

The Renaissance of Active Management

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Despite the share market's recent rally, investment manager NZ Funds remains cautious on the prospects for equity market returns over the next few years and says there is likely to be a shift away from index tracking funds towards active portfolio management in future as a result of flat equity market returns.

Michael Lang, Chief Investment Officer of NZ Funds says the secular bull market that drove asset prices higher between 1980 and 2000 resulted in investors increasingly seeking low cost index tracking funds, with investors never questioning the validity of investment professionals' buy-and-hold investment philosophy.

"Passive management overtook the 'active management' of stock pickers' portfolios because of the perceived value for money. In an environment where the share market rose 12.2% per annum after adjusting for inflation, it was hard for active managers to keep up, let alone outperform."

However, all this changed in 2000 says Lang when global shares fell 59% from the peak in August 2000 to the recent trough in March 2009 – a decline that erased 13 years of share market returns and resulted in investors earning a withering return of -9.8% pa, after adjusting for inflation, over the proceeding nine year period.

The recent rally is the result of a co-ordinated and unprecedented response to the crisis by a host of nations according to Lang who says, "The monetary policies now being utilised are in part experimental. We are in uncharted water and cannot know how the individual will respond to the uncertainties."

Despite this Lang says he is not disheartened by the prospect of a further 10 years of flat or negative equity market returns as he believes the opportunity to prosper from active management has never been higher. As a result, he believes there will be a shift away from index-tracking funds to more active portfolio management as we move back into a stock picker's market.

Most investors have only ever witnessed one market and that is the secular bull market of 1980 to 2000. As Bill Gross, founder of PIMCO – the world's largest bond management company – so aptly puts it "we are all children of the bull market".

However, the precedent of history is unequivocal says Lang. "Bull markets, and in particular the period from 1980 to 2000, are not normal. In fact, they are historically quite rare."

Lang points out that a brief analysis of share market returns confirms the presence of what has come to be known as Kondratiev waves after the Russian economist Nikolai Kondratiev. He says, "Unlike the shorter business cycle, the Kondratiev cycle lasts between 40 and 60 years. Kondratiev cycles are typified by 20 years of low returns, cumulating in a boom which is inevitably followed by a bust and a further 20 years of low returns."

Why have share markets regularly moved sideways for 20 years at a time? Initially, shares tend to move sideways to repair the damage done during the preceding boom says Lang. "Maybe it is because it takes 10 years to mend balance sheets and another 10 years to encourage management to start reinvesting in equipment, technology and labour. During this sideways move, earnings and profitability gradually improve until share prices, still close to where they were some 20 years earlier, no longer accurately reflect the assets and earnings power of the listed company. As a result, shares begin to rise."

Unfortunately, until the unprecedented bull market of 1980 to 2000, bull market periods have tended to only last around 10 years before collapsing says Lang. This was the case from 1921 to 1929 (8 years) and again from 1950 to 1959 (9 years). However, starting in 1980, the US share market did a very rare thing. Put simply, it rose, compounding at 9.2% per annum, for not 10 years but 21 years.

Lang says, "Never before in the history of shares has so much of the long-term average return been owed to so few years."

NZ Funds research shows that from 1802 to 2000, shares returned 3% per annum before adjusting for inflation and 1.6% per annum after adjusting for inflation. From 1900 to 2000, shares returned 5.5% per annum before adjusting for inflation and 2.3% per annum after adjusting for inflation. But from 1980 to 2000, shares returned 12.2% per annum before adjusting for inflation and 8.3% per annum after adjusting for inflation.

Lang says, "Little wonder that investors never questioned the validity of investment professionals 'buy-and-hold' investment philosophy and that there was a shift towards passive management. This is all set to change now and we expect to see a renaissance in active portfolio management."

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