Perpetual

Active management II – Research paper

Active to the core

February 2011

The global financial crisis (GFC) re-ignited the industry debate about active versus passive investing. In his second of two papers, Matthew Sherwood, Head of Investment Markets Research, demonstrates that while buying the index helps mitigate manager-selection risk, it also inadvertently sacrifices the key attributes of what a core portfolio should represent.

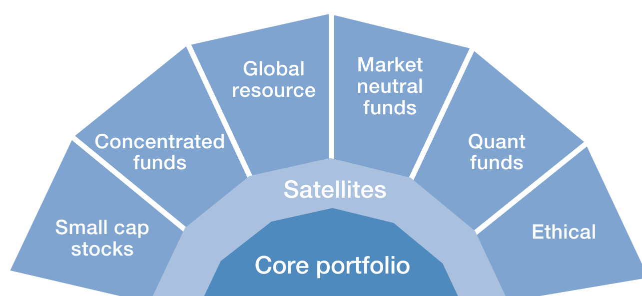
What is the core/satellite approach?

The core/satellite approach simply splits a portfolio into two parts – a lower risk 'core' portfolio and a higher-risk, higher-return 'satellite' component. The approach has become popular because it has the potential to reduce portfolio volatility and enhance return.

The core portion of the portfolio would ideally be comprised of assets with a stable and reliable performance history that are held for a long time. These assets should align with an investor's major financial goals, such as regular income or long-term capital growth.

The satellite portion should be comprised of holdings expected to significantly outperform the core portfolio, but with higher risk and volatility. This may involve more concentrated portfolios or exposure to specialist areas such as global resources, small caps, socially responsible and emerging markets (see Chart 1).

Chart 1: The Core/satellite investment approach



Source: Perpetual Investments, as at February 2011.

What should the core deliver?

The core is the most important part of an investor's portfolio and needs to be strong, reliable and able to absorb shocks. It is what investors must be able to rely on for sustainable long-term performance. The core has two primary functions:

▶ Reduce portfolio risk

The core portfolio should be uncompromising in its strength to reduce overall portfolio risk and provide protection in times of prolonged market turbulence. Its objective should be to outperform the satellite component and protect capital during these times.

▶ Deliver the equity risk premium

The focus in every portfolio should be potential return versus the risk. The return of shares in excess of the risk-free interest rate, known as the equity risk-premium, is the extra reward for the risk undertaken. The core portfolio should deliver this premium to investors for an acceptable level of risk, but it is most valuable when markets are stressed because it is protecting capital.

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What stocks should make up the core portfolio?

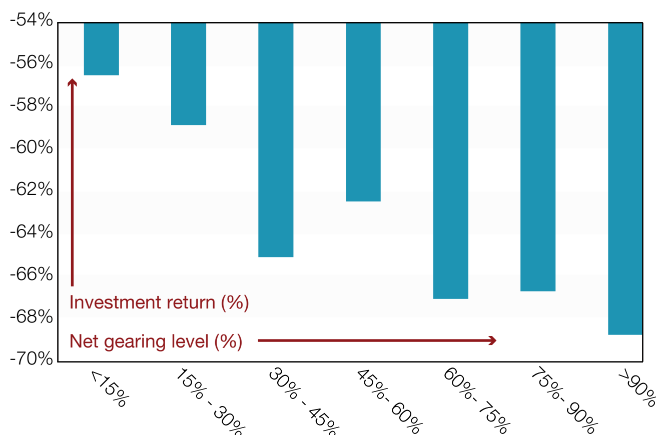
For the core portfolio, investors should invest in companies that can deliver stable investment performance with relatively low volatility. There are three characteristics which, in nearly all international sharemarkets throughout history, have consistently underpinned strong risk-adjusted long-term returns.

1. Strong balance sheet

The biggest share losses in turbulent markets have come from companies with weak balance sheets, such as Bond Corporation, ABC Learning and Allco Finance. Scrutinising a firm's balance sheet is the easiest and perhaps the best form of risk management, for example companies with low debt to equity ratios have more control of their own destiny and, during the recent GFC, outperformed their highly-geared peers (see Chart 2).

Chart 2: Companies with high gearing underperform in market turbulence

Gearing and investment return: Australian sharemarket November 07 to March 09



Source: UBS Australia Limited as at February 2011.

