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At the crossroads - insist on a very active equities approach

Julian Morrison & Dr Richard Whiteoak | Allan Gray | 13 August 2015

Six years into a bull market, Australian equity values are beginning to look stretched. But large divergences in valuations across sectors are creating great opportunities to beat the market. Naturally, this is impossible to achieve through a passive approach. The smooth sailing of the last few years has developed complacency among investors. But rougher seas ahead will require a more active approach. It's time to ensure that you engage a truly active manager who can capitalise on the current value dispersion.

THE MORE THINGS CHANGE THE MORE THEY STAY THE SAME

The notion that we are at a crossroads is not something new. Many important aspects of financial markets are cyclical. Uncertainty is ever present, irrespective of whether investors feel confident or afraid. New eras, unprecedented situations, behaviour of investors, behaviour of product providers, volatility, corporate profit margins, risk appetite and risk premiums... It is the cyclicality of these things that creates the opportunity to buy at particularly cheap (or expensive) prices.

For those committed to pursuing better than average investment performance, this is always front of mind – avoid overpaying for popular ideas, shun the crowd, buy cheap and be patient. Unfortunately, this is difficult. Investors' commitment to strict valuation discipline waxes and wanes in a cyclical manner, depending on the latest popular ideas and investment trends.

Today, some of the features pushing valuation discipline to the back of minds include record low interest rates, the retirement cliff and focus on the latest risks to worry about – such as sequencing risk (the risk of a material drawdown at a particularly inconvenient time), and an investment community consequently in hot pursuit of strategies targeting income, low volatility and high quality.

Investors have been distracted from valuation discipline before. There are too many examples to list, but the following excerpt from the classic text 'Security Analysis' provides a handy reminder of one of the more extreme episodes….

> 'The investment process consisted merely of finding prominent companies with a rising trend of earnings, and then buying their shares regardless of price. Hence the sound policy was to buy only what everyone else was buying – a select list of highly popular and

> exceedingly expensive issues, appropriately known as the 'blue chips'.
>
> The original idea of searching for the undervalued and neglected issues dropped completely out of sight. Investment trusts actually boasted that their portfolios consisted exclusively of the active and standard (i.e. the most popular and highest priced) common stocks.
>
> The man in the street, having been urged to entrust his funds to the superior skill of investment experts – for substantial compensation – was soon reassuringly told that the trusts would be careful to buy nothing except what the man in the street was buying himself.'[1]

Here, Graham and Dodd are discussing investor behaviour in the US share market during 1927 to 1929. But, with barely a tweak, how relevant this is when considering the environment today!

In recent times, we have seen investors chasing blue chip income with little regard for price. This has pushed up prices of large dividend paying shares – often dominant constituents of benchmark indices. This is observable in the performance of those shares over recent time periods shown in Figure 1.[2]

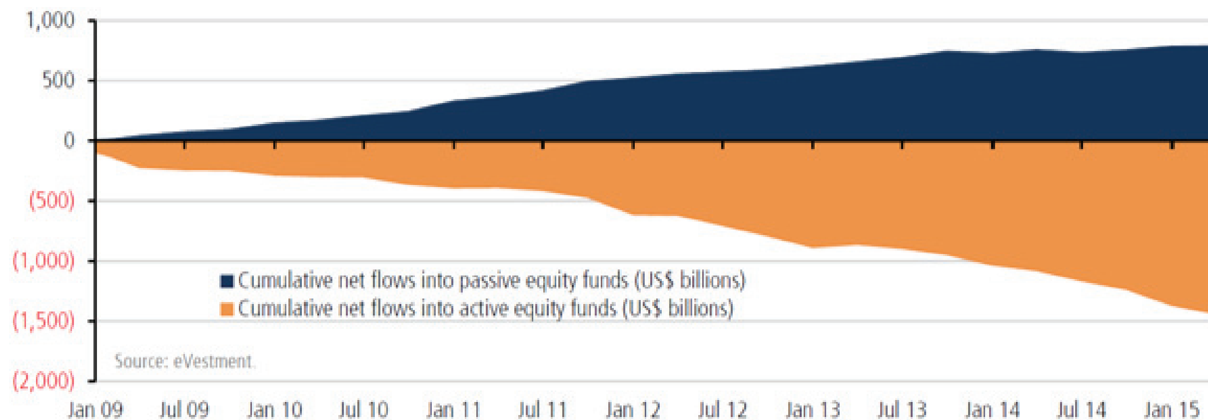
Figure 1: Performance of Australian equity market sectors (as at 30/06/2015)

	1 Year (%)	3 Year (% p.a.)	5 Year (% p.a.)
S&P/ASX 200 Financials Index	3.7	11.7	7.8
Russell Australia High Dividend Index	3.7	11.7	7.8
S&P/ASX 200 Index	3.7	11.7	7.8

Source: ASX, Allan Gray Australia

At the same time, there has been a notable growth in demand for passive funds.

