How active are Australian equity funds?

by Leah Kelly

Active managers tend to be lumped together against their obvious counterparts – passive managers. S&P for example, provides an annual update on the performance of the average active manager (usually they report that the average manager disappoints). However, not all active managers are the same – clearly. And some do add value, the difficulty is finding them when there are so many active managers to compare.

Differentiating between active managers is not easy, mainly due to the issue surrounding data transparency. It is enough to say that looking at high-level performance numbers does not help you at all in identifying an active manager that is likely to perform. In previous articles, we have looked at fees – where our results back up results of other researchers – the lower the fee an active manager charges the more likely you are to benefit from excess returns. We have looked at whether a manager invests in their own fund and whether that helps identify if a fund is likely to outperform (it appears it does). In this article, we start looking at whether knowing how 'active' your active manager is helps identify whether or not they are likely to deliver excess returns. At the very least, we hope being able to understand the level of 'active' your active manager is delivering should help investors determine whether they are getting what they pay for.

How to judge the 'activeness' of your manager?

One metric that is often used is tracking error. Tracking error measures the variance in returns between an active manager and their benchmark. It is sometimes used to judge how active a fund is, that is, the higher the tracking error the more active the manager. However, this is not necessarily the case. A manager that has a value tilt for example, will show a high tracking error even if they aren't being particularly active in their stock selection.

An alternative measure is known as 'active share'. Active share looks at the weight of each stock in the fund and the weight of that stock in the benchmark and measures the absolute difference. More simply, it can be thought of as the percentage of a portfolio's positions that look different from those of its benchmark. It can range from 0%, a pure index strategy, to 100%, no shares in common with the benchmark.

Example of calculating active share

Say for example, a manager has a portfolio that consists of five stocks. And for simplicity we use an equal weighted benchmark of the 10 largest ASX-listed stocks. We calculate the absolute difference between the fund and the benchmark (column |B-A| in the table), sum the differences and then divide by two to get the active share.

Stock	(A) Weight of benchmark	(B) Weight of fund	IB-AI
AMP	10%		10%
ANZ	10%		10%
BHP	10%		10%
CBA	10%	15%	5%
CSL	10%		10%
IAG	10%	10%	0%
NAB	10%		10%
QBE	10%		10%
RIO	10%	30%	20%
WES	10%	25%	15%
AGL	0%	20%	20%
		Sum the differences	120%
	Divide by 2 to get the Active Share		60%

Source: Owners Advisory, February 2017

The active share of this fund is 60%. Put differently, 40% of the portfolio overlaps with the benchmark.

How do Australian funds measure up?

Large cap managers: In the large cap space, we examine 47 Australian large cap equity funds that varied in style and assets under management. Fund size varied from small, i.e. circa $500,000 to the large (greater than $3 billion). Active share was taken as calculated by Morningstar.

Small cap managers: For small caps, we consider funds defined by Morningstar to be Australian Equity Small or Mid Cap managers. We do not differentiate by style ie value or growth. Again, the funds vary by size from the small, approximately $3.5million to the large ($1.6billion). There are 27 funds included in the sample. Active share was again taken as calculated by Morningstar.

As at the end of 2016, the maximum active share in our sample of large cap managers was 85%. The minimum was an enhanced index fund with 8.1% active share. The median active share was 49%.

Active share at the end of 2016 – Large Cap Managers

	Minimum	1st Quartile	Median	3rd Quartile	Maximum
As at the End of 2016	8.10%	42%	49%	60%	85%

Source: Morningstar, Owners Advisory, February 2017

In an article by Kevin Ely of Cambridge Associates, a rule of thumb for determining whether a manager is "truly active" is that active share should be greater than 80%. Active share measures of less than 60%, according to Ely, identify "closet indexers". Now, these rules of thumb are based on US funds. It is worth noting that it is too early in our study of Australian equity managers to have rule of thumb but it is interesting that the median active share of 47 Australian equity funds is low at 49% as at the end of 2016. (Ely's rule of thumb was based on the fact that the median active share for US large cap managers was 80%). This is something that I will be exploring in greater detail in forthcoming work.

In the small cap space – the high level results are quite different.

