Index funds offer diversification and simplicity. Michelle Innis looks at why they can be a good alternative.

Identifying a fund manager who will outperform the market – any market – is no trivial pursuit these days. Despite the fact many charge hefty management fees, a turn in the economic cycle may mean that you, the investor, perform is rendered to the bottom of the league tables. “Some investors feel they just can’t determine which managers are going to get positive returns for them,” says Macquarie Funds Management’s division director, Phil Dolan. “You could choose a good manager based on past performance. But quite often, the reason a fund manager has a positive or negative return is out of the manager’s control anyway.”

Dolan says many managers have a bias – towards either growth or value shares – but they have no control over the economic cycle that determines whether growth or value shares make gains.

“Our studies have shown strong out-performance through the late 1990s, largely because banks went from being 10 to 12 per cent of the market to over 20 per cent,” he says. “At the same time, resource stocks, which are considered growth-style assets, went from being over 30 per cent of the market to around 10 per cent.”

The head of Vanguard Investments Australia, Tony Winwood, goes further. Winwood says that over the long term, very few fund managers outperform the index.

“Over 10 years or more, in the United States, in the United States, it is hard to find an active manager that has outperformed the index,” Winwood says. “Active managers also have high costs and poor returns.”

Winwood concurs that economic cycles change and active fund managers can be locked into a particular style of investing that means funds will dip into negative territory. “It is very difficult for active fund managers to outperform the long term,” he says. “And because cycles change, does that mean you should buy in and out of certain types of actively managed funds every two or three years rather than investing for the long term?"

Winwood presides over the Australian arm of one of the world’s oldest and largest index fund managers. Vanguard manages more than $US550 billion ($1 trillion) in indexed funds in the United States and $15 billion here.

An index manager can offer managed funds in all asset classes, and sometimes in a mix of asset classes as well. Vanguard has an Australian equities fund that tracks the ASX/S&P 100, but it also offers fixed interest, property, cash, international shares and diversified index funds. The latter combine assets but still track indices.

“When you are looking for an index fund, you’re looking for a manager that can match the index, with little tracking error,” says Standard & Poor’s David Collins, the director of funds services. “You are going to get diversification and very low fees. But the trade-off is that you do not have an active manager adding any value. You will track the index, going up and down.”

An active manager may turn over – or buy and sell – anything from 50 to 150 per cent of a share portfolio over a year. An index fund manager only changes the weight of a share in the fund if its weight in the index changes. Buying and selling shares means increased costs.

From where he sits, Winwood is looking at what makes an index manager successful. “We have always been focused on costs,” Winwood says. “The Vanguard approach is to keep the fees that investors pay as low as possible.”

Dolan says the fund has achieved this result since its inception 13 years ago. “We personally think that you can add value,” he says. “And because cycles change, does that mean you should buy in and out of certain types of actively managed funds every two or three years rather than investing for the long term?”

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TONY WINWOOD, Vanguard Investments management fees. Index fund managers charge significantly less than active fund managers because their overheads are lower.

Winwood says Vanguard would typically charge investors a maximum management fee of 0.9 per cent, compared with about 2.2 per cent charged by active fund managers.

“[You are paying an additional management expense ratio (MER) to an active fund manager for that expertise],” says Colin Lewis, from Ipac. “But whether you decide to buy an index fund or not should come down to whether you want manager risk or not.”

Macquarie’s Dolan says there is a place for indexed funds but he thinks that if investors are paying any sort of management fee at all, they should get value out of it – not just an index return.

“Macquarie has a true index Australian share fund and there are no investment management fees to pay in it,” he says, adding that Macquarie makes money from this fund because it runs a more actively managed fund in which it invests.

“The out-performance of the underlying fund provides us with fees,” he says, “but if the underlying fund underperforms the index, we make up the difference so that the client receives exactly the index return.”

The underlying fund is a Macquarie enhanced equities fund, which invests in Australian shares. The aim is to generate returns 50 basis points a year above the ASX/S&P 100 Accumulation Index.

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OPTIMISING WEALTH

Scott Middleton (above) says anyone committed to the theory of long-term investing should be buying actively managed funds.

“If you are a purist, someone who really does have their money invested for 15 or 20 years, then you should invest in index funds,” Middleton says.

“Research shows that one person is highly unlikely to outperform the market over this time frame,” he adds. “And even if you could pick that person who could outperform, there are tax implications in investing in actively managed funds, or moving from manager to manager.

“Changing fund managers can trigger capital gains tax liabilities. Middleton, a partner at financial planning firm Moneytree Partners, invests his own money and clients’ funds in indexed international and Australian equity funds. He says the majority of his clients are focused on long-term wealth creation, which means investing and holding for more than 10 years.

“There are exceptions,” he adds. “But our goal and time frame involves optimising wealth over the long term.”

“Some of the money we invest in indexed funds is superannuation money, but some is not. After all, superannuation is just a tax structure, and a good investing environment is good whether you’ve got superannuation money or not.”

Middleton says other positive reasons for index investing include low management fees and the ability to obtain good diversification for a small amount of money.

“You’re not paying a heap of people to do a lot of research and make decisions about which companies to buy or sell,” he says.

“People have it in their mind that when they pay high management fees (to fund managers), they are paying a fund manager to make those decisions. But they are not always right. With index funds, you’re not paying for all that extra research to be carried out.”

“And you get all the benefits of untised wealth – for a small amount of money you can buy into a large number of companies. You are getting diversification.”

Dolan adds that the return is not huge compared with returns some fund managers achieve – especially higher risk hedge fund managers – but it is consistent.

“But there is no free lunch,” he says. “If you want higher returns, you have to accept the potential for higher losses as well. You want to make sure that the risk in your portfolio is not ‘unrewarded’ risk – that is, risk that the manager can’t really control.”

Michelle Innis

The Sydney Morning Herald

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Photo: Paul Jones
Family rules

Good habits start at home. Michelle Innis investigates why some family businesses are more successful than others.

It is the best of times. It is the worst of times, says Charles Dickens to describe a family business. Many examples of migrants who came here with little or nothing have built businesses that are now considered the envy of the world. How do they do it? Wisely, says Graham Hubbard, professor of strategic management, that means having the right family expertise in the right place at the right time.

But when I started, I made a commitment to shareholders that within five years, I would be on the ASX. By 1985, they had achieved a floatation. That's what we were shooting for. We treated the business as if it was still their own, with no other interests but their own. It's been fairly open and they treat the company as if it was still their own. That's why family businesses are the oldest wealth creation strategies, and secondly, you won't get off track.

The family's values are often the positives. You'll see them in firms like Johnson & Johnson and Ford Motors. The family brings most of the people who own the business.

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