Figure 2: Since the financial crisis, investors have flocked to passive funds over active ones



Source: eVestment. Cumulative net flows into passive and active equity funds tracked by eVestment, 2009 through March 2015

Plenty of active managers also follow popular demand by paying close attention to the passive index and not straying too far from that. The comments below are from a Morningstar research report in November 2014 which reviewed the activeness of managers using the active share measure.

> "... the market's 2007 sell-off coincided with a sharp reduction in active share. We find this somewhat counterintuitive – when certain sectors are under enormous pressure and stock prices are falling, fund managers decide to return to the herd.
>
> It appears that portfolio managers in aggregate preferred to safeguard their relative returns instead of looking after the absolute asset values of their investors' portfolios.
>
> The research also indicates that there hasn't been a return to pre-GFC levels of activeness. If anything, large-cap Australian equities managers have been moving closer to the benchmark."[3]

This paper will return later to the measure of active share in more detail, as well as to the issue of career risk whereby fund managers safeguard relative returns over all else.

So what does this mean for investors?

To help reflect on the current dilemma, this paper considers the following questions:

- Is the environment today really more challenging than "unprecedented" situations in the past?
- Where is it best to allocate mental capacity, thinking and research?
- What does the Australian market look like today? If the market overall is not cheap, is there then a greater argument for active investing?
- If using an active approach, what should we look for in a manager? Is there a major gap between managers who claim to be active and those that are truly active?
- Even those who choose well will be challenged at times. Are you prepared?

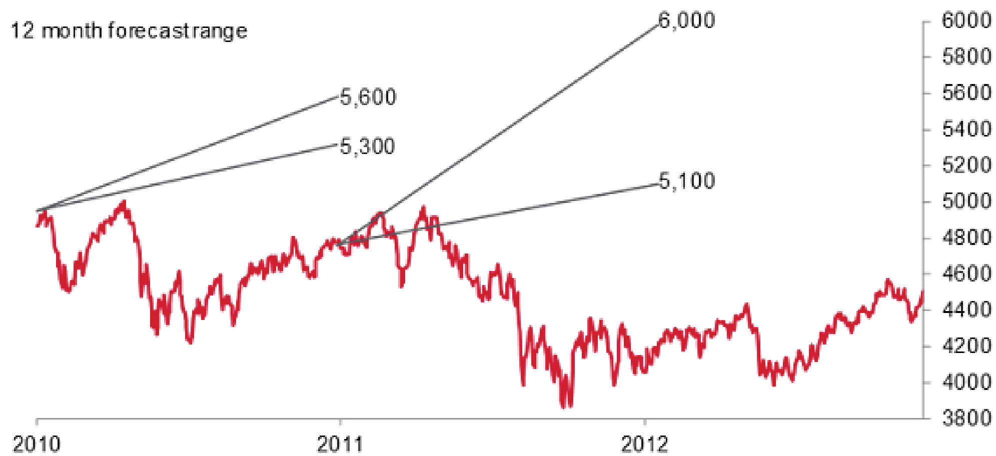
TIMES ARE NOT UNPRECEDENTED, WE ARE ALWAYS AT A CROSSROAD

The things that concern, excite and influence us may change. But we always have to assess our environment and make decisions about how to act. There is nearly always an exciting menu of headline issues for investors to contemplate – although, for most items on the list, time spent thinking about them is unlikely to contribute to better investment decisions.

A selection of today's idea bank would include Greece and the EU, China, Russia, their wider influence, terrorism, the resource boom and downturn, the roaring Australian property market, record low interest rates, the strength of Australian banks, immigration, ageing population, sequencing risk, the importance of income – the list goes on. The trouble is that the broader and more general the subject, the harder it is to use successfully for investment purposes.

To highlight this, the Chief Economist Forum held each year in Sydney and Melbourne features a number of leading economists discussing their views on the Australian and global economies. They have also been known to offer their forecasts for the Australian sharemarket, based on these views. In Figure 3 below, the red numbers indicate the range of forecasts for the ASX 200 index made by the economist panel in 2010 and 2011, for the following year. The red lines converge back to the point the forecast was made in early February each year. On average, the forecasts overestimated the year end level by 26%.[4]

Figure 3: Range of forecasts by Chief Economist Forum panel in 2010 and 2011 for the following year



Source: Chief Economist Forum, Allan Gray Australia

In similar fashion, another survey taken in early January 2013 asked economists for their year-end predictions for four different equity markets. In this instance, the respondents underestimated the year end outcome by an average of 20%.[5]

So, while the economic narrative may provide for interesting debate, it is often of limited use in formulating a reliable investment strategy. Indeed, this evidence suggests that when many people are investing based on a generalised popular idea, it is often a sign that it is not a sensible place to be.

