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PRIVATE PORTFOLIO MANAGERS

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INSIGHTS

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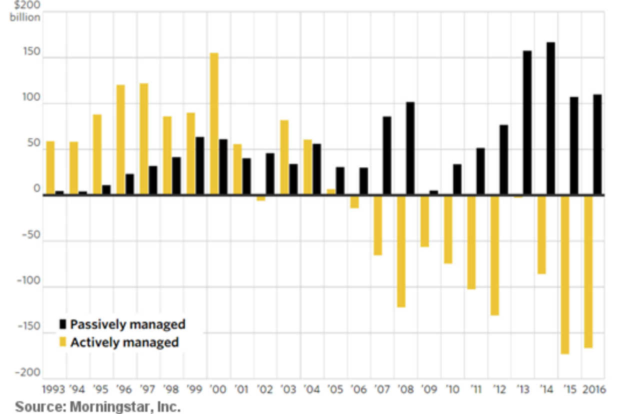
A discussion by
Hugh MacNally, Chairman
of Private Portfolio Managers

Index Funds – the untold risks

The advocacy of index funds has reached fever pitch. However, the critical element omitted in this discussion is the fundamental risk that is being taken by these funds. Private Portfolio Manager's 20 year performance track record provides clear rationale as to why you don't want to trust your portfolio to a risk unaware formula tracking the index. Hugh MacNally, PPM Chairman and Portfolio Manager shares his views and questions investors understanding of the risks of index funds.

Significant index fund inflows

Currently nearly 20% of domestic Australian share funds are invested via Index strategies and their share of the market is rising as indicated by the graph below. In the US this market share is approximately double the Australian market.



The arguments for Index Funds

The argument for using an index fund is usually along the lines that no manager beats the market consistently so why pay active management fees? Masses of data argue that the average cannot be higher than the average, so the best solution is to go for the lowest cost. Any advantage that a strategy might have is temporary and will be competed away. To argue otherwise is heresy; *the earth is the centre of the universe!*

A risk assessed perspective – active management matters

Our point of view is that a well-structured investment process that addresses the fundamental risks is absolutely vital and that to absolve oneself of this responsibility is professionally irresponsible. Assuming that one piece

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of data entirely describes the quality of companies is patently ridiculous; Index strategies use the capitalisation or size of the company (but one could equally pick any number of other arbitrary bases). We would argue that Index Funds ride on the back of the decisions of active managers and that the Index Funds are essentially a form of momentum strategy dressed up "*in vestments*" (pardon play on words).

Let us see what risks Index Funds are taking when the investments are chosen by applying one criteria and taking no account of any other characteristics.

In many small markets, such as Australia's, capitalisation weighted indices are inherently risky as there are just a few large companies that have abnormally large weighting in the Index and thus in Index Funds. In Australia, in the ASX300 (a commonly used basis) nearly 60% of the Index is in two industries: finance and resources and at times in the past they have been a much higher proportion. The top 10 companies represent 47% of this Index, these are currently: five banks, two grocers, Telstra, BHP and CSL.

"Our point of view is that a well-structured investment process that addresses the fundamental risks is absolutely vital and that to absolve oneself of this responsibility is professionally irresponsible."

The concentration risk and interdependency is totally unacceptable to PPM's investment philosophy. Out of these 10 stocks our core domestic portfolio has investment in only 5 representing less than 30% of the value of the core domestic portfolio; even then we are a little uncomfortable. In our view four of the ASX top 10 stocks have insufficient capital to support their businesses in a serious economic downturn, one is getting badly disrupted, one has a pitiful record of mal-investment and at least one is grossly over-priced.

These characteristics above pretty much cover the three capital offenses against our investment process, that is, investments should: have strong financial structures, be in attractively structured industries and be attractively priced.

So, let's put half your portfolio into that lot for the sole reason they are big. Is there really a problem in practice? After all these are household names. If we wound back the clock 30 years to 1987 (the first market crash that I experienced as a fund manager), of the top 20 companies, 9 of them went broke or disappeared to microcaps soon after. Names that might be remembered are: Bond Corp, Bell Resources, Bell Group, Elder IXL, Adsteam, Clayton Robard (a listed funds manager capitalised at more than Westpac!), MIM and TNT. Many had appalling fundamental characteristics or were grossly overvalued. An Index Fund would have swallowed these grenades whole. If Index Funds had represented 20% of the funds management market there would have been no liquidity for them to "re-balance" when the "ASX 300" was rebalanced.

The essential problem with having an investment strategy that has no fundamental underlying logic is that when the true fundamentals are laid bare there is a discontinuity and the assumptions that had underlain the approach disintegrate.

