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Moment of truth for active funds

Institutional and retail investors alike have formed the perception that traditional active Australian equity management is just not delivering. And the numbers are in their favour.

Outperforming the bullish market of 2019 proved difficult for most. Only a quarter of active Australian equity large cap managers within the Morningstar coverage universe beat the index after fees, according to Morningstar's Annual Australian Equity Sector Wrap 2020.

About 60 per cent the Australian large cap managers researched by Morningstar failed to outperform, but still charged relatively high annual fees.

But Morningstar analysts suggest market volatility spurred by the pandemic may give the best active managers an opportunity to prove their worth.

"History has shown us large market dislocations have been times when good active managers have proven their worth, the best of them delivering lower volatility and greater downside protection than the passive index funds," analysts say.

And some have already done just that done just that. In the first three months of this year, 25 fund managers under Morningstar coverage outperformed the S&P/ASX 200 TR AUD index. Fifteen of those also outperformed in the distressed market of early 2020. These include **Hyperion Australian Growth Companies 3344**, **Platypus Australian Equities 14369**, **Bennelong Australian Equities 16998** and **Greencape High Conviction 14653**.

Volatile periods also tend to flush out some underperformers. As the Warren Buffet saying goes, when the tide goes out, we see who has been swimming naked.

More than two-thirds of managers delivered first-quarter 2020 returns either in line with or below the index. Many of these strategies were overweight banks, energy, and mining stocks prior to the outbreak of COVID-19. These sectors have borne the brunt of the global economic shock and associated oil crisis.

Outperformers of 2019 and 2020

Name	Morningstar Category	Total Ret YTD	Annual Ret 2019
Hyperion Australian Growth Companies	Australia Large Growth	-11.35	30.61
Platypus Australian Equities - Wholesale	Australia Large Growth	-17.37	27.42
Greencape High Conviction	Australia Large Growth	-20.89	27.42
Bennelong Australian Equities	Australia Large Growth	-19.94	27.34
Pendal Focus Australian Share	Australia Large Blend	-22.42	27.14
Alphinity Concentrated Australian Share	Australia Large Blend	-22.55	26.24
Greencape Broadcap	Australia Large Growth	-20.20	26.17
CFS Wholesale Australian Share	Australia Large Growth	-19.07	25.99
T. Rowe Price Australian Equity	Australia Large Growth	-23.05	25.78
CFS Wholesale Imputation	Australia Large Blend	-21.15	25.69
BlackRock Advantage Australian Equity	Australia Large Blend	-22.06	25.00
Airlie Australian Share	Australia Large Blend	-21.20	24.37
Alphinity Australian Share	Australia Large Blend	-21.29	24.26
Pendal Ethical Share	Australia Large Blend	-22.10	23.87
Pendal Australian Share	Australia Large Blend	-22.85	23.79
S&P/ASX 200 TR AUD		*-23.10*	*23.40*

Source: Morningstar coverage universe, Morningstar Direct

Passive management appeals in good times

The struggle for dominance between active and passive managers continued through a buoyant 2019. Low interest rates and the momentum-driven market confounded most value managers.

"Value managers became increasingly perplexed by the market which valued companies that were new, disruptive, or which offered elevated dividend payout ratios," analysts say.

Meanwhile the S&P/ASX 200 index scaled new heights as investor money flooded into passive funds, which now comprise more than 30 per cent of Australia's total funds universe.

However, Morningstar analysts say there are several arguments for maintaining faith in good active management, especially at this point in the cycle.

"Outperforming an index after fees over a sustained period in a relatively well-researched and small equity market is very difficult, and there are a multitude of factors both within and beyond the control of Australian active managers that can affect performance," analysts say.

"Unfortunately, the task is beyond the reach of many active managers on a consistent basis, and until lower fees and greater outperformance consistency are achieved by these active fund managers, it is difficult to see the flow of money to passive declining.

"However, there is also evidence that some active managers are capable of consistently outperforming the index through the cycle."

Morningstar analysts delved into the team structure, performance, staff turnover, investment processes and other qualitative measures of 89 Australian large-cap equities strategies and 36 Australian small-cap strategies in 2019, as part of their regular reviews.

They then issue an Analyst Rating indicating whether they believe the fund will consistently beat its peer group or relevant benchmark by a large enough margin given the risk it entails.

Analysts say this year's Medalists share many common traits, including a stable team, robust process, solid business structure, reasonable pricing and an ability to deliver in a variety of market conditions.

See the full list of ratings, upgrades and downgrades for 2019 here.