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Trust takes a nosedive

By Martin Roth
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Active fund managers charge handsomely for their efforts but often don't deliver.

The global financial crisis has sparked an enhanced appreciation of the attractions of low-cost index funds, with some investors wondering why they should pay high fees to active fund managers who seem unable to protect them from a crashing market.

A survey from the Investment Trends research house, released in September, found 54 per cent of the investors questioned no longer trusted their fund managers. In November last year, Investment Trends found a rising trend among financial planners towards index funds and direct investing.

At the same time, investors are steadily coming to recognise the benefits of the fast-growing number of exchange-traded funds, which replicate indices and are traded on the stock exchange like shares.

However, at a time when there is concern global sharemarkets may be running ahead of themselves, some experts caution that index funds have inherent drawbacks that could limit the returns investors can expect.

Investors moving into index funds point especially to their low fees and to the notion that so few active fund managers seem able to beat the indices consistently over a lengthy period of time.

The Australia and New Zealand director for ETF Securities, Nigel Phelan, suggests other attractions: “You are getting diversification – you are essentially buying the market.

"The other thing is that they are extremely transparent.”

What about the other key attraction of index funds, their low fees?

Marcus Padley, author of the book Stockmarket Secrets and the Marcus Today stockmarket newsletter, argues: “When your competitive edge is to be able to charge 0.5 per cent instead of 1.5 per cent, you are talking about 1 per cent. The truth of the matter is one day in a direct investor's life can negate that. You could drop that amount on the horses on a Saturday.”

He says a particular weakness of index fund investing is that it entails buying not only the good stocks but the bad ones.

“A fund manager is able to add a lot of value by excluding the bad stocks,” he suggests. “Sometimes that can actually be easier than picking the good stocks.” Against this, the head of the global structured products group at State Street Global Advisors, Susan Darroch, argues that, historically, it has not always been obvious that certain stocks are going to become bad.

“It is true that you will get the good and the bad,” she adds. “But at least with an index fund you are not going to miss out on the run that the good stock has, because you will hold it.”

Opponents of index funds point to another perceived defect – that the local market is quite narrow in its focus.

According to the editorial and communications manager at Morningstar Australasia, Phillip Gray: “A downside of indexing is that you get exactly what the market is. So if the market is skewed in favour of one particular sector, you will get that market skew in your investment.

"If you invest with an active manager you are more likely to get exposure to sectors in differing proportions to their market weightings."

Thus, investors buying a fund replicating the benchmark S&P/ASX 200 index would, in late September, have had about 58 per cent of their money in just two sectors: financials (excluding property trusts) and materials. The four major banks comprised almost a quarter of the index. BHP Billiton alone represented nearly 12 per cent.

By contrast, in the US, the two largest sectors in the benchmark S&P 500 index, information technology and financials, represented less than a third of the index. The single largest stock, ExxonMobil, was 3.6 per cent.

“When BHP goes up, well, guess what, so does the index,” says the chief executive officer at fund management and market data firm Lincoln Indicators, Elio D'Amato. “And when the global financial crisis was happening all around us, were the banks the stocks you wanted to be in? Wouldn't you rather have had a lot of your money in defensive stocks like Woolworths and CSL?

"This is where the active manager adds value: by positioning the money where it needs to be.”

However, Darroch argues that even active fund managers typically operate under mandates with many constraints. They can be limited in how far they are able to stray from the sectoral breakdown of their particular benchmark.

So perhaps the debate need not be about the respective qualities of active and passive investing – each clearly presents strengths and weaknesses – but how to employ both.

This is the position of the head of retail at Vanguard Investments Australia, Robin Bowerman, who argues that investing in funds means taking on a combination of risk – the risk of buying the wrong shares, of choosing the wrong fund manager and of buying in the wrong market.

“Take the first two off the table by buying a particular market through an index fund,” he says.

“Then, when you have locked in your market return, you can tilt the portfolio by adding elements where you have a lot of confidence that there is going to be some strong performance.

“This debate gets a bit hung up on index versus active. To me the real debate is about what is the right blend of index and active.”

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