Active share at the end of 2016 – Small Cap Managers

	Minimum	1st Quartile	Median	3rd Quartile	Maximum
As at the End of 2016	68%	79%	84%	88%	99%

Source: Morningstar, Owners Advisory, February 2017

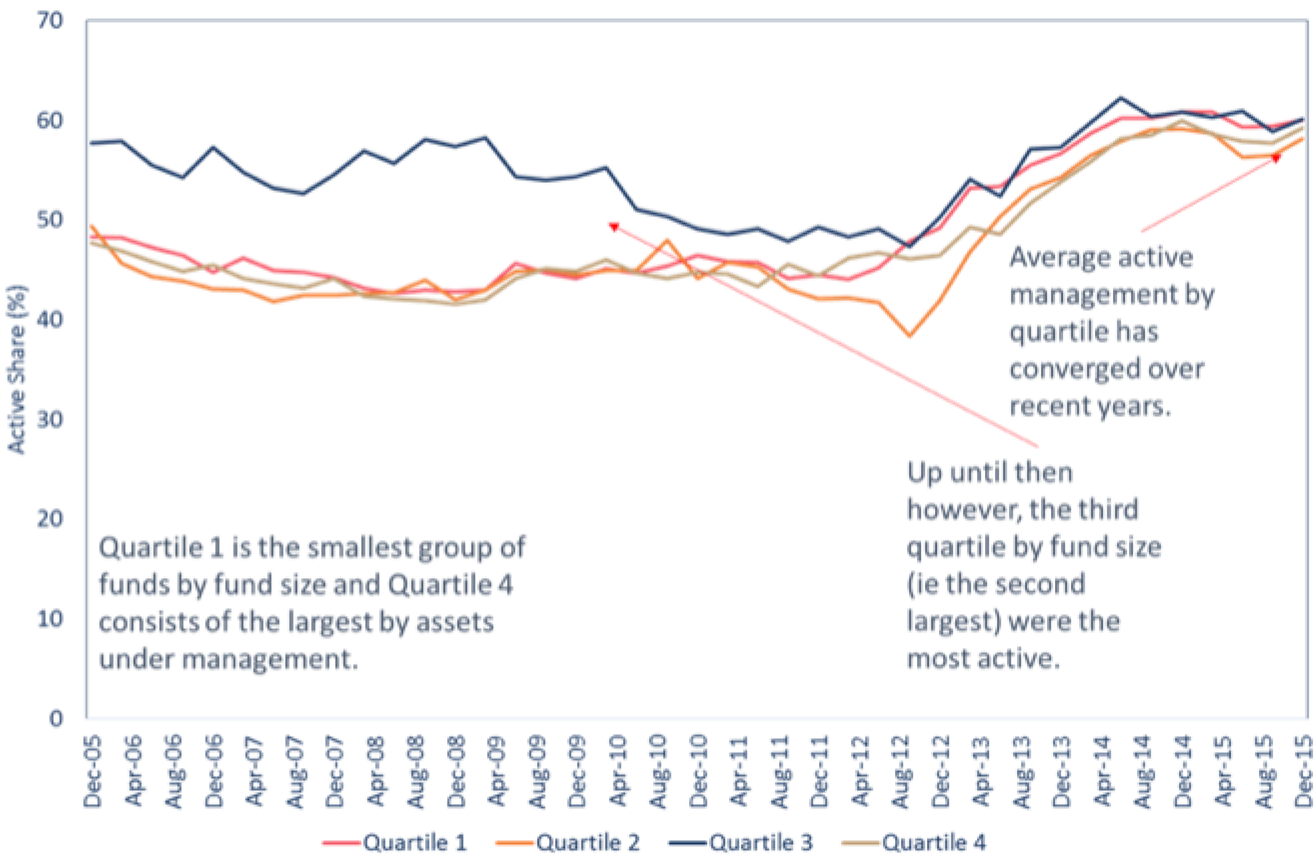
In general, small cap funds have a higher level of active share than their large cap counterparts. This may be explained by the fact that their universe is less concentrated. Where most large cap managers are benchmarked to the S&P/ASX 200 which is dominated by the big four banks and the two large miners, the S&P/ASX Small Ordinaries (the predominant benchmark of the small cap managers) currently consists of 199 companies where the average weight of an individual stock is around 0.50% - the maximum weight is currently to Oz Minerals (1.98%). So conceivably it is much easier to put on large positions that differ from the benchmark when the benchmark is not so concentrated.

