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When are fees too high?

The potential impact of smart beta
to disrupt active Australian equity strategies

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Introduction

The use of smart beta is on the rise by asset owners, as evidenced by the growth in the number of exchange traded funds which track smart beta indices. Their appeal is that they provide a combination of both active and passive management: combining professional investment techniques with low fees in a rules based construct, to deliver potentially better outcomes for investors.

Smart beta is a disruptive innovation. A 2014 article in *The Economist*, "*Will Invest for Food*", described how the investment industry around the world is being squeezed¹. Australian equity managers are not immune. Our analysis shows that much of that alpha that high-fee active managers produce can be replicated more economically using smart beta techniques. Only those active managers who can demonstrate identifiable and persistent 'real' alpha will prevail.

Defining smart beta

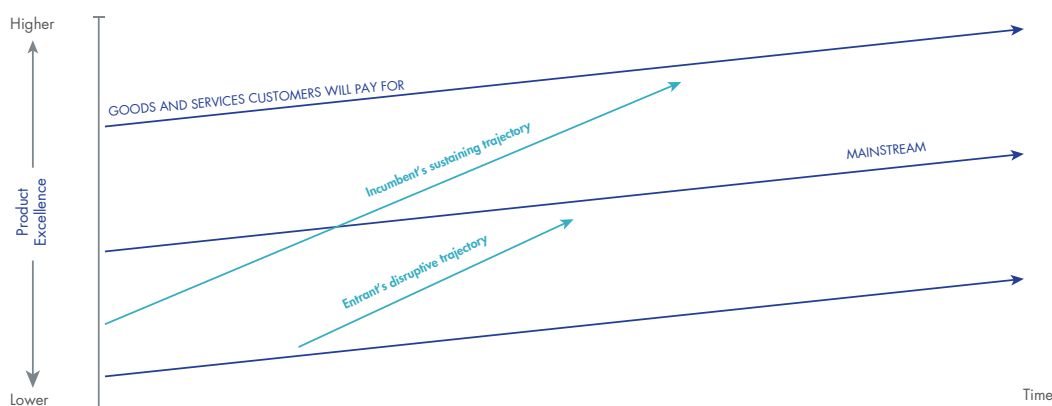
"The term smart beta is now used to describe any, transparent, rules-based investment strategy, the simplest of which can be reproduced as index benchmarks, that is, as 'smart beta' indices that can be compared with the more familiar market cap-weighted indices such as the S&P500 Composite or the FTSE-100 indices."²

Disruptive innovation

In *The Innovator's Dilemma*, Clayton Christensen introduced the world to three types of innovation:

1. **Revolutionary** – these are very rare. They result in products that are so improved or new that they simply replace the previous product. For example, the horse and buggy was replaced by the car.
2. **Sustainable** – these are common. They are incremental improvements on existing products. For example, the fifth blade in a razor, the clearer TV picture, better mobile phone reception or lower costs.
3. **Disruptive** – these are also rare. They create new markets. According to Christensen, disruption is a process whereby a company is able to successfully challenge established incumbent businesses. Specifically, as incumbents focus on improving their products and services for their most demanding (and usually most profitable) customers, entrants that prove disruptive begin by successfully targeting overlooked segments by gaining a foothold by delivering more-suitable functionality—frequently at a lower price. Incumbents, chasing higher profitability in more-demanding segments, tend not to respond vigorously initially. Entrants then move upmarket, delivering the performance that incumbents' mainstream customers require, while preserving the advantages that drove their early success. When mainstream customers start adopting the entrants' offerings in volume, disruption has occurred.

Chart 1 – The disruptive innovation model



Smart beta: A disruptive innovation

According to Kahn and Lemmon, "Smart Beta strategies are a disruptive innovation with the potential to significantly affect the investment management industry, particularly traditional active management"³. We are witnessing this in Australia as smart beta moves into the mainstream.

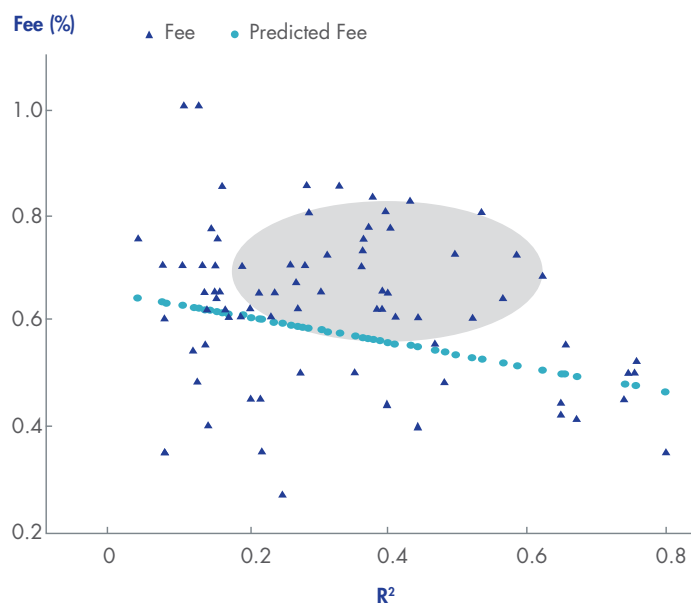
Kahn and Lemmon were able to demonstrate the scope for disruption in their paper *The Asset Manager's Dilemma: How Smart Beta is Disrupting the Investment Management Industry* by examining a sample of 79 active global equity managers and comparing them to the market size, value, quality, momentum and low volatility smart beta factors. These factors are identifiable, persistent drivers of return.