WHERE ELSE MAY THE INVESTOR FOCUS THEIR ATTENTION?

Fund researcher and investment consultant, Zenith Investment Partners, commented recently on the importance of valuation considerations:

> "... investors should be cognisant of broader market valuations when making investment decisions; specifically when considering the allocation of capital between active and passive investment managers.
>
> By definition, there is no valuation discipline in the construction of a passive index strategy. Accordingly, relative to the actively managed peer group, a passive investment strategy is likely to be overweight companies represented at the top of the index. These companies are typically overbought by market participants, hence their lofty position within the index."[6]

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Whatever the current popular themes, sticking to disciplined valuation based on business fundamentals can have tremendous merit as a stabiliser and a guide. Like when driving in fog, the white line down the centre of the road is most informative.

We need to ensure the most effective use of our limited brain capacity on the problem of investment. Howard Marks expresses a clear view on prioritising investment thinking:

> "We don't know what lies ahead in terms of the macro future... The investor's time is better spent trying to gain a knowledge advantage regarding 'the knowable': industries, companies and securities. The more micro your focus, the greater the likelihood you can learn things others don't."[7]

Why might this may be the case? A review of the well-known rich lists demonstrates that a disproportionate amount of wealth compounding over time has accrued to the owners of businesses. The order of these lists may vary according to the relative fortunes of different industries. What doesn't change is that they are repeatedly dominated by those who have owned a successful company over time. This is a common feature of rich lists around the world.[8]

Where should the equity investor expend most thinking capacity? After all, an equity investor is, first and foremost, part owner of a business. Consider a school kid who sets up a lemonade stall to earn some extra money. If they are even slightly diligent they stand a good chance of making a profit, (particularly if they fly under the radar of regulation and taxation). In any case, they are likely to find that the key factors affecting their success are things like amount of foot traffic, number of competitor lemonade stalls in the area (none is better than many), willingness of patrons to pay a price that exceeds costs of production, understanding scalability, availability of setup funding, if required, from parents. If borrowing is required, at what rate will the business pay down the debt and increase equity value for the owner?

In contrast, the global macro fortunes of the world may be more exciting, but are clearly less helpful in determining success for the business owner, in this example.

So, focusing on business fundamentals and valuation discipline can be helpful in preventing the investor straying from the most important drivers of investment outcomes.

It is of equal importance to consider the human or behavioural factors:

- Why do you think you are able to buy at cheap price?
- What is the consensus view?
- Have you considered contrary views?
- What is the expected result in each case?
- How will you respond if future developments go against you?

> "The secret is to understand why you are able to buy the stock. Obviously, when you buy the stock, someone is selling it to you. Now, you may think that is a mistake: but you must understand why that person is making that mistake. Why is he doing something illogical? Investors should devote a lot of effort to trying to understand that. Generally people make mistakes if there's undue pressure on them to do something."[9]

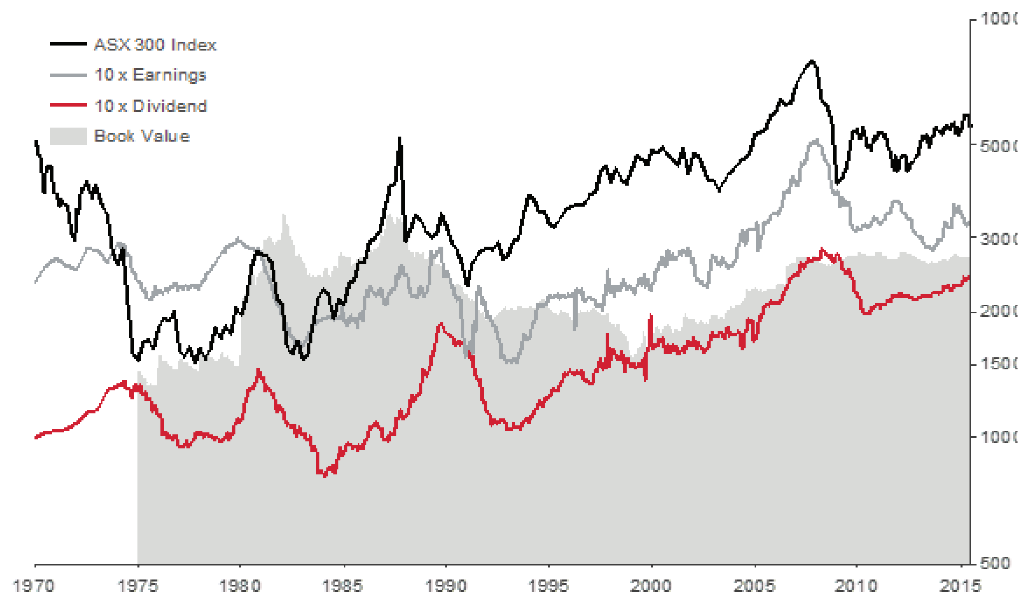
AUSTRALIAN MARKET ON THE WHOLE IS FAIR VALUE AT BEST

With the above thoughts in mind, what is the opportunity for successful investment today?

