Time to buy Australian?

Is there a better way to invest in Australian equities? PHILLIP BOUSTRIDGE and DENIS CARROLL investigate.

As a country, we've had a really great run. Since the early 90s, all we've known is basically upward trending share markets in Australia and a consequent reliance on equities and growth in our market, regardless of what was happening in the world at large.

Of course, some of this phenomenon can be attributable to the strategic insight behind Paul Keating's dividend imputation program to encourage investment in Australian equities at a time when the Government wanted to encourage the population to invest in its own country.

This strategy has been enormously successful to the point where Australians enjoy a proud reputation as one of the world's largest number of investors per capita per country. But, can this continue?

Up until the Global Financial crisis (GFC), it seemed as if the share markets would continue rising unabated.

Sure, there was the Tech Wreck in 2000, and some other potholes along the way, but we all saw them coming, didn't we? Or we all wanted to believe or hope they wouldn't happen! But overall, it was a pretty good ride until statistical reality intervened.

This was a huge shock to almost a generation of investors who had been nurtured on continually rising share markets. The notion that the markets could actually strip investors of their wealth in one dramatic movement was unthinkable.

The fundamental factor behind this loss of wealth was that very few investors understood the real meaning of investment risk, let alone how to address or alleviate that risk. And why should they? They had been continually buoyed by relatively consistent positive returns over an extended period of time.

The massive bail-out packages which followed the GFC did help to restore some investor confidence – until May 2010 that is. Again, the markets were rocked by the European debt crisis and yet another severe correction in the markets which some say was the most catastrophic in such a short timeframe.

So those investors who were seduced back into equities investing again had their confidence severely dented.

Those who did not and had chosen to stay in cash felt empowered and were naturally quite pleased with their investment decision-making.

Over the last two years, the responses to these global events have been very mixed from an Australian perspective. Some of our very large superannuation funds have gently dipped their toes back in the water by embracing index funds as a means of participating in the equities markets – without paying large management fees for questionable returns.

Some have embraced enhanced passive strategies while others have determined that they can't stay out of the market forever so have re-embraced their traditional approach of long-only equities investing and chosen to ride with the market.

And with world opinion seemingly evenly divided as to the direction of world markets, who is to say which path is the more correct or safer?

At the recent annual gathering of central bank governors at Jackson Hole in the US, opinion on the direction of global growth was again evenly divided, as evidenced by some reportedly "spirited" discussion!

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Clearly the European debt crisis is weighing heavily on people's minds, as well as the slowly moving US recovery which seems to be geared to just how fast the Federal Reserve can print money.

Clearly we Australians live almost in a different world where our fortunes are very much tied to the Asian economies where growth is surging and the demand for our resources seems, in some ways, suspiciously endless.

Our sharemarket has performed surprisingly well and current indications are that it should continue to do so, provided everything stays on course and China continues on its current trajectory.

Again it almost seems almost too easy in plotting the direction of Australia's economic fortunes and this is where the danger lies. Once again,it is timely to ask ourselves, "Is everything as good as it seems? Is my investment strategy as robust as it needs to be in such uncertain times? Is there a better way to invest in Australian equities?"

If there is one lesson that investors learnt from the GFC, it was that much to their dismay, almost everything was correlated with everything else.

Those strategies where investors thought they had truly diversified portfolios with hedge funds and unlisted assets suffered much the same fate and even worse in some cases, than the more conventional strategies.

Those investors discovered that they had paid higher fees for little or no more downside protection. And while the Australian market held up comparatively well, we still suffered proportionately.

So it is timely to ask: Is there a better way to invest in Australian equities, or will everything be all right in the long run?

This latter proposition would be okay if superannuation funds could afford to adopt a genuinely long-term investment strategy and didn't have to worry about annual mark-to-market valuations, let alone the need to ensure there is sufficient liquidity in their funds to meet ongoing benefit and rollover payment obligations.

So the question really is; is there a better way to manage risk in Australian equities without sacrificing returns?

In asking this question, we are not advocating a total ditching of the traditional approach to investing in Australian equities but more accurately, broadening that approach.

We would argue that there should be the ability in an Australian equities portfolio to embrace a strategy which facilitates participation in the markets but does so from a risk-controlled basis which seeks to eliminate the "noise" in the market and focuses on capturing positive returns regardless of its direction. We believe that this can best be achieved with an Equity Market Neutral (EMN) strategy.

We define EMN investing as a strategy where funds hold equal portfolio values in both long (buying listed equities) and short positions (borrowing listed equities in order to sell them) in stocks while seeking to minimise exposure to the systematic risk of the market (i.e., a beta of zero), sectors, and stock size.

By minimising these market exposures an Australian EMN portfolio has a very low correlation to the market index (e.g. S&P/ASX300 Index), sectors (such as financials, resources, health care etc.) and the size of stocks (e.g. large cap, mid cap, or small cap).

