EAST PRIVATE WEALTH

Investment Philosophy

Investors have two main overarching investment strategies that are typically employed to generate a return on their investment portfolios: active portfolio management and passive portfolio management. These approaches differ significantly in how investments are both selected, held and managed in the portfolio over time, which can lead to vastly different outcomes as the timeframe is extended. Our goal here is to initially understand which strategy is more likely to produce a better outcome over time, and once known, how to implement such a strategy consistently through a well-documented investment and governance process.

Active management (also called *active investing*) refers to a portfolio management strategy where the manager makes specific and targeted risk-adjusted investments within their designated asset classes (equities, property, fixed interest for example), with the goal of outperforming either a relevant relative investment benchmark index, or target return. The use of benchmarks in the investment industry are common and are a direct reference point to monitor how various portfolios are performing relative to industry-wide targets and standards. Effectively, they allow outsiders looking in, to determine if the manager has any ability to add value, or not.

An actively managed investment fund has an individual portfolio manager, co-managers, or a team of managers actively making investment decisions for the entire fund. The success of an actively managed fund depends on combining in-depth research, market forecasting, and the experience and expertise of the portfolio manager or management team. Managers in active investing generally pay close attention to market trends, shifts in the economy, changes to the political landscape, and factors that may affect their investments or asset class. This data is used to time the purchase or sale of investments to take advantage of irregularities.

Active managers claim that these processes will boost the potential for returns higher than those achieved by simply mimicking the stocks or other securities listed on an index. But to gain access to such strategies and teams, active managers have traditionally charged high fees and whether this cost is justification for all this sophistication and concentration, recent research comes into play.

Passive management (also called *index investing*) on the other hand foregoes the fancy marketing and storied histories on stock picks by active investment managers. Nor would a passive investor care to undergo the process of assessing the virtue of any specific investment and building a portfolio completely from scratch in an attempt to beat the market.

The goal of a passive investor is simply to *match* the performance of certain market indexes, that being possible by using low-cost passive index funds. Through such a strategy, you simply seek to own all the stocks in a given market index and in the proportion that they are held in that index. You then sit back and let the magic that is time, tax-effectiveness and compounding do the rest.

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One way of tracking the success or lack-thereof of both main groups of managers, and therefore, whether investment portfolios should be tilted more towards the 'active' style or more towards the 'passive' style, is to refer to the actual evidence of the industries endeavours which is where SPIVA Scorecards (Standard and Poor's (S&P) Indices Versus Active) come into play. SPIVA has been the de facto scorekeeper of the ongoing active versus passive debate since the first publication of the SPIVA U.S. Scorecard in 2002.

Standard & Poor's is an American financial services company that publishes industry-leading financial research and analysis on stocks, bonds, and commodities. As part of this process, S&P are dedicated to the collection, measurement and analysis of the performance of actively managed funds against their relevant index (passive) benchmarks not just in Australia, but worldwide - https://us.spindices.com/spiva/#/reports.

The outcome of this activity is designed to do determine what percentage of 'active management' funds over time have a genuine ability to beat their relevant index benchmarks – and thus add value to their clients. The main results table is displayed below;

Report 1a: Percentage of Funds Outperformed by the Index (Based on Absolute Return)

FUND CATEGORY	COMPARISON INDEX	1-YEAR (%)	3-YEAR (%)	5-YEAR (%)	10-YEAR (%)	15-YEAR (%)
Australian Equity General	S&P/ASX 200	86.69	85.81	79.61	83.20	83.68
Australian Equity Mid- and Small-Cap	S&P/ASX Mid-Small	51.94	88.89	70.09	47.22	49.18
International Equity General	S&P Developed Ex-Australia LargeMidCap	70.37	82.38	89.40	90.87	92.64
Australian Bonds	S&P/ASX Australian Fixed Interest 0+ Index	98.36	83.64	90.20	70.97	NA
Australian Equity A-REIT	S&P/ASX 200 A-REIT	78.87	66.22	83.33	78.13	84.62

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2018. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

Source: https://us.spindices.com/spiva/#/reports

As shown, the latest SPIVA Australia Scorecard has reported on the performance of Australian active funds against their respective benchmark indices over 1, 3, 5, 10, and 15-year periods, evaluating the returns of over 860 Australian equity funds (large, mid, and small cap, as well as A-REIT), 436 international equity funds, and 116 Australian bond funds.