If we look at the overall market today, it does not look anywhere near bargain territory – rather, it appears to be fair value at best. The black line in Figure 4 shows the price level of the ASX 300 index over the last 45 years, adjusted for inflation. The grey line shows the earnings of the companies in the index, and the red line the dividends, each multiplied by ten to make them relevant on the scale. The last of the fundamental measures shown is the grey shaded area which is the book value of the index.

In simple terms, the greater the distance between the price (the black line) and the fundamental measures, the more expensive the market is, and vice versa. But, simple valuation measures are heavily influenced by cyclicality of earnings. So, it is important to consider what may be cyclical extremes versus more normal conditions. For example, at the 2007 peak, the multiple of earnings didn't look excessive on face value. However, we can see clearly that earnings were well above trend, and therefore on a normalised basis, the market was expensive indeed.

Figure 4: Australian share market (ASX 300) – long term versus fundamentals



Sources: Allan Gray

Currently, it could be said that earnings seem to be about in line with the long term trend, keeping pace with inflation, or a little more. However, the multiple that investors are paying for these earnings looks to be a full price.

Putting this in the context of the full history of this series, a few things stand out. Firstly, if you invested in the broad market index 45 years ago, you would have earned nothing in price appreciation after accounting for inflation. After including dividends, your total real return would have been a more reasonable 4.5% per annum (though still below Australia's long term average). What is more striking is that if you instead invested in the same index only four years later – 40 years ago – you would have instead made an annualised real return of 7.7% per annum.[10] When you buy, and more precisely the price you pay, matters greatly to your long-term investment return.

If we consider some of the other terrible times to buy the market, like the peak of 1987 and 2007, the common human feature to each of those times was extreme bullishness towards the broad market. In contrast, the best times to buy the market were lows like 1974, 1982, 1991 and 2009, when sentiment was overwhelmingly negative. In general, negative sentiment corresponds to better buying opportunities.

Today, with the market on aggregate looking fair value at best, what are the options?

Firstly, we don't have to invest in the aggregate. Accepting that the best times to invest are when sentiment is weak and bargains are more prevalent, we can look for individual

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companies that are today experiencing their own troublesome 1974 or 1991, but that are likely to return to more average conditions in time. This improves the likelihood of paying a low price, and earning a better return.

VALUATION DISPERSION IS EXTREME – GREAT OPPORTUNITIES EXIST TO BEAT THE MARKET

The past 10 years have yielded reasonable returns for those invested in Australian shares – a nominal return of around 7% per annum assuming exposure to a broad market index.[11]

However, when one digs a little deeper, the disparity of returns between sectors within the Australian sharemarket is quite stark and positioning investments correctly may present a significant opportunity for above average returns for long-term investors.

Lately, with many investors pursuing the same types of shares, there has been a high level of trending in the market (Figure 5). This occurs when winning stocks from last year have continued to be winners this year, more consistently than usual.

Figure 5: Australian stocks have been trending more than usual

Sources: MSCI data, Allan Gray. Chart shows the sum of the directional correlation of individual shares in the Australian market year on year. If every winning share from last year was a winner this year (on a relative basis) and every loser last year a loser this year, the correlation would be 100%. If there was absolutely no relationship it would be 0, and if they all changed direction perfectly it would be -100%.

Valuation dispersion has increased as the most popular shares have continued to perform particularly well, while out of favour shares have fallen further still.

This has meant a challenging period of performance for contrarian investors who see greater long term return prospects in the latter category of unpopular and undervalued shares. In

simple terms, contrarian ideas that were assessed as cheap 12 months ago have become cheaper still, and vice versa.

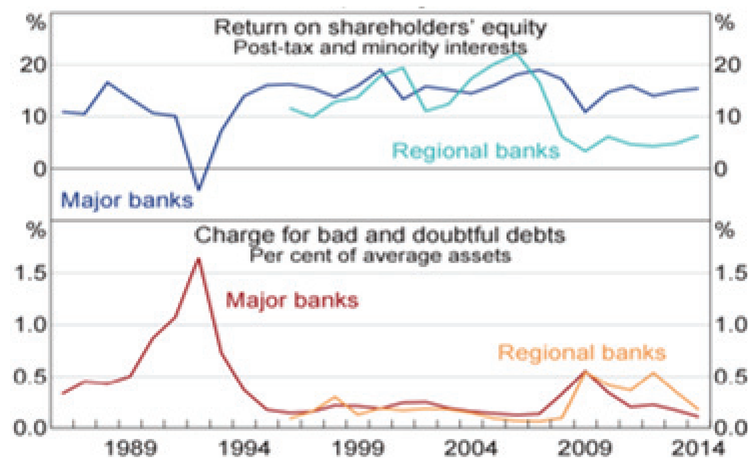
For any given future earnings produced by these companies, the prospective return potentially increases as the share price is pushed incrementally lower. But as always, it goes against human instinct to pursue an investment option that is being shunned by the crowd.