Without being tied to the movement of the overall market index, the performance of a market neutral portfolio is almost entirely made up of fund manager skill or "pure alpha" that cannot be easily replicated by a passive index strategy. This is what you are really paying for with active management fees.

When you compare this with the more common large cap long only equity investment strategy, you typically find that up to 90 percent of the variation in returns can be explained by the market exposure (beta) and 10 percent in fund manager skill (alpha).

Not only does EMN flip these exposures over but it actually goes further. For the two years that we have been running the Pengana EMN fund, the market exposure (beta) accounts for only three percent of the variation in returns with 97 percent coming from fund manager skill or alpha.

And let's not forget that this period includes a short selling constraint that was imposed on the market from September 2008 through to May 2009.

The message is that while risk is reduced by including a number of large cap long only portfolios, the benefit is small in comparison to including EMN.

One of the main strategies used in market neutral portfolios is traditional quantitative long/short.

Quantitative modelling is generally required to deal with the complexities involved in the construction of a market neutral strategy.

During the GFC, a number of quant funds did not perform well and have failed to deliver on their promises.

While there are any number of reasons for this, one of the underlying causes has been the mainstreaming of quant managers following the same models and an over-reliance on the integrity of these models with an almost blind faith in their ability to cope with all market conditions. This is what we would term traditional quant or "lazy quant".

We build on a variant of this with a fundamental quantitative model – that is, we like the disciplines and structures that finance has to offer, but we also recognise that there is also a place for fund manager insight and intuition where we constantly ask the question "Is the model right, and if not how do we override it?"

There should be the ability in an Australian equities portfolio to facilitate participation in the markets but from a risk-controlled basis.

It is our firm belief that proper execution of a quant market neutral strategy needs constant attention and evaluation.

There is a perception in the marketplace that all quant models are driven by propeller-heads, with multiple degrees and sometimes very little practical sense.

To effectively manage such a strategy requires a thoroughly disciplined approach applying state of the art quantitative modelling together with an integrated approach that is able to leverage fundamental equity analysis together with rigorous back-testing to validate results.

The use of sophisticated investment tools together with a fundamental overlay analysis will enhance investment returns while reducing the volatility of those returns.

For example, the fundamental law of active management (see Grinold & Kahn, Active Portfolio Management, 2nd Edition, 1999, pp. 148) says that you can improve the chances of success by investing across many investment strategies and stocks, or put another way the Information Ratio of a portfolio is equal to manager skill times the square root of Breadth (number of stocks).

In other words, the greater the number of stocks, the greater the chances of success, provided of course that there is a robust screening process in place.

Investment risk is managed by holding many stocks with smaller portfolio weights. Now as soon as you move from a concentrated portfolio of say 30 stocks to 150, the complexities in alpha construction, portfolio construction, trading implementation and risk management substantially increase.

Naturally the investment process employed by the fund manager should be state of the art. Any quant market neutral fund manager of substance should be able to fully demonstrate and document each of these applications.

One of the strengths of quant market neutral investing is that it facilitates a rigorous risk management process over stock selection, portfolio construction and mandate monitoring.

The fund manager should always be able to provide the client with as much detail as he or she requires with regard to management of their portfolios.

Indeed we distribute a daily risk management report to our marketing team that shows among other things our portfolio exposures to the systematic market risk, sectors and size. In our minds risk management is just as important as return management.

One area of quant investing that we cannot stress too highly is the area of research. This is a fundamental part of the quant investment process.

Given the very nature of quant investing which relies on capturing as much data as possible from multiple sources, it is essential that sufficient resources be devoted to this task by the fund manager. The need for constant testing and validation is paramount.

In-house research tools and customised software provide significant enhancements to the research process and can facilitate greater speed and flexibility in research and modelling. This can result in more effective control and a greater understanding of the underlying data and increased investment oversight.

This, in turn, can facilitate more rapid reaction to suddenly changing market conditions thereby reducing the capacity for potential downside effects on a portfolio. We firmly believe that a quant fund should be devoting a significant amount of time to research and software development.

While there seems to be an ever-increasing number of Australian equities managers in the Australian market, the number of quant managers in this space is relatively small and the number of successful market neutral managers even smaller.

The primary reason for this is that successful investing in this space requires a unique set of skills developed over a number of years and also continual investment to maintain that success.

Investors therefore should expect to pay a premium over a traditional long only manager for the risk management capabilities implicit in a market neutral strategy. However the net result should justify the cost.

Market neutral quant investing has a loyal band of followers overseas but that has not yet happened in Australia.

However as investors think more deeply about the way forward and are increasingly concerned about capital preservation and risk management in equities investing, we expect that this type of strategy will increase in popularity over the next few years.

We are not saying that this should be the only type of equities investing that should be embraced, but we do believe that there is definitely a place in an equities portfolio for a strategy which is not correlated with the market, is non-directional in nature and can consistently benefit through market movements both positive and negative.

If investors are concerned about real portfolio growth and effective risk management, then there should be a place for this type of strategy. **SF**

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