For the year-ended Dec 31, 2018, the overwhelming majority (86.69% to be precise) of Australian Equity, International Equity, Australian Bonds and A-REIT funds, failed in their attempt to outperform their respective (passive) benchmarks over past 12 months. A staggering number which one would hope that as the time-frame is extended, more active managers should begin to shine.

When we analyse other periods however and take for example the 15-year period results, here we still see SPIVA reporting that 80%+ (90%+ in the case of International Equity) of actively managed funds failed to beat their relative (passive) index' benchmarks over that period, and in fact, likely detracted from an investors potential wealth. LESS than 2 out of every 10 Active Management Funds (1.632 to be precise) failed to add ANY value over this time period. A similar picture exists over 3, 5- and 10-year periods.

Although these are quite sobering statistics, a logical argument that could follow on from here is because there are a handful of managers that do out-perform overtime, we should just find out who they are and put our money with them. But will that simplistic approach work?

SPIVA has an answer for this question as well by extending their measurement and analysis of active management into an additional factor called ‘persistence’, a test that highlights a manager’s skill over different market environments. Effectively the question is asked – if a manager is out-performing their relative (passive) index’ benchmarks today, what are the chances this remains the case into the future?

According to SPIVA, in the 24-month period following the end of June 2016, of the 187 Australian active funds which were then ranked in their respective top quartiles (the best of the best in other words), just 16 or 8.6% stayed in the top quartile thereafter. If we extend the timeframe further to a similar study from a few years earlier, out of the top-performing funds in the 12-month period ending June 2014, only 4.0% consistently beat their benchmarks in the following four consecutive years. SPIVA backs up these statistics by noting that since their research has begun, over successive three- and five-year periods, most outperforming funds today failed to beat their respective benchmarks into the future. Further they noted that most funds in a top quartile today, did not remain there consistently.

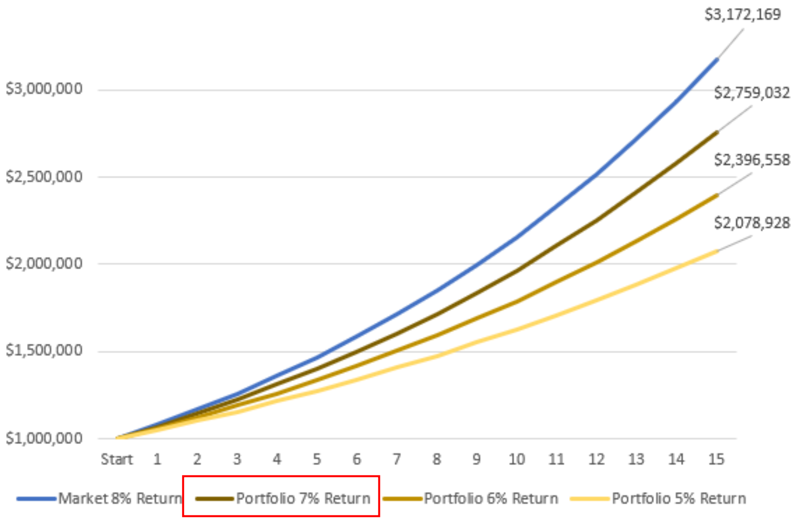
The answer to our simplistic question therefore seems to leave little doubt - picking tomorrows winners out of today’s best performers, is incredibly hard. Even if you find a manager that is currently outperforming, their winning streaks are often short lived.

Consider a summary of the above facts over a long-term horizon (15 years) to Dec 31, 2018;

- 83.68% of Australian Active Managers failed to beat their passive investment benchmark;
- 92.64% of International Equity Investment Managers also failed;
- 78.13% of A-REIT Managers likewise, failed;
- While Australian Bond managers don’t yet have a 15-year comparison period, their future looks to be less than favourable of adding out-performance, and;
- If you do find a manager that is out-performing today, they are very unlikely to be tomorrows winners.

Trying to build a long-term horizon ‘Active’ investment portfolio with such odds is an intensely difficult task, and, is a task that is likely to be to be detrimental to your wealth if you fail to achieve even getting the basic returns of the market.

Take a hypothetical example where we construct a portfolio, of today’s managers who are delivering excellent results for their investors. Whilst we hope to be adding value in conducting all of this work in finding and researching them, given the odds are simply not on our side, let’s make the assumption that such a portfolio subsequently underperforms by 1%, 2% or even 3% per annum from there on vs. their passive benchmark brethren. The result at the end of a similar 15-year period on a $1m portfolio is material.