So where is this dispersion greatest, and valuations most attractive, for the contrarian investor?

Australia's best performing sector has been healthcare, which has returned 15.7% per annum over the past 10 years.[12] Above average returns would have also been earned from investments in the financials, telecommunications, utilities and consumer staples sectors over the past 10 years. Call these sectors the "Defensives", with everything else being the "Cyclicals".

Defensives earn their classification thanks to their seemingly low risk and highly resilient earnings streams. One may well question why Australia's banks should sit in the Defensives category. Certainly, this seems to be how many investors are viewing them. Based on how extraordinary and consistent the major Australian banks' profits have been over the past 20 years (Figure 6), perhaps they have earned this classification – for now. Whether this appropriately reflects their risk is another question.

Figure 6: Bank profitability*
Institutions operating in Australia



Sources: Banks' Annual and Interim Reports; RBA. *From 2006, data are on an IFRS basis; prior years are on an AGAAP basis; includes St. George and from 2009, Bankwest

In any case, the Defensives have benefited from significant tailwinds in recent times. Most

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notable of these tailwinds is the low interest rate environment which has driven a ferocious desire for high dividend yields and low risk returns.[13]

Figure 7 shows it is stocks perceived by investors as defensive holdings that have performed best over the last few years. At the same time, companies deemed cyclicals have fallen notably from favour – almost halving in price relative to the well-loved defensives.

Figure 7: Index of cyclicals relative to defensives

Sources: Datastream, Deutsche Bank

Within the cyclicals, resource-related stocks have felt the effect of deteriorating investor sentiment as the resources boom has faded, and the market darlings of a few years back become today's investment lepers. This is a good example of the latent and often unrecognised risk in holding shares alongside the crowd at the point of greatest popularity. If the company delivers future outcomes that are merely 'good', rather than 'fantastic', there may be a much larger downward movement in the share price than people thought possible.

A few years ago, the resource boom was in full swing and the IPO market was completely dominated by new listings in mining and energy (Figure 8). The resources industry was enjoying record profits and bringing on new supply[15]. It was a good time for those companies, but the high share prices made it a risky time to invest.

Figure 8: ASX list of upcoming IPOs, as at November 2011[14]

888 Resources Limited	Global Mineral Resources Limited
Aperio Resources Limited	Goldphyre Resources Limited
Aurelia Resources Limited	Goodrich Resources Limited

Beachfront Resources Limited	Instinct Energy Limited
Blenheim Resources Limited	Kara Minerals Limited
Bligh Resources Limited	Klondyke Gold Limited
Blue Sky Alternative Investments Limited	Kumarina Resources Limited
Cassini Resources Limited	Melrose Gold Mines Limited
China Integrated Media Corporation Limited	Messina Resources Limited
Classic Minerals Limited	Mogul Resources Limited
Cohiba Minerals Limited	New South Resources Limited
Coritcal Dynamics Limited	Precious Metal Resources Limited
CountryCoal Limited	RXP Services Limited
Discovery Resources Limited	Spencer Resources Limited
Federation Metals NL	Titan Energy Services Limited
FeOre Limited	Walla Mines Limited
Flinders Exploration Limited	West African Gold Limited

Source: ASX

Today, with sentiment having turned the other way, we may be seeing a build-up of latent return opportunity in some of the cyclical sectors, with low prices actually providing a less risky opportunity to buy the shares than, say, in 2011.

Figure 9 shows the Australian energy sector has fallen to depressed multiples of book value as operating conditions have toughened considerably.

Figure 9: Australian energy sector – price to book value

Sources: MSCI data, Deutsche Bank

In contrast, if we look at the same metric for Healthcare, the best performing sector over the last 10 years (Figure 10), we see that its' popularity in recent years has resulted in valuations moving to the higher end of the scale. As discussed, other sectors featuring popular blue chip defensive shares – Telco, REITS and banks – have also enjoyed strongly rising share prices.

Figure 10: Australian healthcare sector – price to book value

Sources: MSCI data, Deutsche Bank

So, investor behaviour has continued to drive a trend of rising prices in popular Defensive stocks. At the same time, out of favour Cyclicals have continued to trend lower as they are neglected by the crowd.

The growth in popularity of passive investments and direct share holdings in names that dominate passive indices may have perpetuated the strong performance of this section of the market. But those investors who believe that this level of trending cannot persist indefinitely should seriously consider the risks of continuing to hold popular shares, alongside the crowd, at elevated price levels. One may also consider the opportunity for outsized returns by investing in out of favour depressed shares.

