INVESTMENT

{ANTHONY EDMONDS}

PASSIVES JUST CAN'T HELP GETTING ACTIVE

It was Monty Python's Michael Palin who said: "I am very cautious of people who are absolutely right, especially when they are vehemently so."

I often think of this quote whenever the great "passive versus active" argument flares up in the New Zealand investment management industry.

The passive camp appears to attract zealots who argue vehemently for the righteous cause while quoting at length from global studies.

But we need to consider the active/passive argument from a New Zealand perspective and relate it to the actual products available to local investors as well as our own market structure and tax rules.

Before writing off all active managers as below-average fee-gougers, let's consider what the "average" New Zealand fund looks like. Morningstar's online database includes a grand total of 681 New Zealand funds with just on $36.8 billion under management, of which 50% is invested in the 30 largest funds.

The median fund size is $9 million, with the 472 smallest funds having the same combined total funds under management as the single largest fund.

The only person with any real interest in the "average" Kiwi investment fund will be the one who spots the sizable business opportunity in the fund rationalisation game.

If we narrow the focus to the funds in the Morningstar database within the "NZ Bonds General PIE" category, we find that there are 32 funds available, with 19 of these having less than $10 million each in funds under management.

How many of these funds would you consider using for your clients? A handful at best, I suspect.

Investors and advisers most likely don't have any real interest in how the median or average active fund performs – they're more focused on the funds they use.

This is where we can look at data that reflects what is really happening in the industry, such as that supplied in the Melville Jessup Weaver (MJW) Survey to June 30. This quarterly survey of the performance of different fund managers' investment solutions has a long history.

The funds that make up each category in the MJW survey are the same products advisers and their clients are actually using. Within the NZ fixed interest sector the field is narrowed to just five funds with combined assets of $3.99 billion, and include AMP Capital's fixed interest fund and the likes of Tyndall's solution.

This graph shows the 10-year returns from MJW Survey for each of the major sectors for the median manager, as well as the benchmark within each sector. In all four of these sectors, the "average" managers have added value relative to their benchmarks.

But this won't be enough to silence the anti-active crowd, some of whom may point to a few issues with the data.

Some may note, for instance, that the New Zealand fixed interest benchmark is the NZ Government Stock Index, so managers get a bit of a free ride from investing in credit.

But I reckon the concern about benchmarks actually strengthens the case for active management in fixed income. Yes, NZ fixed income indices are odd, as would you really want a Government-only bond portfolio, or a portfolio comprised of just Government and A-grade corporate securities? If you passively followed the benchmark, that's exactly what you would get.

There are a couple of other related points that also call into question the feasibility of passive management of NZ fixed income assets.

Firstly, managing a fixed interest portfolio on an indexed basis requires a fair bit of activity on the manager's part, including reinvesting coupons, dealing with issues of new securities and managing the maturity of existing securities within a portfolio.

Secondly, there are few decent indexed or passive fixed interest funds available to Kiwi investors that I am aware of.

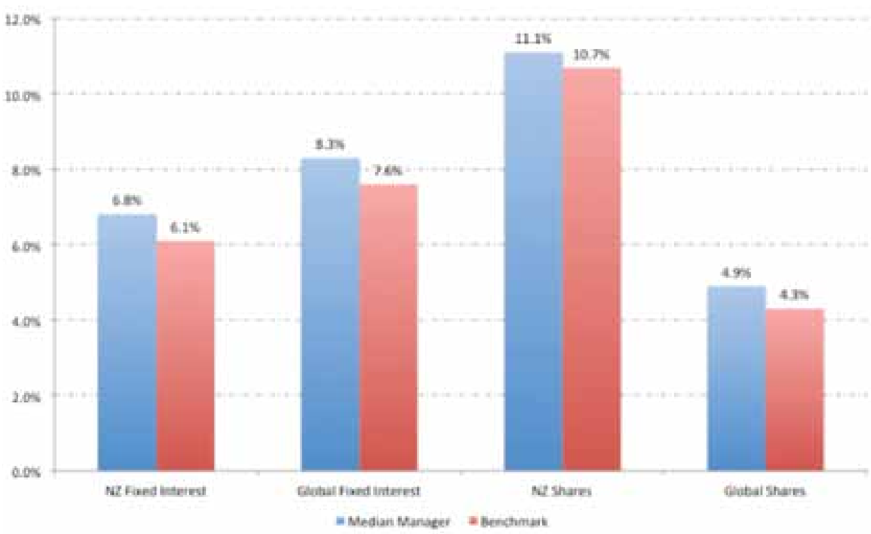
The practice of buying and holding a portfolio of fixed interest securities is a form of active management, as consideration and thought is put into selecting the securities that are included in the portfolio.

