

MyConsultant

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Anthony Ballard is the Head of JANA's Australian Equities Research Team, responsible for capital markets and investment manager research across JANA's client base. Anthony has been researching Australian Equities for JANA clients since 2009.

Anthony also has a Consulting role at JANA, providing advice to a varied range of clients across JANA's traditional asset consulting business and to outsourced clients that access JANA's Implemented Consulting Platform. Client responsibilities include Industry, Government and Corporate Super Funds.

Anthony joined JANA following the completion of his studies in 2007, where he graduated with a Bachelor of Commerce (Economics) degree from Monash University.

Active Managers Have the Edge in the Concentrated Australian Equities Market

2016 has started poorly for Australian Equities with falls of 5.5% and 1.7% for the S&P/ASX300 Index over the months of January and February respectively. On a rolling one year basis to the end of February the asset class is now firmly in the red, delivering a return of -13.5%. A large portion of the result for the market can be attributed to the significant pull back in the S&P/ASX20 Index, which equates to around 60% of the market value of the S&P/ASX300 Index and has returned -16.3% for the year.

The benchmark return over the year is disappointing in an absolute sense, however if your Australian Equities portfolio utilised active management, it is likely that the managers provided some protection from the negative result for the market.

Active Australian Equities managers, with a few notable exceptions ('Value' style managers generally had a harder time of it), generally delivered a strong outcome for investors for the year. This is evidenced in the median portfolio return for the Australian Equities component of the SuperRatings Accumulation Fund Crediting Rate Survey¹ outperforming the benchmark by 3.1% over the year to February, and top quartile performance being 4.8% ahead.

In contrast, if your Australian Equities portfolio had been 100% passively invested, the benchmark performance delivered would have placed the return in the bottom quartile of respondents in the SuperRatings Australian Equities Survey in this time.

Although the time frame is short the heightened level of market volatility through the period, driven by a range of external (i.e. economic, geopolitical) and fundamental (i.e. earnings and balance sheet concerns) factors, has provided active management with a favourable opportunity set to outperform the benchmark. The performance benefits, after fees, of active management over the year significantly outweigh the cost savings that would have been delivered through a passive approach. We are pleased by this result as ultimately the benefits should be reflected in our clients' returns and accordingly provide a boost in a relative sense which is helpful in the challenging market environment.

It is an interesting exercise to examine what has driven this outcome over the course of the year, and of course the key question is: 'can it continue'?

Active management in Australian Equities

A core tenet of JANA's investment beliefs is that markets are inefficient and, as such, we believe quality active managers can add value over time through the exploitation of imbalances that exist. This is underpinned by our view that active management provides an opportunity to outperform the capitalisation weighted benchmark on two fronts:

- 1) Through allocating capital to companies that can deliver above benchmark returns, and
- 2) By avoiding risks that tend to build up during periods of extreme market exuberance.

¹ The SuperRatings Survey is a monthly ranking of the performance of up to 200 superannuation funds. The returns for Australian Equities component of the survey are indicative of the returns of both superannuation and non-superannuation Australian Equities portfolios in the universe.

Each is important at various points in time, although the avoidance of risks can be of particular importance late in the market cycle. There are times when both can contribute together, such as experienced during the past year, where active managers have been particularly cognisant of certain risks that have evolved in the market (economic, commodity and geopolitical) whilst remaining focused on the underlying company fundamentals. The ability to reposition the portfolio has allowed active managers to provide some protection in the weak market environment relative to passive managers who have followed the benchmark performance down. This was again evident at the peak of the global financial crisis (GFC) where active managers, as measured by the Median SuperRatings manager, outperformed the benchmark by 4.2% for the year ended February 2009, the worst period of the GFC.

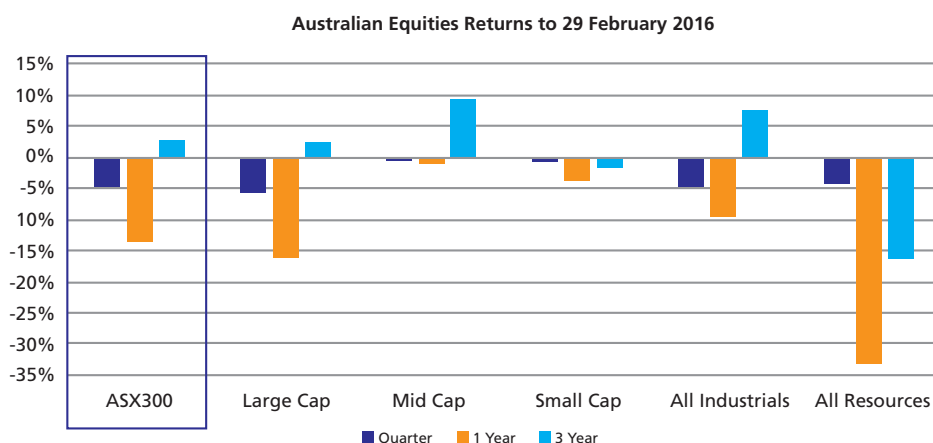
It is important to note that while we believe in the benefits of active management, we acknowledge that there is an element of cyclicity to outperformance. Even the best active managers with strong long term track records of outperformance should be expected to underperform the benchmark over certain shorter time periods. Over the long term, we believe our clients will be rewarded with superior performance outcomes on an after fee basis through the use of quality active management in their Australian Equities portfolio.