By investing in every company in the index, an investor is effectively saying that debt and balance sheets don't matter and that weak, highly-geared companies deserve to be in their core, as much as strong, lowly-geared companies. However, market performance in difficult times indicates this has never been the case. Having a strong balance sheet means that a company is in a much better position to weather a cyclical downturn without suffering financial distress.

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2. Attractive valuations - the index is backward-looking

Valuations should be a key determinant of every stock in a portfolio. Investors would want to invest in a company because its valuation is more attractive, not because its market valuation has increased and therefore constitutes a higher share of the benchmark index. Unsustainable increases in valuations are dangerous for investors as was seen in the 'Tech Wreck' in 2000/02 and Australia's mining boom between 2006 and 2008.

These are examples of when share prices simply rose too much. Actively managed portfolios periodically rebalance to mitigate this risk but buying the index has the opposite effect. As stock prices rise and a company becomes more and more expensive, its weighting in an index portfolio will increase. Similarly, prices can decline too much during market turbulence and this may represent an excellent buying opportunity. During these times it is important for investors to understand the difference between a stock's price and its value (relative to its earnings). Warren Buffet sums it up as 'price is what you pay and value is what you get'.

History has demonstrated that expensively-valued stocks eventually respond to their earnings capability, and therefore every stock should be managed for valuation risk.

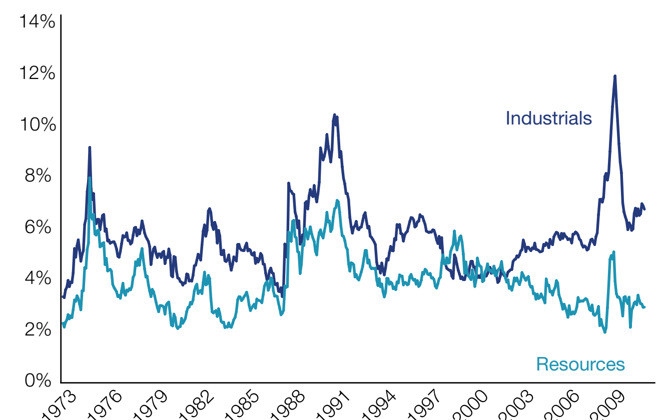
3. Firms with sustainable earnings and dividend growth

Firms typically need to produce surplus cash flow (or earnings) to pay dividends. Since 1882, the Australian sharemarket has averaged an annual total return of 12% and around half of that has come from its annual dividend yield. Although the contribution of dividends to 20 year average total return fell to a low of 26% in September 1997, in the wake of the GFC it has subsequently rebounded to around 35%.

Given that resources are capital-intensive industries, a large portion of profits fund future investments, whereas the majority of industrial shares are serviced-based companies which are less capital intensive. As a result, industrial shares have nearly always paid a higher dividend yield than resource companies (see Chart 3).

Chart 3: Dividends are likely to contribute more to total return

Dividend yield: industrials vs resources (adjusted for franking credits)



Source: Datastream as at 31 January 2011.

In the next decade, governments and households in advanced economies with large budget imbalances will need to reduce their debt to deal with their ageing populations. This is likely to dampen the pace of global economic growth and reduce sharemarket returns. In a lower return environment, risk in portfolios will need to be lower to ensure the lower returns provide adequate compensation. This means dividends are likely to make a larger contribution to total return than in the past 20 years.

The average listed company will find it more challenging to continually increase dividends when top-line revenue growth is more subdued. This means investors will need to ensure that the core portfolio has a large exposure to dividend-paying companies as they typically provide capital stability and greater predictability of returns. In contrast, investing in the index would mean that investors are saying they don't think dividends and earnings matter, even though this is the ultimate driver of share prices and investment returns.

Constructing a superior core portfolio

As the core portfolio is all about investment stability and returns, it should be constructed with the most resilient investments. Buying the index may enable investors to mitigate manager-selection risk, but in the process it ignores all fundamental risks (such as balance sheet, earnings and valuation risk) and by doing so inadvertently sacrifices the key attributes of what a core portfolio should represent.

In contrast, investments chosen on the basis of valuation, balance sheet and earnings/dividend risk should reduce risk and therefore deliver superior returns relative to the index over the long term.

To demonstrate this point we have used Perpetual's Wholesale Industrial Share Fund as the core portfolio – given its focus on balance sheet strength, recurring earnings and companies with solid operating models, and combined this fund with high alpha satellites.