Does fund size influence the level of 'active' in a fund?

Of interest was does the size of the fund matter with regards to how active a manager is? It is often said that bigger funds have less opportunity to add value for their investors because it is difficult for them to concentrate their positions due to the size of the fund.

To examine this, I divided the funds into quartiles based on their fund size as at the end of December 2016. Quartile 1 is the smallest group of funds by assets under management where Quartile 4 is the largest group of funds.

Active share has started to converge across fund size



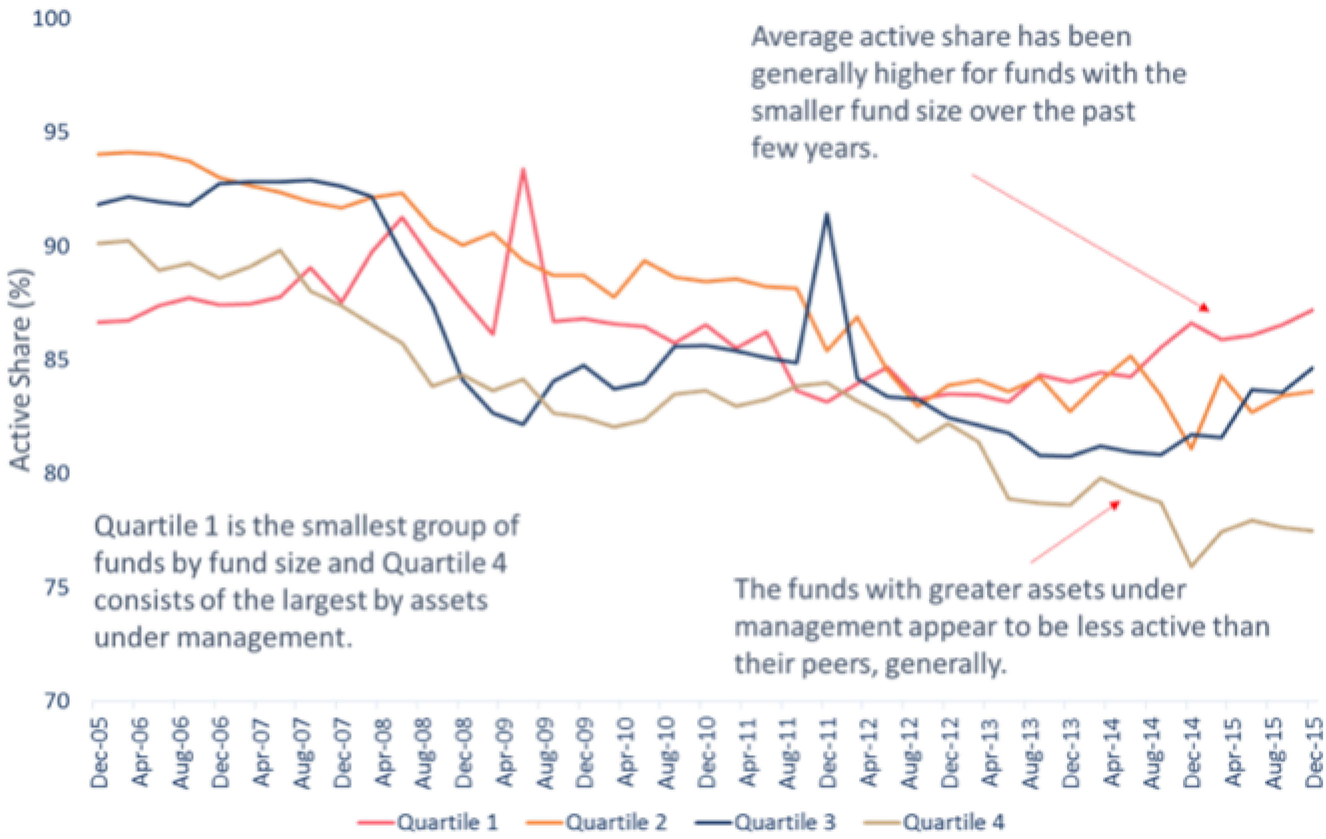
Source: Morningstar, Owners Advisory, February 2017

While there is some variation between fund size, it is barely noticeable by the end of 2015. Investors in large cap active funds can take heart – just because a fund is big, doesn't mean the fund is less active than its smaller peers.

