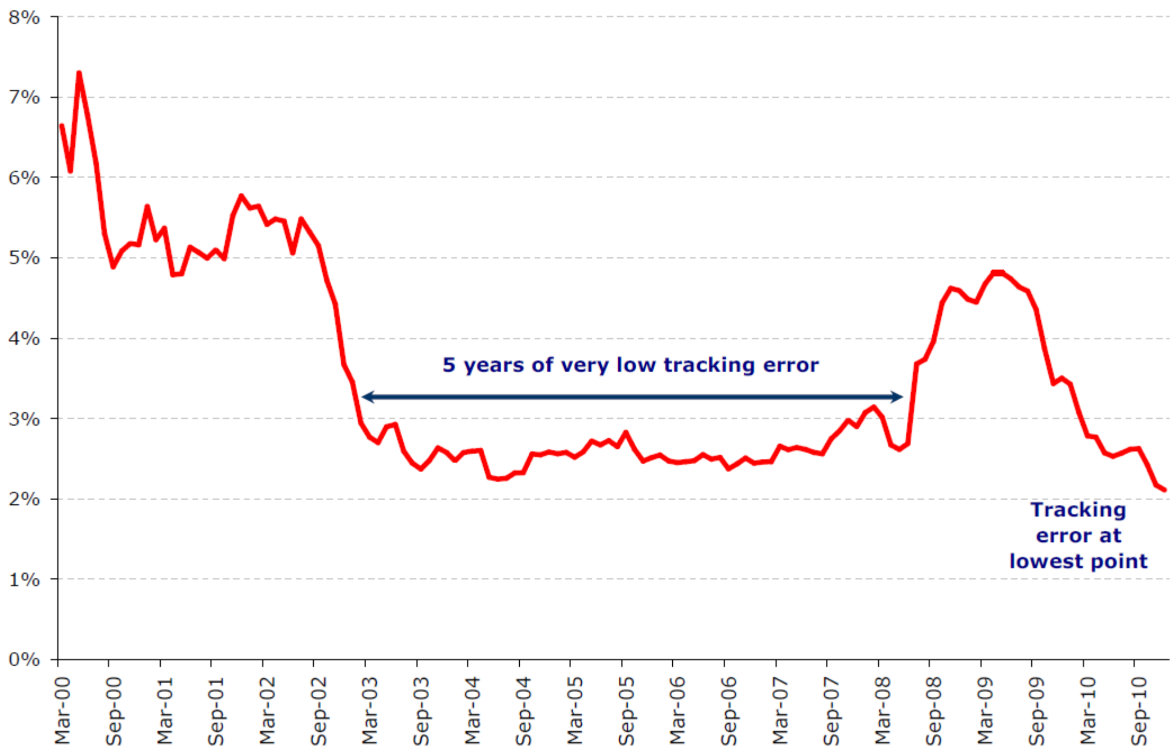
CAN THE PRO'S STILL BEAT THE MARKET?

CAPE TOWN: I feel that there are very few fund managers who have the ability to beat the market over the long term. However there is a massive asset management industry which generates hundreds of millions in profits on an annual basis attempting to do just that. Cynics might argue that this is one of the biggest scams of all time. New research shows that even the good fund managers are finding it progressively more difficult to beat the market. This type of research shows that a private investor might be getting the advantage over the professionals.

BIG FUNDS ARE STARTING TO LOOK LIKE THE MARKET

Over the last 11 years, portfolios managed by large asset managers have increasingly started to track the overall stock market. The graph below shows the average tracking error of their portfolios compared to the market. If the tracking error is high, it means that the portfolios are moving much higher or much lower than the market. From the year 2000, the tracking error has consistently narrowed to the point where there is little difference between the market and the fund managers. If this trend continues it is likely that the costs of these funds will eventually drive their performance below the market on a permanent basis.

Asset Managers are not beating the market by much - Average Manager tracking error



Source: Prescient, Monthly information drawn from Alexander Forbes SA Equity Manager Watch

This means that any investor who wants to invest with a large, well-established asset manager, might not be rewarded for taking the risk. The research for the graph above was done by Prescient Investment Management which is one of the managers aiming to beat the market. To their eternal credit, they are not afraid to point out flaws in the asset management industry. They are of the opinion that they will be able to find ways to increase their performance relative to the market but they point out that this will be very difficult. Prescient says the diminishing tracking error is probably due to a range of factors including: the more efficient flow of market information, electronic trading, less listed shares and improved financial reporting standards. With the way that companies now report their results on their websites, it is now possible for any investor in the world to do proper research on listed companies without being in the country. This means increased competition combined with improved financial information which is only going to make life tougher for the fund managers.

WHERE IS THE OPPORTUNITY?

If large fund managers are becoming closet indexers - investors must consider their options more carefully. One option is to convert all your equity investments to index trackers. I think this is a sound strategy and will reward investors over the very long term. You will just need to select your index very carefully. There are some downsides to this approach: you will lose out on the potential upside generated by a great manager (if you can find one) and you are more exposed to asset bubbles.

Another option would be to choose a small asset manager who can invest in a wider selection of companies (especially smaller companies) in an attempt to beat the market. This type of manager must have a very different approach to the herd and you will need to be satisfied that they know what they are doing. Don't simply rely on re-treaded stockbrokers in the hope that they know what they are doing, they are usually as clueless as everyone else.

Private investors have a real advantage in this environment, you can select your own companies without any of the restrictions that large funds have. For instance, you can invest a large chunk of your assets in a few companies so that you have a concentrated portfolio. This could increase your risk if one of these companies underperforms so you will need to do your homework. Alternatively, you can invest in an index as your core holding and then choose a range of smaller listed companies to add the potential upside to your portfolio. Large fund managers simply cannot invest in small companies because they would have to buy the entire business in order for it to make a difference to their portfolios. This means that small companies are not really researched by institutions, so there are opportunities to buy undervalued companies. Unfortunately, many small companies are not worth much because they are poor quality businesses, so you need to do your homework.

Another option is to select a large fund manager who you believe has the ability to beat the market. As more funds become more average in their performance, there might be scope for exceptional managers to beat the market. Unfortunately, there is no certainty that managers with a great track record will replicate this performance in the future. You cannot rely on their past performance only, you need to be certain that they can still do the job in future.

REVIEW YOUR EXISTING INVESTMENTS

Portfolio managers and their marketing teams are very adept at selling themselves and their investments to new and existing investors. They have a way of showing their performance in the best possible light so that even mediocre performance looks impressive. As an investor, you need to be awake to these tricks, don't be caught out. Check for yourself that your fund is matching its benchmarks and don't rely on the information from your fund manager. Rather check the actual performance of your investment and compare it to the returns of the stock market and comparable unit trusts.

If you are prepared to spend the time and effort on managing your own assets, I believe you can beat the big players in the industry. If you are not willing to do the research, take the safer approach with indexation, you will not be sorry over the long term.