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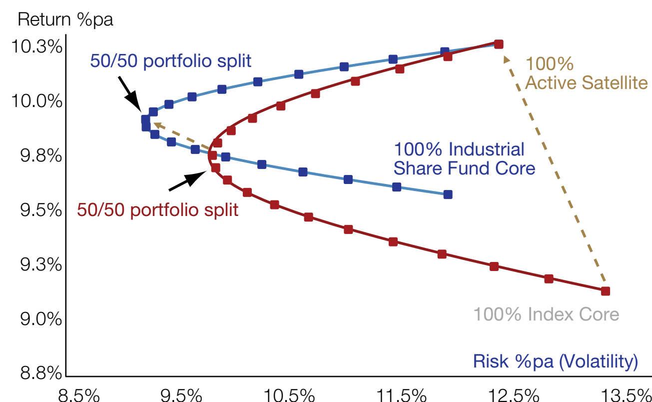
Returns since end-1993 indicate that a portfolio with 50% exposure to attractively valued quality industrial companies and 50% exposure to other actively managed Australian share funds (as represented by the average active Australian share fund) has provided investors with a portfolio with a higher return (of 9.5% pa after fees between December 1993 and December 2010) and lower risk (a standard deviation of 11.9% pa).

In contrast, an index-based core with the identical satellite funds have produced a lower return (of 9.0% after fees pa) and higher risk (13.3% pa – see Chart 4).

Chart 4: An industrial core and high alpha satellites boosts return and lowers risk

Efficient frontier: active vs index core portfolio



Source: Perpetual Investments. Original data is from the Mercer Consulting Survey of Retail Australian Share Fund after fees, as at December 2010.

Example

The impact of the choice of core can have a sizable impact of the final retirement nest egg of all Australians. A 25-year old with a $10,000 initial investment, who earns $70,000 per annum (growing at 6% per annum) and splits their portfolio 50%/50% between the core and satellite components, would have a nest egg at retirement worth an extra $0.5 million with industrial shares as the core portfolio relative to the Index (see Table 1). Similarly, the difference for a 35-year old accumulator is slightly under $300,000 and a 45-year old mass affluent the difference is around $200,000. All this is achieved with lower volatility along the way.

Table 1 – Long-term impact on portfolio nest-eggs is quite large (after fees)

	Investor's age		
Data	**25 years old**	**35 years old**	**45 years old**
Investment duration	42 years	32 years	22 years
Initial investment	$10,000	$100,000	$400,000
Salary	$70,000	$140,000	$200,000
Salary growth	6%	6%	6%
Industrial core/ alpha satellite	$9.9 million	$6.7 million	$5.3 million
Index core/ alpha satellite	$9.4 million	$6.4 million	$5.1 million
Difference	$0.5 million	$0.3 million	$0.2 million

The results in this table are based on historic returns between December 1993 and December 2010. Source: Perpetual Investments as at February 2011. Past performance is not indicative of future performance.

Long-term performance is a good indicator of a fund manager's skill

When investors construct their core portfolio, they need to select managers who pay significant attention to risk management (balance sheet, valuations and earnings/dividends) in their process, have a philosophy of long-term prudent investing and returns that are indicative of successful investing. Investors also need to understand that active managers, in carrying out their trade, will endure some periods of underperformance – this is inevitable as investing is a patience game.

What this means for investors

The choice of core can have a substantial impact on the final retirement nest egg of all Australians.

Beyond the evidence, perhaps advisers should ask which approach best passes the 'client sleep well test'?

Would they rather put their faith in the overall fortunes of the market with a lack of focus on risk or know that their investments are being carefully researched and selected for their quality and value.

Perpetual's investment philosophy

Perpetual is an active fund manager. Our disciplined approach of focusing on quality companies at attractive prices gives our investors the best chance of achieving consistent returns and dividends over the long term, and peace of mind that these companies will survive even in the most difficult of times.

Our investment philosophy is based on the premise that:

- the index is not an efficient portfolio
- opportunities for adding value exist through stock selection
- investing in quality companies minimises downside risk
- outperformance can be achieved through the selection of stocks trading at a discount to their inherent value
- these can be identified through thorough in-house fundamental research.

In summary:

- Quality comes first. We add a lot of value by not investing in certain stocks.
- Our portfolio is value biased. This is an output of our stock selection process.
- Monitoring and accountability is important, so that we know where value is being added or lost.

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