However, in the small cap space – it does appear to make a difference to level of the active share in the funds. The argument is that in small cap funds, the size of the fund is even more important. This is simply because there is less liquidity in the market for smaller listed companies. In that regard it makes sense that we should expect to see a difference in the level of Active Share for smaller small cap funds. In general, I would expect to see them as more active.

> "Differentiating between active managers is not easy, mainly due to the issue surrounding data transparency. "

When the universe of stocks is small caps, the smaller funds are more active



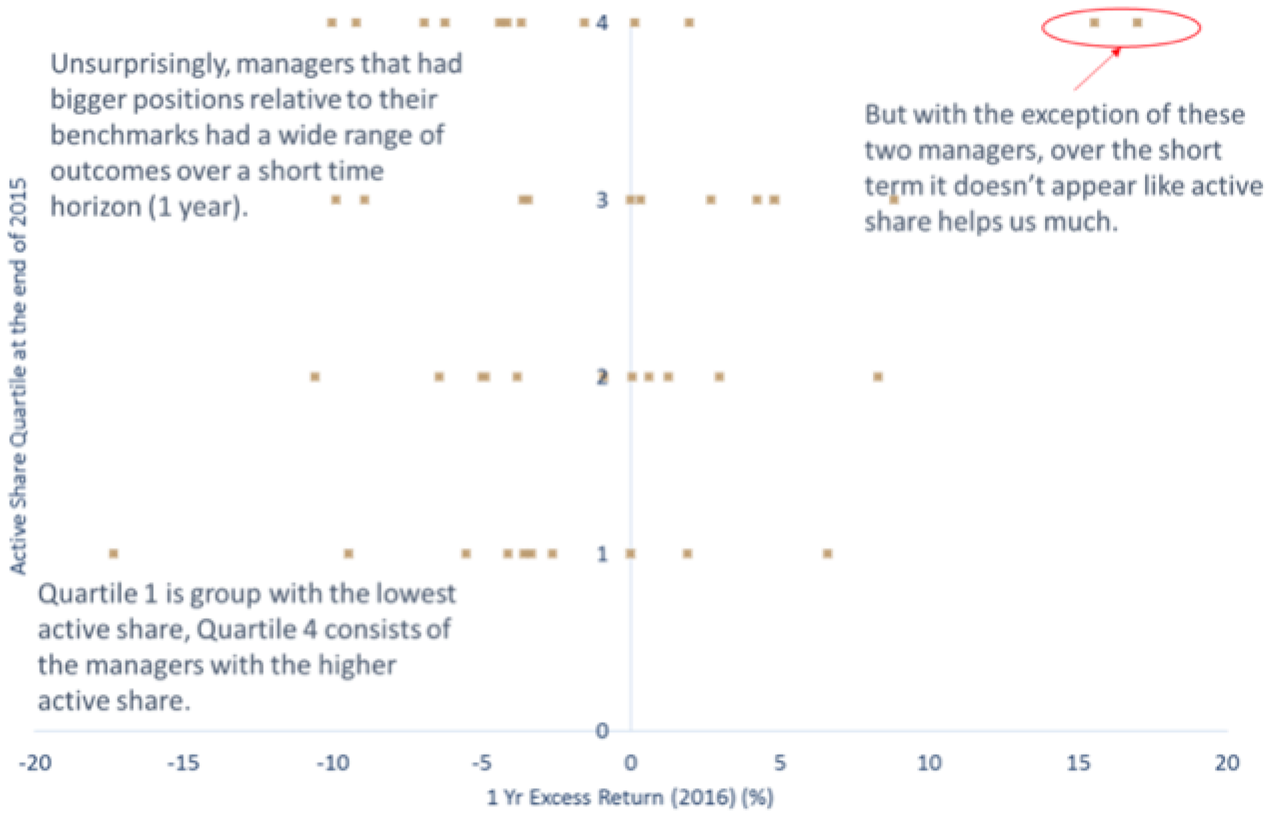
Source: Morningstar, Owners Advisory, February 2017

This does appear to be the case, at least in recent years, where managers of larger funds are more likely to be less active on average.