YOU CAN'T CAPTURE THESE OPPORTUNITIES WITH A PASSIVE APPROACH – YOU NEED A TRUELY ACTIVE APPROACH

If one decides to aim for outperformance by taking advantage of current valuation divergences, a passive investment approach will not help. It is worth reminding ourselves of the passive proposition. Whatever reasons are argued for taking a passive approach, the investor should know that they are, first and foremost, accepting the following position:

> "As a passive investor I am content with achieving an average investment outcome."

In most cases this is because...

> "I am happy to forgo the potential for a better than average outcome in return for removing the potential for a worse than average outcome."

There are legitimate and sensible arguments for passive investment management. But it is critical that these central truths are accepted consciously. If the passive investor is not fully accepting of their decision to target average outcomes, they may experience disappointment when they actually achieve just that. This would be particularly so when the average outcome is a bad one.

For investors who want to be positioned away from the crowd, a truely active approach is a necessity. The investor's motivation may be to take advantage by buying unpopular stocks at depressed prices. Or, it may be to avoid the risks of overvalued popular stocks. Either way, if you want a different outcome to the average, you have to be positioned differently.

But how do you select an active manager? After all, we are regularly presented with evidence that the majority of active managers underperform.[16] If we followed the suggestion of these surveys, we would immediately quit trying to outperform. But that only makes sense if we believe all active managers are the same, and if we actually try to select managers using a random dart throw. On the assumption that people don't actually select investments that

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way, a useful step may be to first distinguish active managers according to their investment behaviour.

PROCLAIMED ACTIVE MANAGEMENT VERSUS REAL ACTIVE MANAGEMENT

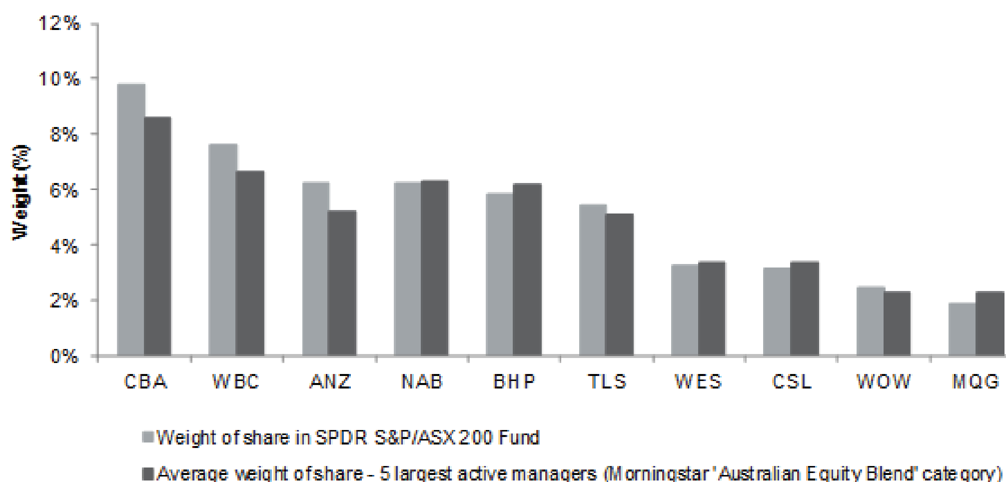
Some useful advice for setting expectations regarding human behaviour is to focus first on what people do, rather than on what they say. This certainly applies when assessing fund managers and may be particularly useful in weighing up whether a manager is truly active, or really just hugging the benchmark.

Many active managers do indeed underperform but this is not a good argument for giving up on active management. The same point is made every year, with studies across many markets citing that the majority of active managers fail to outperform the broad market after fees.[17] But this shouldn't be a revelation.

It is a superficial argument because the fact that "most active managers underperform" is incorrectly used to assert that "active managers have no skill and can only outperform by luck. It is not worth trying to select a good active manager".

If we think about why most active managers underperform, we can account quite easily for a large component. A large proportion of the money under active management is managed with minimal divergence from market benchmarks. Looking at the top 10 holdings of the largest funds versus benchmark, Figure 11 shows how an equally weighted portfolio of the five largest actively managed Australian equity funds closely overlaps the ASX 200 top 10 shares.