If we turn the argument to NZ equity managers, index-lovers often claim that the added value comes from decisions like holding Australian shares, as opposed to any real "alpha" generation.

But it is worth reminding ourselves that the median NZ shares manager return was 11.1% for the 10 years to June 30, while the ASX 200 Index only returned 9.8% in NZ dollar terms.

The New Zealand share market itself also has some peculiar characteristics that might actually play into the hands of active managers. A couple of years ago the New Zealand Herald provided a breakdown of who was investing in the New Zealand stock market. This data showed professional investors (aka fund managers and groups like the investment team at ACC) make up just 15% of the market.

The remainder of the market is fuelled by retail investors who own shares directly and investors with long-term strategic stakes in companies. These investors have no interest in trying to "beat" the market.



If the special nature of the New Zealand equities market tends to favour active managers, does the passive approach make more sense for offshore investments? Well, maybe, but an interesting feature of the New Zealand active global shares landscape is the predominance of "manager-of-manager" solutions.

This investment approach provides Kiwi investors with access to leading global investment specialists and experts, each of whom have been carefully selected for their specific investment skills and expertise with scant regard given to the concept of investing with "average" fund managers.

Bringing the argument back home, the case for active management is bolstered in New Zealand by our tax laws. For local and global shares we have namely, two different tax treatments that both result in the same outcome. In both sectors outperformance is tax-free, while the cost of obtaining the outperformance (management fees) is tax deductible.

For example, within a New Zealand shares PIE, IRD rules allow tax-free capital gains. Manager outperformance, then, simply increases the tax-free component of the return – the capital gain. Equally, under the Fair Dividend Rate (FDR) regime, any additional return above 5% that a global shares manager ekes out is a tax-free

> **"There is nothing more supremely useless than an average fund manager"**

bonus because the FDR tax is a constant regardless of the return (ignore, for a moment, the serious problems with FDR I outlined in a previous column).

For a Kiwi investor on a 28% PIR rate (in New Zealand shares or global shares), paying 1% of management fees to get 1% of outperformance is a great deal because they should get a tax deduction on the fee (meaning their fee on a net of tax basis is 0.72%), while the gain is free of tax – resulting in a net positive benefit of 0.28%. I am not sure of anywhere else in the world that this happens, and we managed to achieve it in two sectors using two different tax methodologies!

This underlines why we have to view the passive/active arguments in a local context rather than rely on offshore studies and experts.

To further muddy the waters for index-investors in New Zealand there is a lack of decent passive product structures in some sectors. This creates a big problem for those who argue vehemently against active management – in practice, it's very difficult to construct a diversified portfolio for a Kiwi client without using active management in some shape or form.

Over the medium term New Zealand's passive product gap will likely be overcome, driven largely by KiwiSaver providers. The temptation for some will be to adopt low-cost passive solutions in most sectors. This may lead to the evolution of decent passive products for all sectors – which is positive for the industry as a whole.

Active and passive solutions are both important tools. The application and use of these solutions will depend on the circumstances of the investor.

New Zealand is unique from an investment perspective for a whole range of reasons, from the size and composition of our markets, application of our tax rules, and our ability (or inability) to access different solutions globally.

Any commentary on the merits of active and passive management needs to be based on the unique circumstances that exist in our industry and market, not on slavish deference to international academia. A