The real question is, is there any difference in outperformance for more active managers?

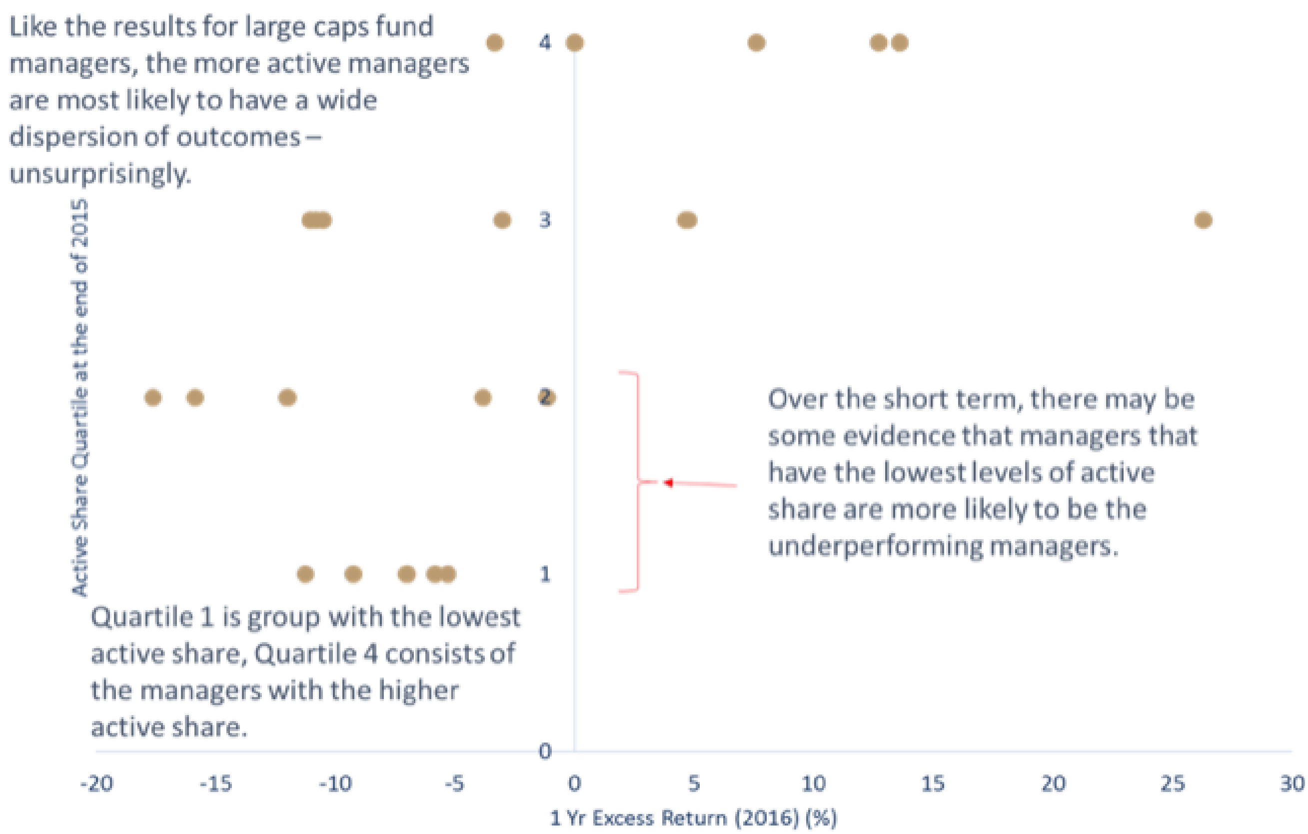
To look at whether we can use active share as an indicator to improve our odds at picking a successful active manager, managers are divided into quartiles based on their active share. Quartile 1 is the 25% of managers with the lowest active share, Quartile 4 is the 25% of managers with the highest active share. To gain some insight whether it helps us pick a successful active manager, I take the active share at the end of 2015 but compare it to the returns for the following year, i.e. for 2016.

