

If you follow the sharemarket or invest in a managed fund you may be aware of the two broad types of investment approaches employed by fund managers – index management and active management.

How are indices used?

An index is used to measure the performance of a market, and there is an index to measure the performance of most asset classes. An example of an Australian share index is the S&P/ASX 300 Index which is made up of around 300 Australian stocks and measures the change in value of those stocks over a specified period of time.

Indices can also be used to measure the performance of managed funds. A managed fund pools investors' money and invests in a selection of securities. A fund manager chooses an index for their fund as a 'benchmark' or performance standard based on how closely the index matches the market from which they select securities. For example, Perpetual uses the S&P/ASX 300 Accumulation Index to measure the performance of several of its Australian share funds.

A fund manager may employ one of two methods of choosing the securities in its portfolio relative to its benchmark – index or active.

What is the difference between index management and active management?

An index fund manager builds a portfolio that typically buys and holds securities to match the proportional weightings of their benchmark. By doing this, index managers aim to equal the performance, on average, of a financial market or index before fees are taken into account. Supporters of index investing believe that fund managers will not be able to exploit mispricings in the market for a reasonable cost and should simply copy the index.

In contrast, active fund managers don't aim to imitate their benchmark. For example, an active manager may hold 15% of their portfolio in BHP Billiton shares when the stock accounts for only 10% of the index. In this situation, the fund manager will be 5% overweight BHP Billiton. Or they could have a smaller weighting in BHP Billiton (say 5% of their portfolio) and have an underweight exposure to the company. Or they may not hold all the stocks in the index.



Can active management add value?

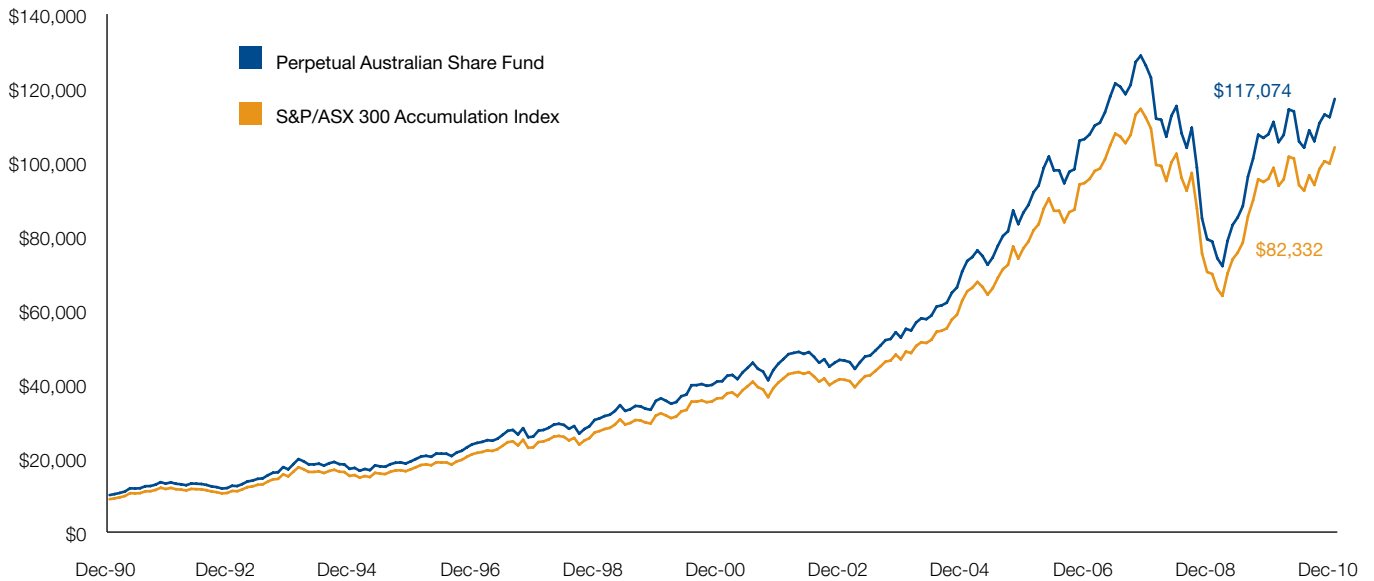
Supporters of active investing believe that it's possible to consistently identify enough high-performing investments to achieve better-than-average investment returns over the long term.

This can be tested by comparing the returns from actively managed portfolios to the market return over the long term. Chart 1 over the page shows the performance of the Perpetual Australian Share Fund, an actively managed fund which invests in quality industrial and resource companies, compared to its benchmark, the S&P/ASX 300 Accumulation Index, after fees. Over a 20 year period the actively managed fund clearly outperformed its benchmark even after fees are taken into account. This shows that quality active managers are able to outperform their benchmark over the long term.

Risk and return

To achieve a higher return it's sometimes necessary to accept a higher level of investment risk. Actively managed funds risk underperforming index funds in order to generate higher returns. This is known as active risk, which means that the investment performance of active managers will vary more, relative to an index, than the investment performance of index managers.

Chart 1 – Performance of an active manager compared to its benchmark over a 20 year period



Source: Perpetual. As at 31 December 2010.

- 1 Total returns shown for the Perpetual Australian Share Fund have been calculated using exit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.
- 2 Prior to 31/3/2000 this Fund's Index was the ASX All Ordinaries Accumulation Index.

Since an index manager aims to match the securities in its portfolio to its benchmark, it naturally will have a lower level of active risk than an active manager who may not closely follow the security weightings of its benchmark.

Taxation is also an issue that should be considered when comparing index and active funds. Active managers buy and sell securities to take advantage of mispricings in the market. The turnover of securities within their portfolios is therefore often higher than index funds. This can trigger capital gains that are then passed on to investors. However, the impact will vary for each individual investor and they may be able to offset these gains elsewhere.

It is, however, important to note that index investing is not completely without risk.

The main risk of index management lies in the momentum of the market. An index manager will have the same exposure to securities as the market (according to its benchmark). This can be good in a rising market when those securities are increasing in price. However, when market prices increase to unsustainable levels, index managers are forced to expose their investors to over-valued securities, whereas an active manager can easily avoid them.

An example of this was the tech boom in 2000. During this period the weighting of the technology, media and telecommunications sectors in the US S&P 500 Index doubled over the five years to early 2000 to 36%. In the wake of this dramatic and unsustainable rise, index managers were forced to increase their exposure to highly overvalued sectors at the wrong point of the cycle. When prices fell, the index managers were forced to sell securities in order to replicate their benchmarks. Their investors experienced large capital losses in the subsequent tech wreck. Active managers who recognised the high valuation of these stocks (many of which had never made profits) lowered their exposure to these stocks when valuations were too high and potentially avoided the ensuing capital losses.

Another risk is that an index manager needs to buy all the securities in its benchmark, even lower quality securities that are likely to perform poorly. An active manager can easily avoid them.

Clearly active and index investing both carry risks, which need to be carefully considered before investing in any managed fund.

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Further information

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au