Deliver or don’t get paid

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Fund managers who fail to outperform the broad sharemarket are expected to find it increasingly difficult to keep clients and justify their often expensive fees.

Aviva’s Craig Bingham. **Photo: Luis Enrique Ascui**

Sentiment towards fund managers is on the rise after a couple of difficult years. But investors no longer take a fund manager’s claims about its prowess at face value, monitoring strategy and returns more closely.

The 11th Morningstar Fund Manager of the Year awards, announced on Friday night, celebrate those firms that excelled not just in 2010 but over time. The results, exclusive to the *Weekend Financial Review* , highlight the skills required to deliver consistent returns to investors who rely on professionals to manage their money.

The overall winner, for the first time in its history, is Aviva Investors. Craig Bingham, chief executive of the Melbourne-based company, says this year is a turning point for the industry.

“There is going to be a much more discerning clientele … saying you have to deliver in order to get paid – and what you get paid should be fair and reasonable,” he says.

He acknowledges the industry has not delivered on promises, which has inevitably led clients to question how they can efficiently use fund managers – and which ones will get their money.

But many say investor trust is improving. “We’ve found some improvement in investors’ trust of fund managers, [but they are] still much less confident than before the global financial crisis hit,” says Recep Peker, analyst at research house Investment Trends.

A survey by Investment Trends found that in June 2010, 42 per cent of active investors disagreed with the statement “I no longer trust fund managers and will invest directly in the future”.

This is better than the 39 per cent recorded in July 2009 and the 34 per cent in November 2008.

Market conditions played a large part in the fortunes of fund managers in the past year. For the Australian stockmarket, it was a fairytale run for the resources sector, particularly among many smaller companies, thanks to burgeoning commodity prices.

The result of this was obvious in the list of finalists for the Morningstar awards. Share managers well weighted in resources, particularly the second-tier companies, tended to outperform their peers.

Most Australian share managers struggled to beat the broad market as they focused on companies with a strong financial pulse and a good history of profitability, which made it hard for them to get ahead of the index, says iPac Securities chief investment officer Jeff Rogers.

“Many of the smaller companies don’t make profits so it is much harder for managers to make forecasts and invest in them. Unless fund managers were well weighted in resources last year it was hard to keep up with the index,” he says.

According to investment consultancy Mercer, the median manager underperformed the S&P/ASX 300 Index by 0.6 per cent in 2010 – after beating it by 1.9 per cent the previous year. This compares with by 1.4 per cent outperformance in the longer term, before fees.

If there is some good news for those managers who invest more in major industrial stocks than small miners, it is that markets are cyclical. “If an equity manager sticks to their disciplines, given we are seeing a turnaround in the sentiment of the trajectory of China and India and we do see commodity prices peaking, then the market might swing back to favouring industrials and that will be favourable for equity managers,” says Rogers.

It is the ability of fund managers to outperform the index – whether in Australian or international shares, listed

property or fixed interest – that makes investors prepared to wear a fee.

If funds don't outperform the broader market then investors may just as well invest in an index fund or an exchange-traded fund (index-based funds that can be bought and sold like ordinary shares on a stock exchange) sometimes for a fraction of the price of other funds.

Rogers says if all an equity manager is providing is broad diversification, without adding any value, and is charging a premium price for that, then index strategies and ETFs will steal business from that manager.

"More and more investors and advisers are understanding they can get diversification inexpensively through an ETF and we are seeing that rise in their usage," he says.

The market for ETFs has grown to about $4 billion in assets under management in the 10 years since the product was introduced to Australia. Russell Investments is expecting the ETF market to grow to more than $6 billion in assets under management in 2011, still a small sum compared with other investments, such as superannuation.

Aviva's Craig Bingham is not convinced that Australian investors will embrace ETFs with the same enthusiasm as some other countries.

"We don't think investors will jump in quickly without assessing their risk return and liquidity needs. They can see it is not always the best way," he says.

He also reckons investors' reaction to fund costs and performance are more likely to result in a fundamental shift in the platform space – where investments are managed under one account or fund.

Bingham says products such as the separately managed accounts – where investments are held in individual clients' names – offer better cost- and tax-effective alternatives than ETFs.

Rogers says fund managers can win back disenchanted clients through building portfolios specifically aimed at meeting the unique position of individuals. For example, low turnover portfolios for people on a higher tax rate or income-oriented funds for people looking for income.

"Neither of these portfolios looks like the index," says Rogers.

Rogers says some managed funds may be forced to reduce their fees to better reflect the service they provide.

"Managers who have a reasonably diverse group of clients or a unique product will be able to hold their fee. Managers with a small number of clients would be under threat if they lost a big client," he says.

A principal consultant with advisory firm Godfrey Pembroke, Mike Ingham, says he is happy to pay fund managers for the prospect of superior performance.

"There are fund managers that do deliver superior performances but there are not that many of them. So let's not get carried away and pay fund managers for the sake of it," he says.

A lot of fund managers are peddling products that are not true to label, he says. Others only ever return the same as the market but charge a fee that suggests they will do better.

"The value-add of a fund manager is in bringing their expertise to the table in providing better than market index performance," says Ingham.

Ingham generally works on a core satellite approach to overcome some of the problems encountered with managed funds. An index fund or exchange-traded fund that covers the index would be the core investment, while fund managers with a high conviction style of investing would be added to give the potential of superior performance.

"A majority of investment returns come from exposure to the market rather than an investment manager, stockbroker or adviser picking a winner and trying to shoot the lights out," says Ingham.

Ingham says the consistent rise in do-it-yourself super funds, where members make their own investment decisions, illustrates disenchantment with professional money managers.

"Why would a DIY fund member invest in a managed fund unless they believed it would beat the market and do better than they can do themselves," he says.

Ingham says fund managers tend to tout their latest performance. "In reality, I would never look at performance

under five years and preferably over a decade," he says.

It is not easy to find a funds management team still managing the same fund after 10 years.

The Australian Financial Review

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