Over the short term, knowing a funds active share does not help us much in the large cap space



Source: Morningstar, Owners Advisory, February 2017

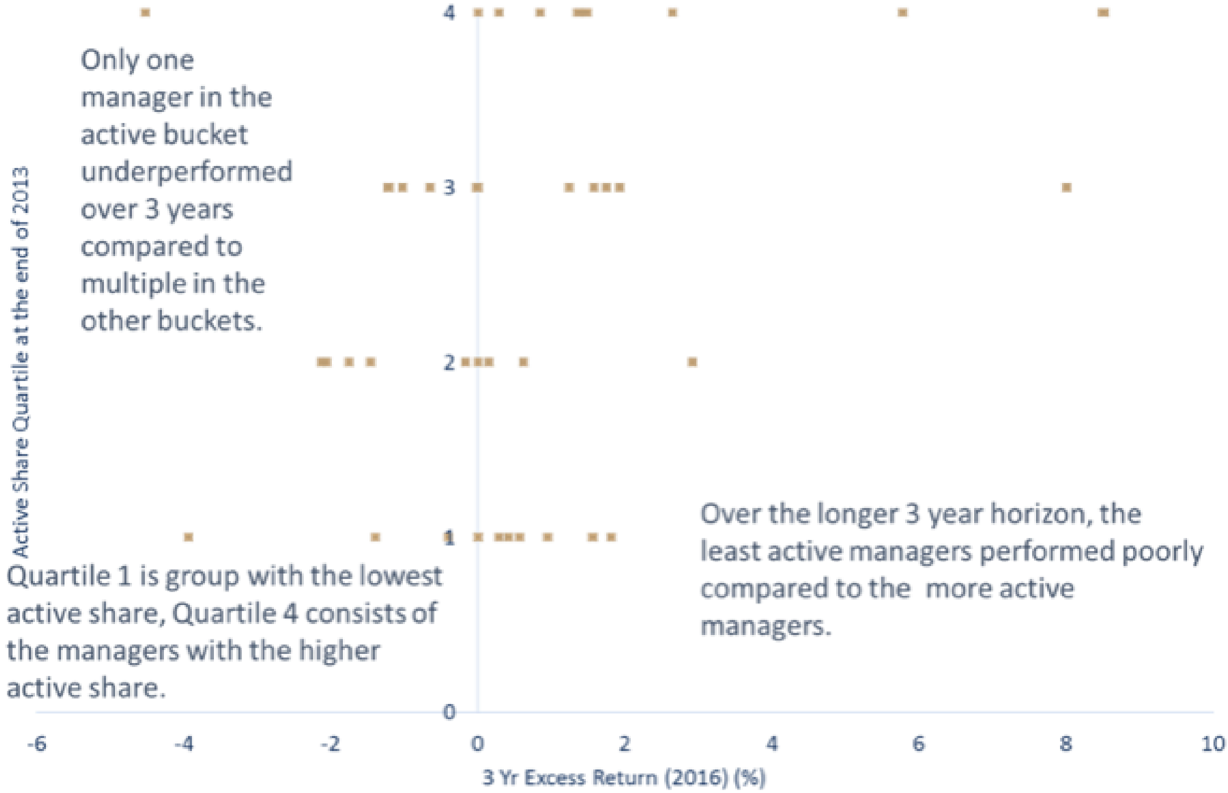
Over the short term, knowing a funds active share was low may have helped us dodge the underperforming funds in the small cap space