Among the sample, the fee for the median active manager was 65 basis points (bps). The database the authors used was the eVestment database, which is primarily used for institutional investors, hence the lower average fee.

By using the returns of each fund and attributing the returns to the factors, they were able to illustrate that smart beta exposure is already a significant part of active management. That is, much of their performance can be explained by factors; the same factors used in smart beta strategies.

The problem for active managers is that their clients could use a smart beta strategy at a significantly lower cost to achieve a similar outcome. Kahn and Lemmon then plotted the actual fees charged by the active managers against the fee that the client should be paying an active manager for, what they call 'pure alpha'. This is the 'predicted fee'. The results are shown below.

Chart 2 – Actual fees and predicted fees vs the fraction of manager's active variance (R^2) explained by six smart beta factors, January 2010 to December 2014



Source: Kahn & Lemmon, 2016. "The Asset Manager's Dilemma: How Smart Beta Is Disrupting the Investment Management Industry." Financial Analysts Journal

The triangles in Chart 2 show the actual fees versus predicted fees. The light blue dots are the fees that should be charged (predicted fees) based on the 'true' amount of alpha being produced. The result show instead of 65 bps, the appropriate fee for these clients to pay should have been closer to 42 bps where all the alpha can be explained by smart beta factors.

The blue dots are downward sloping, showing lower fees should be paid for smaller amounts of alpha. The highlighted area, according to the authors, shows roughly those funds that are most likely to be disrupted by smart beta. There are 29 out of 79 in the sample. That is over 30% of global equity managers, according to Kahn and Lemmon that will be disrupted by smart beta.

Australian analysis

Intrigued, we conducted a similar analysis on active Australian equity managers benchmarked to the S&P/ASX 200. The monthly performance returns for 79 active Australian equities funds from the Morningstar database were analysed. In the instance two similarly named funds were managed by the same fund manager we selected the lower fee wholesale fund for inclusion in our results, removing the higher fee fund. The fee field used in Morningstar Direct is Indirect Cost Ratio (ICR).

We compared the returns against either MSCI Australia Value, Growth or IMI Diversified Multiple-Factor Index monthly returns over the five years of April 2014 to March 2019 to calculate R².

R-squared (R²)

R² is the coefficient of determination. It is a statistical measure used to determine the proportion of variance of a dependent variable (in this case the monthly returns of the active manager) that is explained by an independent variable (in this case the returns that can be attributed to factors). If the R² is 0.50, then half of the variation can be explained by the independent variable. In Kahn and Lemmon’s example, R² of 0 is ‘pure alpha’.

While the earlier study used six factors to analyse global equities, due to availability of data, to demonstrate the performance of MSCI’s factors we have assessed performance over the last five years using value, growth and multi-factor indices covering the Australian market. We have used Morningstar’s fund style classification to determine the strength of the relationship between the applicable MSCI Australia factor index and the active fund.

