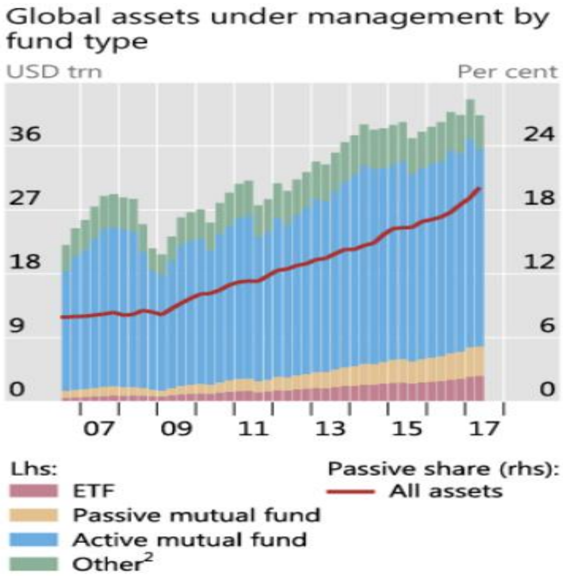
Active Management: Hold Your Proposition

Active fund managers had a year to forget in 2018. Investment returns relative to passive benchmarks generally suffered as investors fearing risk-off sentiment, continued to pile into high priced quality stocks and away from companies that would benefit from a coordinated global growth scenario. A mounting pile of global debt and trade-wars also weighed heavily on investors risk appetite. The potential for a slowdown in growth changed the US Fed's rhetoric to less interest rate hikes in 2019 (potentially no hikes). This led to a focus on large market cap, liquidity and paying even more for quality.



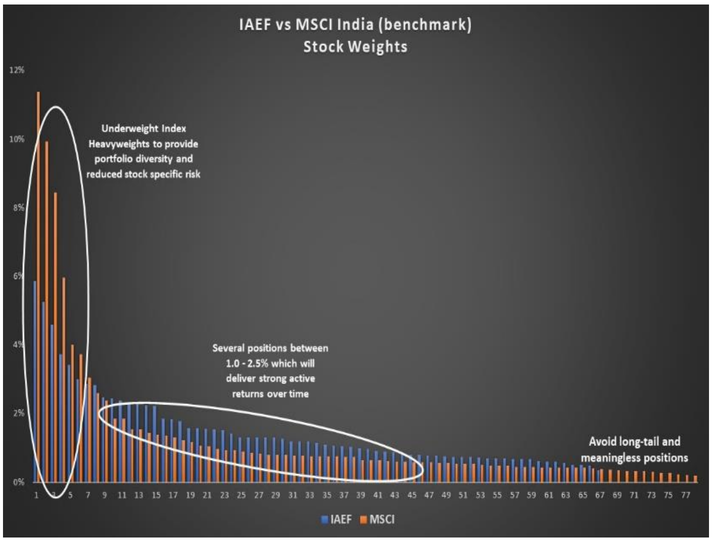
Source: Lipper, BIS Quarterly, March 2018 Vladyslav Sushko/Grant Turner

Holding cash balances and focusing on value as a style bias, offering a margin of safety, offered little protection as those who continued to allocate to equity as part of their asset allocation focused on liquid, large cap, quality companies regardless of valuation. Most of this allocation was driven by rising passive or ETF strategies which over the last 10 years have increased at a significant rate (approximately 10% to 20%).

The drivers of this shift over the last 10 years has been reducing cost of investment portfolios and less business risk against conventionally accepted norms to measure benchmark performance. The concept has become a self-fulfilling prophecy either through a shift to passive implementation or by closet indexing to reduce risk of underperformance

However, the construction of benchmarks is a reason for significant discussions around the virtues of active and passive management. As a stock selector or portfolio constructor, you pay little heed to the market capitalization of a company as a guide if it will be successful or not. At some point in the business cycle it pays to be large and benefit from scale economics, whilst at other points being small and unburdened with significant infrastructure and legacy is more optimal. Yet benchmark indices are generally constructed with a bias to market capitalization.

Active managers are not stupid for holding their fire when it comes to their proposition. They are being paid to build a balanced portfolio which considers investment risks as opposed to the listed market capitalization of a company. The virtues of this are hard to measure unless longer horizons are considered for evaluation periods (5-7 years plus). Over time investors respect fundamentals of a company, which highlights why market leading companies at the top of the Index tree change shape every 10 years or so. Ten years ago, the Top 10 of the S&P500 included Exxon and Chevron in its top 10. Also big were Pepsi, Coke, Phillip Morris, Intel, Cisco and IBM. Additionally, Apple was a US$124bn company then, now standing at close to US$1tn. Index weights changes with structural evolution in markets.



When we look at our portfolio (India Avenue Equity Fund), we can see the structure of portfolio weights are significantly different to the construct of the MSCI India Index. This Index has some large weights i.e. the top 6 stocks by market cap comprise 43.5% of the weight. These large-cap companies are significantly covered by stockbroking research. There is less opportunity to profit from market inefficiency. Additionally, the likelihood of being overweight a stock with 5-10% weight in is low, given the desire for stock specific diversification.

Note the spread of stock weights roughly between 1-6%, which is more typical of a diversified portfolio and pays little or no heed to the weightings of a market-cap weighted benchmark, but looks more at investment disciplines such as diversification, valuation, growth and quality.

No, we aren't just writing this because our alpha has been poor over the last 13 months. It's to reinforce that our proposition remains the same. This is to deliver to Australian and NZ clients an exposure to India's fast-growing economy by providing investment returns which far exceed the performance of market cap benchmarks over longer-term periods.

In our view when it comes to investing in a market like India, it makes more sense to seek companies which are largely undiscovered given their propensity to re-rate upon recognition of their opportunity. Broker coverage largely extends to the top 150 stocks by market capitalization. Local asset managers seem to have achieved better results than the benchmarks they measure themselves against through insightful primary research which involves knowing their market, understanding the nuances of local founders (who own 40% of listed market cap), local networks and their microeconomics. Over time their capability to outperform market cap benchmarks is about 4-5% per annum (after fees)[1].

Investing in a location like India, from a foreign domicile is likely to result in a "forced" large cap focus, guided by global broker reports and basic management meetings, without perhaps understanding the intricate cultural nuances that drive management thinking, the market players or their level of rationalization in business strategy or the grassroots impacts of Government initiatives.

[1] India Avenue Research (rolling one-year outperformance of diversified cap funds from 2000-2018)