Source: Morningstar, Owners Advisory, February 2017

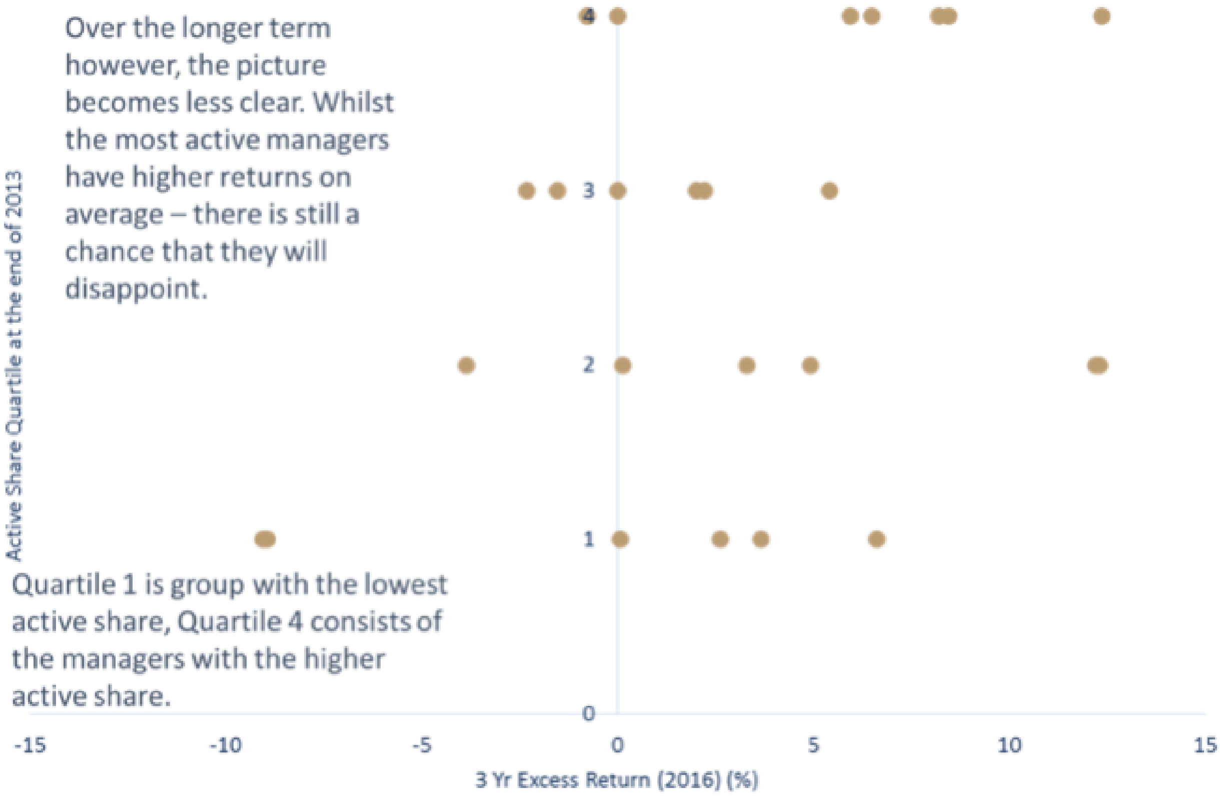
However, when I do the same thing, but with a longer horizon, the results are more promising – at least for large caps.

The least active managers deliver disappointing excess returns over a three-year horizon in the large cap space



Source: Morningstar, Owners Advisory, February 2017

While more active managers have a higher return on average, it appears active share alone doesn't always help us dodge the disappointing funds over the longer term



Source: Morningstar, Owners Advisory, February 2017

Here I took the funds' active share at the end of 2013 – before the performance was measured – to see if there was any indication that active share may help us pick successful active managers.

This is the start of the work on Australian funds and active share. Other papers, again referencing US data, suggest that there is a link between active share and predicting excess performance. There are still many avenues to explore in finding simple ways of differentiating between active managers and improving our chances of identifying those active managers that are likely to outperform. The next steps will be to combine some metrics that we have previously examined, like fees, and see whether together with active share we can identify managers that are more likely than not to deliver their stated objective. As well as looking at the results through time. But what we know so far is that it appears that Australian large cap active managers are less active than their US counterparts, that small cap funds are more active on average than large cap funds, if the fund has a low active share today, then chances are that investors will be disappointed in three years' time, at least in the large cap space.

Leah Kelly

www.ownersadvisory.com

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Leah Kelly is a Portfolio Manager for Owners Advisory, a wholly owned and operated digital wealth manager of Macquarie Group.

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