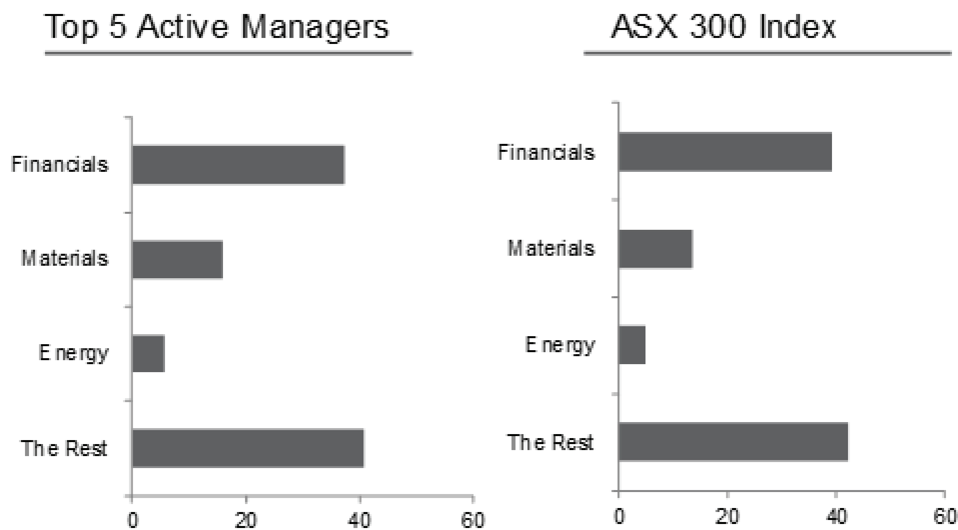
Figure 11: An equally weighted portfolio of the five largest 'actively managed' Australian equity funds overlaps the ASX200 top 10 shares



Source: Morningstar. Data as at May 2015

If we equal weight these five largest active managers, we get a portfolio that looks very similar to the benchmark (Figure 12). This is also apparent when we compare sectors.

Figure 12: Equal weight the five largest 'actively managed' Australian equity funds



Source: Morningstar. Data as at May 2015

If one invests this way, and pays an average active fee of say 0.90% per annum, a reasonable base case assumption for future performance might be for annual underperformance of about... 0.90% per annum. And, many actively managed funds exhibit this behaviour of acute benchmark awareness. So the annual statistics for underperformance of active managers should not be a surprise.

It is likely that fund manager business risk and portfolio manager career risk drive this behaviour. Jeremy Grantham's description of career risk is useful here for two reasons. Firstly, it is an articulate warning that the influence of career risk is very real. Secondly, it reminds us that this behaviour can create great opportunities for active investors who are willing to deviate from the herd:

> "The central truth of the investment business is that investment behaviour is driven by career risk. In the professional investment business we are all agents, managing other peoples" money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority "go with the flow", either completely or partially.

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> This creates herding, or momentum, which drives prices far above or far below fair price. There are many other inefficiencies in market pricing, but this is by far the largest."[18]

Benchmark hugging behaviour is not difficult to identify. With a little effort, investors interested in a better than average outcome can avoid these approaches and narrow down their search considerably to more "active" active managers.

Amongst the tools available to investors for this purpose, active share has become more widely known in recent years, and which on the face of it seems to have some efficacy. Active share measures the difference in holdings between a fund and its benchmark on a scale of 0% to 100%. If a fund has exactly the same holdings as the benchmark, it will have active share of 0%. If it holds nothing that is in the benchmark, its active share will be 100%.

Martijn Cremers and Antti Petajisto (2009) developed and assessed this measure and their work was initially published in their paper "How Active is Your Fund Manager. A New Measure that Predicts Performance." They have since followed up with further work on how active share may be used, which may prove useful further reading.[19]

Cremers and Petajisto broadly define the activeness of fund managers based on the active share measure. Active share of up to 20% is categorised as "passive", while funds with 20% to 60% active share range are termed "closet indexer". Active share of over 60% is considered "active", but the level of activeness ranges considerably.

In the original paper, Cremers and Petajisto found that:

> "Active management, as measured by Active Share, significantly predicts fund performance relative to the benchmark. Funds with the highest Active Share outperform their benchmarks both before and after expenses, while funds with the lowest Active Share underperform after expenses."

In a 2014 paper,[20] Cremers and Pareek further partitioned funds according to turnover and found that high active share combined with low turnover was a strong indicator for potential outperformance.

Returning to the five largest actively managed Australian Equity funds, active share puts all of them in the closet indexer (20% to 60% active share) category. This is notable given these are five of the largest (most well used) active funds.

