

Expressions of Interest close at 5PM (AEDT) on **Tuesday, 16 October 2018**.

Following expression of interests, a formal procurement process is expected to be undertaken with the following indicative timetable:

Tender documentation issued to relevant vendors on **Friday, 26 October 2018**.

Tenders submitted to Infrastructure by **Tuesday, 20 November 2018**.

Credit purchases from successful vendors settled between **December 2018** and **May 2019**.

Find out more:
www.westernsydneyairport.gov.au/offsets

00694

www.infrastructure.gov.au