If you think your Index Fund is immune because it will magically exit let's see them all try and get out at the same time when they represent 20%...30%...40% of the market (as they do in the US). Lack of liquidity might be their problem.

If you are in any doubt as to the risk that passive funds take in this modern era, in our next issue of PPM Insights will model what a Lehman moment in Australia would do to your ASX300 based passive fund (the bankruptcy of Lehman Brothers bank was the starter's gun for the GFC).

Ultimately, in the long term, the investor's interest is in absolute return (that is the dollars earned) rather than relative return which measures how a manager went against their peers or some index. The two are very different; the first is what the investor gets, the second is partly a marketing tool and related to the managers' business model (XYZ fund was the best performer over 12 months etc) or for the charging of performance fees. Mainstream funds managers tend not to stray too far from their benchmark Index as this runs a business risk, that is, the risk of underperforming their peers and ending up in the relegation zone. Their concept of risk is underperforming their peers not the customer's risk of loss of capital.

There also seems to be a psychological twist to the Index argument, not really expressed in the pages of supporting statistical analysis, and that is that Index Funds are in some way lower risk by not having a human make any decisions; perhaps this is reflective of the era's self-doubt of human judgement (given the political masters we choose we *should* have some self-doubt!).

A discussion by Franklin Djohan, Investment Analyst of Private Portfolio Managers

Is TPG "Free"?

The potential for TPG, a company with a reputation as a low cost provider in fixed broadband, to become the fourth mobile network operator could potentially be very disruptive for incumbent network operators. For TPG the move is driven out of necessity; as more and more traffic migrates to mobile devices, a development which will be accelerated when 5G emerges in the next 3-4 years.

With the roll out of NBN ramping up, TPG needs to find another way to utilise its extensive fibre assets. Building a 4G mobile network is one way of repurposing the fibre network. A mobile network requires a substantial backhaul fibre network to connect the base stations, inter-state and international connectivity, which TPG already has. With the spectrum now already secured (albeit at a very expensive price), TPG will only need to build the base stations to have a working mobile network.

One success story that offers a blueprint for TPG is Iliad's Free. France's Iliad, which started as a fixed broadband provider, successfully built a low cost mobile network in a market with already three incumbents. Shortly after winning the spectrum auction in 2010, Iliad launched "Free", a new low cost mobile brand. With its cut-price mobile offer, Free managed to gain over 6% market share in less than a year. Free now has ~18% of the market.

Figure 4: Free Mobile Reaches 6.4% Share in 9 Months

Source: WCIS, STL

TPG has similarities to Iliad in terms of corporate culture; they are both very cost conscious. In the environment where fixed cost is very high, TPG still expects to be EBIT positive with only around 6-7% market share. It is not improbable for TPG to achieve 6-7% share if you think that Iliad achieved the same level within less than a year. Moreover, TPG will not be starting from scratch. It already has around 500,000 mobile customers and 1.9 million fixed-broadband customers which it can potentially convert over to its mobile network. However, as mobile has become a necessity, customers will not tolerate loss of coverage or slow connection speed. With capital expenditure of only $600 million versus the billions of dollars spent by the other operators, the big question is whether TPG's network will be good enough to entice users to switch to its network.

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The crucial element in Free's success was the roaming contract with Orange (one of the major networks in France), which let Free to use Orange's network when its customers were outside its coverage areas. The roaming deal, which was imposed by the France's regulator, allowed Free to overcome the fact that its network only had 25% coverage to start with.

TPG has no such support from the Australian regulator and will have to rely on a rapid deployment of their network or a deal that allows them to roam on one of their competitor's networks. Telstra, which differentiates its network through superior quality and coverage, would definitely not consider giving a free ride to its potential competitor. Optus will most likely be in the same camp as Telstra. If there is any prospect for TPG to get a roaming deal, it would most likely come from Vodafone. TPG already has a relationship with Vodafone through its MVNO contract, which basically on-sells Vodafone's network using TPG's brand. Being the least profitable amongst the three network operators, Vodafone may feel the pressure to offset some of the potential loss in revenue. It will be interesting to see whether Vodafone will be willing to extend the current MVNO contract arrangement for an additional roaming contract, for a price of course.

Another factor to consider is wireless/mobile penetration. When Iliad entered the French mobile market, mobile penetration in France was around 40%. TPG will enter the market when Australian mobile penetration is already above 140%. Iliad grew its market share by competing for new mobile customers, whereas TPG will have to take away its competitors existing customers to gain market share. This means that TPG will likely experience a different competitive response from the incumbents.

For further information about PPM's services, please contact either Sally Humphris or Adam Griffiths on 1800 463 359 or email ppm@ppmfunds.com.

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