Rather than $1m turning into close to $3.2m via a tax-effective passive investment strategy which returns what the market returns, around ~8% per annum, if our portfolio of 'active' managers went on to under-perform by 3% per annum, the portfolios end value would be just $2.1m. That's a whopping $1.1m or circa 66% of underperformance. Not a great outcome.

Warren Buffett, one of the world's most notable investment managers perhaps summed up the results best; ***"Most investors, both institutional and individual, will find that the best way to own common stocks (shares) is through an index fund that charges minimal fees."*** Warren Buffett, Berkshire Hathaway Annual Report 1996.

Given this was written over two decades ago, recently he furthered those thoughts post the recent passing of Jack Bogle, the father of (passive) Index Investing, in early 2019,; ***"If a statue is ever erected to honour the person who has done the most for … investors, the hands down choice should be [the late] Jack Bogle. For decades, Jack has urged investors to invest in ultra-low-cost index funds. In his crusade, he amassed only a tiny percentage of the wealth that has typically flowed to managers who have promised their investors large rewards while delivering them nothing - or, less than nothing - of added value. In his early years, Jack was frequently mocked by the investment-management industry. Today, however, he has the satisfaction of knowing that he helped millions of investors realize far better returns on their savings than they otherwise would have earned. He is a hero to them and to me."*** Warren Buffett, CNBC.

Warren and Jack are both supported by the SPIVA research we have represented here. The statistics are just so overwhelming in supporting the view that a much greater tilt-towards 'passive management' and away from 'active management' appears warranted. And if you think is something new and that active management will again shine, the late Jack Bogle briefly mentioned before, had been pushing the industry to change how people should invest their money for the better part of 43 years.

The firm he founded, The Vanguard Group, was built on the belief that, over the long term, most investment managers cannot outperform the broad stock market averages.

It was quite an insight to have back in 1976 when he launched the first retail index fund along with Princeton professor Burton Malkiel who had written about the idea of an index fund in his ground-breaking book *A Random Walk Down Wall Street*, first published in 1973.

At the time, and ever since for that matter (for some 46 years – almost half a century), Malkiel has similarly argued that asset prices typically exhibit signs of random walk and that one therefore cannot consistently outperform the market averages. In forming his thesis, Malkiel (like SPIVA today) examined some popular investing techniques, including technical analysis and fundamental analysis, in light of the academic research available on these methods. Through detailed analysis, he noted significant flaws in both techniques, concluding that, for most investors, following these methods will produce inferior results compared to passive strategies.

Further, Malkiel also had a similar critique for methods of selecting actively managed mutual funds based upon past performance. He cited studies indicating that actively managed mutual funds vary greatly in their success rates over the long term, often underperforming in years following their success, thereby regressing toward the mean. Malkiel suggests that given the distribution of fund performances, it is statistically unlikely that an investor would happen to select those few mutual funds which will outperform their benchmark index over the long term.

As we have shown, through this seminal body of work and backed up more recently via SPIVA some 50 years on, he and Jack were right. Despite all the promises made by the 'active' management industry, the odds simply do not work in your favour over building a portfolio today that is likely to add-value over and above respective (passive) benchmarks.

There is one notable exception to the above. Again, according to SPIVA, the mid and small-cap fund segment highlights a sector of the market where 'active management' can add-value over the (passive) broader index'. Within this fund category, SPIVA results show that more than half of 'active' managers (50.82%) have proven over time to be able to add value.

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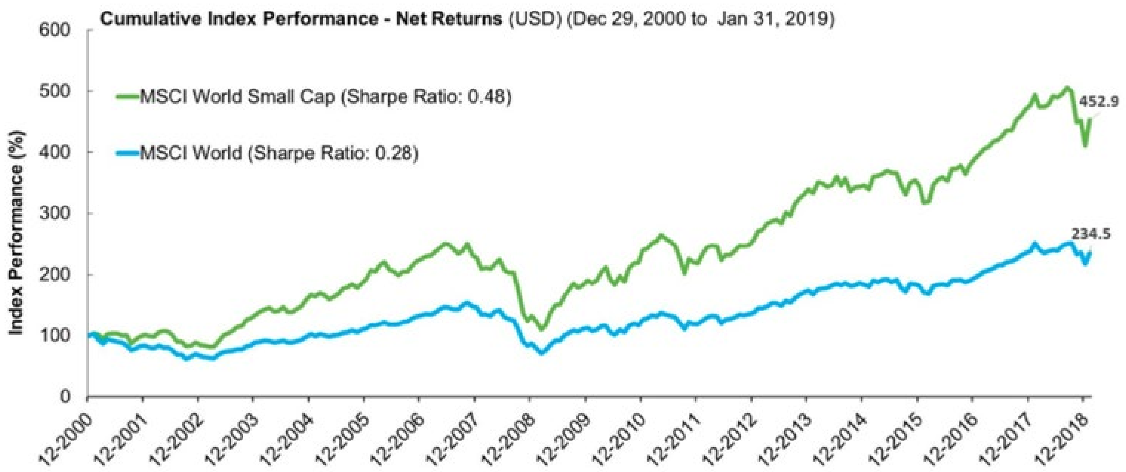
Australian Equity A-REIT	S&P/ASX 200 A-REIT	78.87	66.22	83.33	78.13	84.62

