Views

Which Benchmark is relevant to the retail investor?

By Anton Tagliaferro, Investment Director of Investors Mutual Ltd.

Bear markets are always a time of great turmoil for many participants in financial markets because of the enormous pain they cause investors. It is also often a time when many of the livelihoods of participants in the financial markets are threatened due to the fact that their clients have become very dissatisfied achieving negative returns.

Unfortunately bear markets are a fact of life. Indeed, a bear phase in the sharemarket is a self-purging mechanism, where the excesses from the good times are removed from the system.

This is the second serious equity bear market that I have lived through as a fund manager in Australia. The first bear market I experienced was the 1987 to 1990 period.

I have been asked by many advisers and investors recently, "why have so many fund managers that we have relied on with our funds not foreseen the latest downturn and why have they not protected investors from the large capital losses many have delivered?"

Benchmarking

In my opinion, one of the main reasons why many fund managers have let their clients down has been that too many have moved to benchmarking themselves purely against index weightings, because of an unwillingness to be seen as under-performing the index. Over the last ten years in particular we have seen the maintenance of a low tracking error almost become an end in itself with many fund managers.

Maintaining a low tracking error ensures that your return will match the index returns. This may be fine when markets are rising, but can often lead to disastrous performances at times when the excesses are being purged, as has happened in the last three years.

Expectations of retail clients

Based on what I have seen of the thousands of advisers and investors I have met during my years in this industry, the needs of most retail clients, and hence ***their*** benchmark, appear to be as follows:

Capital preservation
The tolerance for negative returns is very low for most retail clients. Clients expect their fund managers to avoid greatly negative returns in falling markets.

Capital growth
Most retail clients would be happy with a reasonable return when markets are rising. Most clients would be satisfied with a long-term return of 6 to 10% p.a.

Income
Often many clients need their portfolio to produce a healthy level of income. In addition, they enjoy the benefits of imputation credits and the associated franking rebates.

Tracking the index closely in bull markets may satisfy investors' needs, but clearly when indices fall heavily, as they have over recent times, it can cause havoc with many portfolios.

How IML meets retail client's expectations

It became very clear to me in the mid 1980's as a fund manager that equity markets are, by their nature, very volatile. Thus, it follows that equities as an asset class can be very volatile to invest in and often returns can be very unpredictable, particularly in the short term.

So what then have we at Investors Mutual done to reduce the volatility of returns from our portfolios, while at the same time trying to meet the retail client benchmark, as defined above?

1. We only hold stocks whose valuation is justifiable, irrelevant of its index weighting. In March 2000, Investors Mutual held no shares in News Corporation. At that time, News Corporation was trading at $28 and represented 18% of the All Ordinaries Index. It had clearly become caught up in the ridiculous tech boom of the time and whichever way we analysed the company we could not justify holding that stock.

2. We always hold very small holdings in high Beta stocks. Thus, we always tend to shy away from large holdings in the Resource sector or concept stocks like News Corporation. These stocks tend to be extremely volatile, and while they may perform well when investors are bullish, they can perform woefully when markets turn bearish. We would rather own larger holdings in less volatile stocks such as Lion Nathan, TAB and Transurban as the mainstay for our portfolios.

3. We are not afraid to hold a high percentage of cash if we cannot find value in a particular market. Thus in March of 2002, we decided to hold 20% in cash in our Smaller Companies Fund. We did this as we were finding it extremely difficult to find real value in the sector. In the next 12 months the sector returned minus 16.3%, while our cash weighting and good stock selection enabled our Fund to post a slight positive return after fees for this period. Holding cash is not a decision we take lightly, however, when value is hard to find we will make the decision to hold cash.

I am sure that in future years, when the bull market returns, the Investors Mutual approach I have outlined in this article will be criticised as being too conservative. Indeed, I am almost certain our strategy will see our Funds lag a fully blown bull market that is led by fads and high beta stocks. However, as sure as night follows day, such a bull market will be followed by a painful bear market where all the above will become very relevant again. ■