In our experience, some of the largest contributions from active management have been delivered in the Australian Equities asset class. This is an interesting outcome given (intuitively) a broader opportunity set should provide greater outperformance opportunities for active management in Global Equities relative to Australian Equities, however this has not been the result that we have observed over time. Within Australian Equities, the median manager has been able to outperform the benchmark consistently over time, and top quartile managers have delivered circa 2.9% pa in excess of the Index return over 10 years². Given a large proportion of the typical Australian Superannuation 'Balanced' portfolio is allocated to Australian Equities (typically around 26%), achieving an additional 1% to 2% above the return of the benchmark in the asset class can add meaningfully to investors' returns on a compounding basis.

Review of market and benchmark composition

The performance of a cross section of the Australian market over the past quarter, one year and three year periods is shown in chart 1.

Chart 1: Performance variations between the different segments of the Australian Equities market



Source: JANA/FACTSET. Past performance is not a reliable indicator of future performance.

Focusing on performance over the year, the segments that provided the weakest results were Large Cap stocks and Resources, which in combination weighed heavily on the performance of the broader market. While Mid Caps and Small Caps remained flat on an absolute basis they were relative outperformers over the year, while Industrials performed well compared to Resources. Over three years, Mid Caps and Industrials have delivered material outperformance.

An interesting factor that can be observed from the chart is that the return for the S&P/ASX300 Index largely mirrors the performance of the Large Caps segment over these time periods, and the Australian market provides an interesting case study in benchmark composition in this regard.

The Australian benchmark has significant concentration in a small number of stocks, with the largest 20 accounting for around 60% by market capitalisation. Examining just six of these stocks – the 'Big Four' banks and the key commodities-related exposures of BHP and Rio Tinto – in aggregate represented around 40% of the S&P/ASX300 Index one year ago, although this has reduced over the last 12 months due to weak performance of these stocks. Both these sectors have faced significant headwinds in recent times. Through 2015 the banking sector undertook capital raisings (which diluted earnings) in response to regulatory requirements while Resources have seen earnings heavily impacted by a slowdown in China and subsequent fall in commodity prices. In this context, the banking sector delivered a return of -24.0% for the year, while BHP and Rio Tinto have respectively fallen 47.4% and 31.8% amid widespread weakness for the sector.

These six stocks accordingly anchored the broader performance of the benchmark given their market capitalisation weighting, providing a contribution of around 82% of the 13.5% fall in the broader market over the last 12 months. As a consequence, these six stocks heavily drove the outcomes for those that were passively invested.

Active managers, on the other hand, have been able to allocate to segments of the market with visible earnings growth, or perhaps more importantly, away from the headwinds of larger capitalisation companies which have weighed on the performance of the benchmark. The broad trend in positioning across the market for active managers has been underweight top 20 stocks and overweight Mid Caps in particular (and Small Caps to a lesser extent), pushing down the market cap spectrum in search of companies that exhibit greater prospects for earnings growth.

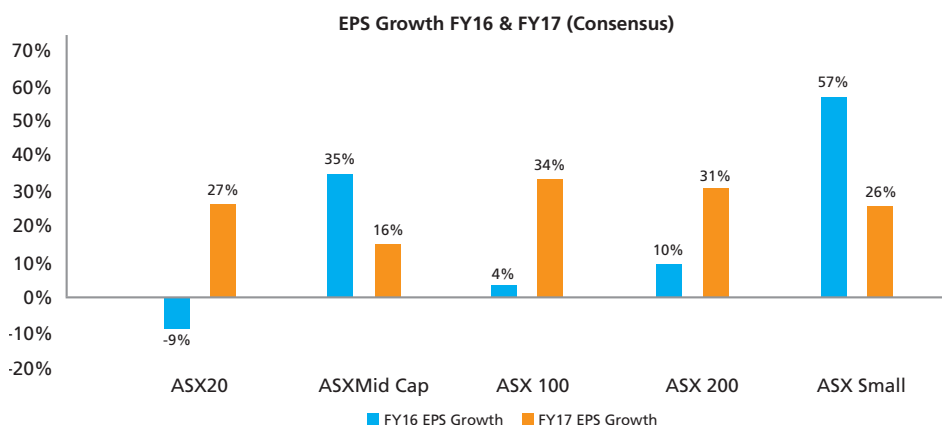
² Based on a representative broad cap manager universe from eVestment. Figures to 29 February 2016.