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2018. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

This research resonates well with our own investing experience, given both Mid-caps and small caps offer the potential to be able to allocate investment funds towards more early-stage, capital growth opportunities in companies that are typically not followed by the major investment houses. Further, mid and small-cap companies offer the opportunity to diversify towards unrecognised growth and thus the potential for rerating as they deliver and hence outperform.

Again, this is not something that is new - Academic researchers have been studying the small cap premium for more than 40 years. A 1981 paper by Rolf Banz argued that “smaller firms have had higher risk-adjusted returns, on average, than larger firms”. This performance difference has come to be known as the ‘size effect’ or the ‘small cap premium’. According to FTSE Russell, “The notion of both a small cap premium and a value premium in equity returns was solidly established with the publication of papers by Nobel Prize winner Eugene F. Fama and co-author Kenneth R. French. The Fama-French three-factor model of market, value and small cap factors has become a bedrock of academic and practitioner research”. From 1927 through 1981, US small-cap stocks outperformed large caps by 3.1 percent annualised, according to the Fama-French ‘small-minus-big’ factor.

The below chart for example shows the performance of the MSCI World Small Cap index since its inception in late 2000, versus the MSCI World index.



Source: Ausbil, FactSet, MSCI. Sharpe ratio calculated from monthly returns; risk fee rate is the ICE Libor 1M.

It is immediately apparent, from this chart, that small caps have significantly outperformed their larger counterparts, by a quantum of almost two-fold over this circa 20-year period. A secondary observation is that while the small cap journey appears to offer a little more volatility, the returns for risk taken relative to this volatility was significantly better than for the larger companies.

The upshot of this is relatively simple, overtime, the only Fund / Asset Category where one can have confidence of a chance of outperformance and adding-value, is with the mid and small cap stocks. Statistically speaking, it is here and really only here that we should attempt to step outside of a passive tilt to portfolio management, and attempt to add value when opportunities present themselves.

Key Takeaways

- *Active management is when managers actively pick investments, usually building bespoke 'style-specific' portfolios from scratch in an effort to outperform some benchmark, usually a passive market index.*
- *Active management funds recent research that dates back to 1973 has called into question their ability to outperform the market with any consistency, if at all.*
- *Passive management is when a manager attempts to mimic some benchmark, replicating its holdings and thus its performance.*
- *With passive management, there are no bells and whistles, you simply aim to match the markets performance over time and pay low-costs for doing so.*
- *The mid and small-cap segments of the stock market have a proven history of offering a pool of assets with an ability to add-value to client portfolios overtime. And it is here, that when an opportunity presents itself, that statistically speaking, there is a higher chance of adding value over the longer-term.*

Conclusion

1. The basis for our portfolio construction should be market exposure via passive ETFs. These should over time provide a cheaper portfolio solution for clients, and should generate at a minimum, market returns. With so few active managers being able to outperform the market and our ability to back them at the right time (almost impossible), this solution puts the odds firmly in our clients favor that they will outperform 80/90% of active managers.
2. Statistically, the small-cap and mid-cap market segments have historically provided the opportunity to deliver performance over and above the broader index with the right skills and process. Hence, our efforts should be focused on value-adding activities and an attempt to deliver overall portfolio returns over and above the market here. Risk will be actively managed by adherence to clear and structured investment process, and a strong governance structure.
3. Holding a portfolio of ETFs with some direct exposure may not look as 'sexy' or as technical as some portfolio's constructed by other advisers/fund managers. We won't get side-tracked or swayed by what we think clients want to see. Our focus should be client outcomes. Outcomes proven over almost 50 years and backed up by empirical research.

Broadly diversified market exposure via Low-Cost Passive Index ETFs + pursuing potentially value-adding activities outside of this framework, <u>only</u> where we have the skills and statistically can outperform = better client outcomes