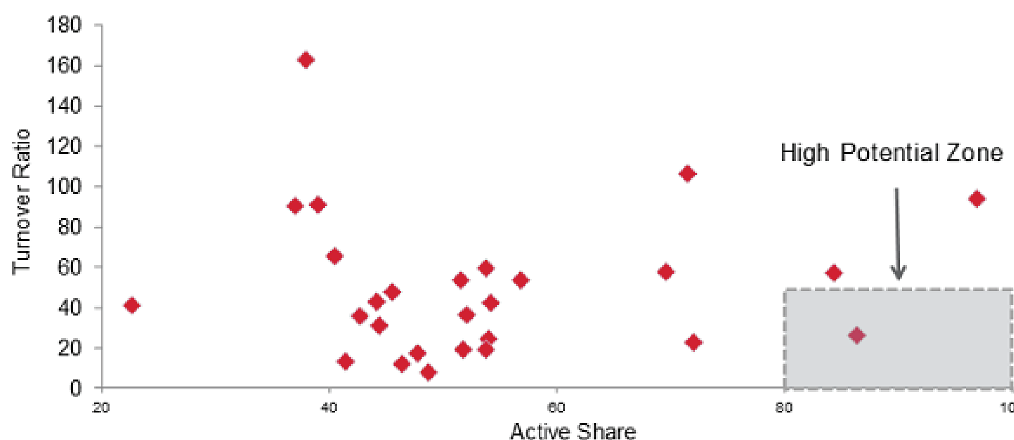
Figure 13: Active share of the five largest actively managed Australian Equity funds

Fund Name	Active Share (%)
Manager A	46.52
Manager B	41.34
Manager C	47.76
Manager D	39.93
Manager E	25.26

Source: Morningstar. Data as at June 2015

Investors can use measures like active share to identify truly active managers from those who are much more index-conscious. This may be combined with other measures such as turnover, and tracking error to further distinguish the universe. As Figure 14 suggests, in the Australian market, managers are avoiding the high potential zone of high active share and low turnover.[21]

Figure 14: Australian equity fund managers – turnover vs active share



Source: Allan Gray Australia

A note of caution is due. To invest purely on the basis of such quantitative measures pays no heed to the vital matter of understanding how your money is invested. Without understanding that valuation discipline has been applied in selecting your investments, you have no idea of whether you have overpaid, nor therefore the true risk faced by your capital. These measures may serve best as a starting point (and potentially a very useful one) for significantly narrowing the list.

Lastly, considering the impact of "career risk" as a key driver of closet index behaviour, it may be helpful to the investor to look for evidence of true alignment of interest between the fund manager and their clients. What evidence is there that the manager puts investment conviction ahead of asset raising? Do they invest a significant amount of their own money in the fund? Are there strong long term incentives for key investment staff?

PERFORMANCE AND PATIENCE

Given the preceding discussion, an important caveat is warranted. Even successful, truly active managers will not outperform consistently every month, quarter or even year. For investors who hold this unrealistic expectation of an active manager, passive investing is undoubtedly the only viable route.

To illustrate this important point, imagine you were able to select a better than average manager. In fact, imagine that 25 years ago, you had the foresight to select the best active equity manager in terms of relative performance over the ensuing 25 years (note, this is not an Allan Gray Australia fund). The relative performance of that manager is shown in Figure 15, which shows cumulative relative performance. That is, when the line is upward sloping, the fund is outperforming; when downward sloping, it is underperforming. There have been seven instances where the fund has underperformed by more than 10%. The average time to recover that underperformance has been 6.5 months, though sometimes it has taken considerably longer.

Figure 15: Cumulative relative outperformance – best performing equity manager in category[22]

Sources: Morningstar and Allan Gray Australia

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Warren Buffett has commented that the share market is a mechanism that transfers wealth from the impatient to the patient. The point is that even if you select a better-than-average manager, you should expect to experience periods of meaningful underperformance. And you will need the fortitude and patience to sit through that, if you want to benefit fully from the outperformance the manager may deliver over time.

We will leave the last word on patience to Buffett's investment partner, Charlie Munger. This was his response to a question about whether he was concerned over a big fall in the Berkshire Hathway share price:[23]

> "This is the third time Warren and I have seen our holdings in Berkshire Hathway go down, top tick to bottom tick, by 50%. I think it's in the nature of long-term shareholding of the normal vicissitudes, of worldly outcomes, of markets that the long-term holder has his quoted value of his stocks go down by, say, 50%. In fact, you can argue that if you're not willing to react with equanimity to a market price decline of 50% two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you're going to get compared to the people who do have the temperament, who can be more philosophical about these market fluctuations."

SUMMARY

Investors always face uncertainty. The environment today presents its own special challenges. But rather than getting distracted by the most interesting economic narrative, investors should be careful to focus their mental capacity, thinking and research on more micro considerations that will be most useful in making investment decisions.

The Australian market today does not look cheap on aggregate. But, we do not have to buy the aggregate, and the notable dispersion in valuations is creating great opportunities for active managers to outperform.

For investors who choose the active path, there is a very wide range in the level of "activeness" displayed by Australian equity fund managers. It is important to take steps to differentiate between truly active managers and closet indexers. Furthermore, it is important look for evidence of alignment of interest and a culture that places investment conviction over asset-raising.

Finally, investors who decide to use an active manager must be mindful that unless they can exercise patience during periods of underperformance, they are unlikely to receive the benefit of any outperformance achieved by the manager.

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ENDNOTES

1. Excerpt: Benjamin Graham and David Dodd. 1934. Security Analysis, McGraw-Hill

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