Table 1: Breakdown of Australian Equity Funds

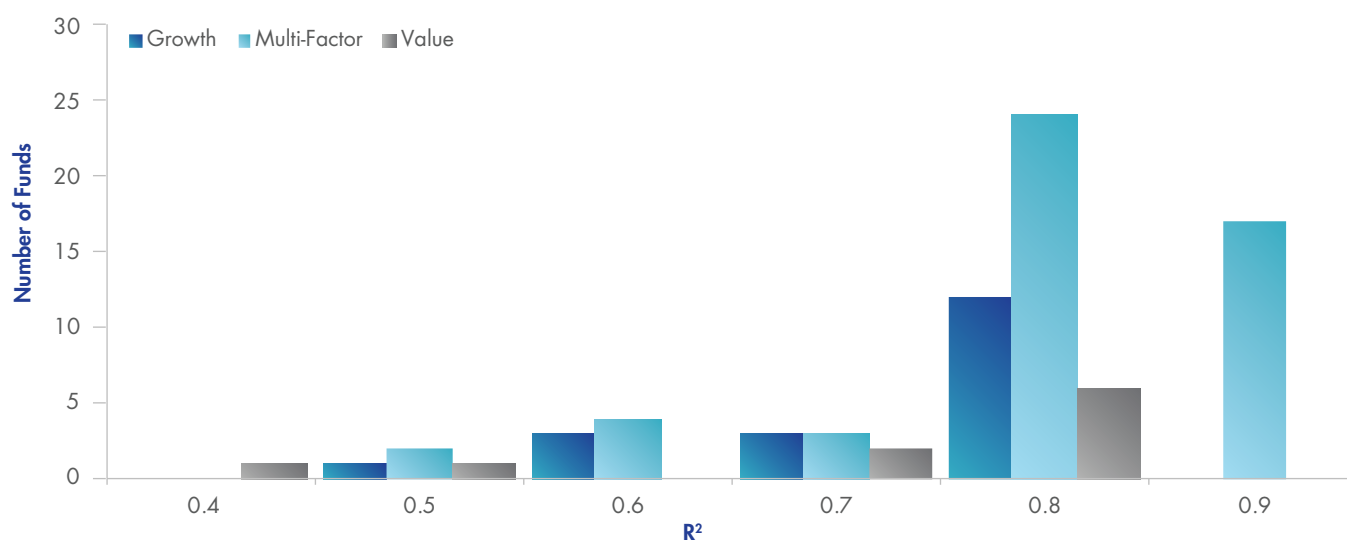
Morningstar Fund Style	MSCI Australia Factor Index	Number of Funds
Blend	IMI Diversified Multiple-Factor	50
Growth	Growth	19
Value	Value	10

Source: VanEck Morningstar Direct, MSCI

As can be seen in Chart 3, R² ranged between 0.48 and 0.94, a tighter range than Kahn and Lemmon’s study suggesting a higher proportion of active managers’ performance in Australian equities is attributable to beta as opposed to alpha. The smaller subset of investable stocks in the Australian universe, compared to the global universe accounts for the difference in R² outcomes.

The concentration in Australian equities further compounds the difference. Unlike the MSCI World Index, the S&P/ASX 200 Index is dominated by a small number of large cap stocks: 60% of the market capitalisation of the S&P/ASX 200 being made up of just 20 stocks. This means only a few sizable stocks, and thus their characteristics, meaningfully contribute to the performance of the market benchmark. Once again the results call into question the high fees investors are being charged for the ‘true’ alpha being produced by Australian active managers.

Chart 3 – Fraction of Australian equities managers’ active variance (R²) explained by factors
1 April 2014 to 31 March 2019



Source: VanEck, Morningstar Direct. Past performance is not a reliable indicator of future performance.

We assumed 111 bps (average active management fee) and 35 bps (smart beta management fee)⁴ for 0.48 and 1.0 R² respectively and for simplicity modelled predicted fee⁵ as a linear function of the R² statistics.



Source: VanEck, Morningstar Direct. Past performance is not a reliable indicator of future performance.

Chart 4 – Australian equities managers’ actual fees and predicted fees vs the fraction of managers’ active variance (R²) explained by smart beta factors, 1 April 2014 to 31 March 2019

In Chart 4, if an active Australian equity fund delivers 50% pure alpha (R² = 0.5), its fee should be about 111 bps. If it delivers 100% smart beta (R²=1), its fee should be about 35 bps. Most Australian equity funds should be charging closer to 35 bps as most of their performance can be explained by smart beta (R² close to 1).

Comparing actual versus predicted fees illustrates that the majority of Australian active managers’ fees are overpriced. Furthermore, we anticipate the 65% of active managers (51 out of 79), captured in the shaded area will likely be disrupted by smart beta because investors are able to achieve the same outcome at a lower cost with smart beta.

Evolve to survive

Active managers need to evolve. Kahn and Lemmon recommend active managers assess their smart beta performance and the pure ‘alpha’ they offer and charge fees accordingly to evolve⁵.

Beyond financial analytics, asset managers need to differentiate themselves by providing what smart beta cannot. If these differentiators do not exist then investors will question the fees they pay and smart beta will enter the mainstream. Incumbents will be displaced. Australian equity managers that continue to charge high fees while only delivering performance that can be matched or bettered by smart beta face extinction.

1 The Economist: Will Invest for Food? (2014)

2 Clare et al: Smart Beta: Part 2: What lies beneath? (2015)

3 Kahn and Lemmon: The Asset Manager’s Dilemma: How Smart Beta is Disrupting the Investment Management Industry (2016)

4 The managements costs of the smart beta ETF, the VanEck Vectors Australian Equal Weight ETF (ASX: MVW)

5 Kahn and Lemmon: The Asset Manager’s Dilemma: How Smart Beta is Disrupting the Investment Management Industry (2016)

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