Prospects for active management looking forward

The near term environment has been particularly accommodating for active management in Australian Equities given the aforementioned comments related to a handful of large stocks in the market. In JANA's view, looking forward, the utilisation of active management in Australian Equities remains an attractive option. While the long term performance results provide historical support for active management in Australian Equities, we expect the shorter term prospects to be similarly accommodative to the experiences of the past year. There are three key reasons for this:

Firstly, the market trends evident over the last year look set to continue. Examining the consensus earnings per share (EPS) growth expectations across the market cap spectrum paints a far more attractive picture for Mid and Small Caps compared to Large Caps, through 2016 in particular. This is highlighted in chart 2.

Chart 2: 2016 EPS growth expectations favourable for Mid and Small Cap stocks



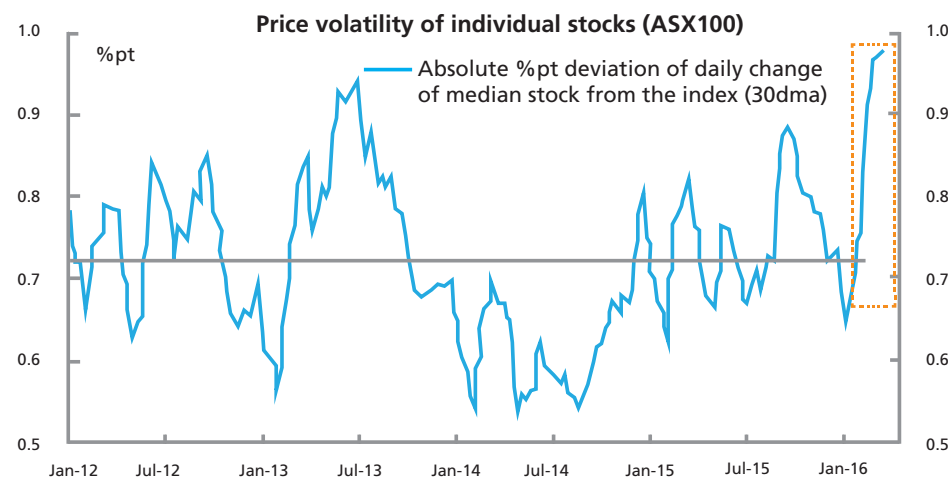
Source: JANA/FACTSET

Secondly, active management provides the potential for a greater level of portfolio diversification. The aforementioned concentration in a handful of stocks magnifies portfolio risk and return drivers within Australian Equities portfolios. By their very nature, passive management approaches allocate around 30% of the portfolio to the 'Big Four' banking stocks, and 60% to the 20 largest stocks in the benchmark. Active managers can construct portfolios with greater breadth and position to avoid certain segments based on perceived risks in the market.

Active managers can also access stock opportunities not represented in the benchmark which can contribute to performance outcomes, through initial public offerings (IPOs) for example, whereas passive approaches will typically not hold ex-benchmark stocks. A significant index 'refresh' over the past three years or so has seen close to 7% of the S&P/ASX300 Index now represented by new names.

Thirdly, the prevailing market environment remains one of uncertainty, with macro factors in particular pushing up market volatility. Chart 3 shows the volatility of the S&P/ASX100 Index.

Chart 3: Volatility of the S&P/ASX 100 Index



Source: Datastream, Deutsche Bank.

It can be observed that volatility has been gradually increasing through 2014 and 2015 culminating in the recent peak in early 2016. JANA expects the market to continue to be volatile which should provide attractive opportunities for active stock pickers to take advantage of near term mis-pricings from underlying fundamentals.

Longer term opportunities?

In recent years the increased industry-wide attention to costs has placed downward pressure on fees and given rise to increased allocations to passive management and 'smart beta' approaches where investors try to cost-effectively replicate an investment 'style' or 'factor' exposure. We have received queries from clients regarding the merits of such exposures and while we acknowledge they can play a role in portfolios (depending on each individual client's objectives) they do have their limitations.

The trend toward these 'cost effective' approaches in itself is interesting given alpha (outperformance) is a zero sum game – for every winner, there is a relative loser on the other side of the trade. The greater prevalence of these strategies has the potential to prolong and accentuate market dynamics and characteristics beyond fundamental indicators, which should provide skilled active managers a greater opportunity set to exploit through the market cycle.

Conclusion

Active managers in Australian Equities have delivered strong relative results over the last year, which has been reflected in the returns for the Australian Equities component of the SuperRatings Accumulation Fund Crediting Rate Survey. While passive management in the asset class would have delivered a fourth quartile return of -13.5% for the year, the median portfolio in the Survey outperformed the benchmark by 3.1%.

The market environment has certainly been conducive to outperformance by active managers, however we believe the prevailing settings continue to present an attractive opportunity set for active managers looking forward. Most notably in this regard, the concentrated nature of the benchmark combined with the prospect for greater earnings growth outside Large Cap names, as well as our expectation for a continuation of the volatile market environment, should allow active managers to take advantage of mis-pricings and avoid built up risks in the market.

We believe the environment looking forward leaves quality active managers well placed to provide meaningful outperformance in the near term as compensation for the additional fees paid relative to passive management. The longer term prospects for active management in Australian Equities also remain attractive, with structural inefficiencies remaining supportive of the historical trend of outperformance within the asset class.

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