.mca

It's a stock picker's market
- Stocks always need to be picked

October 2019

One claim which often surfaces is '***it is a stock picker's market***'. Making the claim is particularly true when the level of uncertainty in the investment market outlook rises, or the volatility in the recent returns experienced increases or reduces, or where there appears to be several major global challenges. This is virtually all the time.

Whatever the market environment, the shares you invest in have to be picked.

The claim is also normally made by 'active' investment managers who charge higher fees. Such managers warn about the dangers of being 'passive' and being exposed to the risks of blindly following the market up and then down. They argue that the "environment" is unique and needs their specialist approach to protect your savings and it is worth paying their fees.

The reality is, that it is always a stock picker's market – shares, like bonds and other investments, need to be chosen. The times of greater uncertainty are no different to the times of less uncertainty. The real question is '***how should you pick stocks?***' There are three main choices. Do you:

A. Pick the stocks, so you capture the market-return? Some call this "index" management.

B. Pick the stocks to try and get a return above the market-return? Some call this "active" management.

   The consequence of this approach is that you might also get less than the market-return. History shows that more than half (typically 70%) end up with a return lower than the market, when costs are allowed for.

C. Pick stocks on a basis to achieve a particular purpose? This may be based on the nature of the return you are after (expected income and growth components), over a specific time horizon, to achieve your goals. It should take account of your needs for liquidity, income and growth/inflation protection. This approach will target the shares with the characteristics that are consistent with the required pattern of the returns you need, to achieve the preferred investment outcomes.

   If you go down route C you may get more, or less than the general market-return, over a period, but under this approach, the market-return is less important to the return that you are looking to achieve to achieve your goals and the risk profile of the share selections.

Within the three main choices there is a range of approaches based on combinations of each approach.

Remember that each approach can work, if measured relative to the market return, but if you are looking to build wealth over the long-term (eg you are saving for retirement), the evidence is that choice A (and/or C) is better than B. Better as they are more likely to achieve the goals. In fact, most studies show that while in any individual year, active stock picking management (ie B) may be successful, it is not consistently successful, so over the long-term and the average return you get is the market-return less fees and other costs. It is therefore lower than average (ie A), because the costs are typically significantly higher than under A.

Alternatively, if you are looking to spend your wealth and you need income (eg you are in retirement), the evidence is that choice C (and/or A) is better than B. This is because it is more important to target (chase) a particular pattern of returns (income), than to try and chase returns that are better than average. The problem is that if you chase high returns in retirement and are one of the 70% that are unsuccessful, the financial consequences can be significant. It is often better not to be greedy, when you cannot afford the risk that either you or your investment manager, or your investment adviser, gets it wrong.

Remember - not all active managers add value

S&P Dow Jones analyses, using Morningstar data, the returns of Australian fund managers and their Australian and international share returns, to see what percentage achieved a net return greater than the general market index (S&P/ASX 200 for Australian shares and the S&P Developed Ex-Australia LargeMidCap index for International shares). The percentages were:

Percentage of Australian investment managers who outperformed the general market index					
Period to 31 December:	1 year	3 years	5 years	10 years	15 years
for Australian shares					
2017	41.00%	33.23%	37.00%	26.06%	23.00%
2018	13.31%	14.19%	20.39%	16.80%	16.32%
for International shares					
2017	47.49%	19.07%	9.14%	11.74%	12.90%
2018	29.63%	17.62%	10.60%	9.13%	7.36%

Source: SPIVA Australian Scorecard. S&P Dow Jones Indices LLC, Morningstar

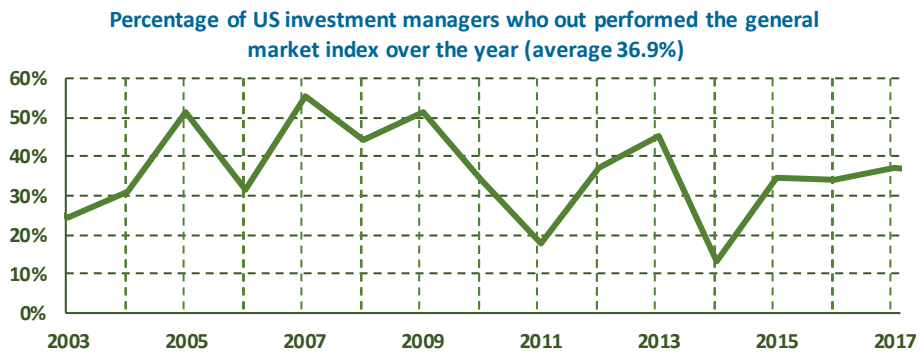
Over the last 15-years to 31 December 2018, 16.32% of the Australian investment managers outperformed the market for Australian shares. Therefore 83.68% of Australian investment managers underperformed. Also, relative to periods to 31 December 2017, managers did not do as well. The conclusion was that 2018 was a particularly challenging year.

Similar outcome patterns apply to US investment managers for US shares, relative to the S&P 500 index.

Percentage of US investment managers who outperformed the general market index in the periods to 31 December 2017					
	1 year	3 years	5 years	10 years	15 years
for US shares					
2017	36.92%	19.44%	15.77%	10.49%	7.67%
2018	31.17%	18.51%	11.87%	15.51%	11.03%

Source: SPIVA U.S. Scorecard. S&P Dow Jones Indices LLC

For the US market, S&P Dow Jones publishes the details of the individual years. While over the last 15 years to 31 December 2018, 11.03% of active US investment managers outperformed the general market index for the whole period, on an individual year basis, it ranged from 55.37% down to 13.27% (average 36.93%) and it was typically a different group each year. The variation year by year was:



Note, S&P Dow Jones does not undertake similar research for New Zealand investment managers.

Shares have to be picked

Whatever the market environment, shares have to be picked. That is, you must make decisions to buy, hold and sell each share, and how his is done.

The questions when you are picking them are 'what outcome are you after? and 'what outcome you are willing to accept, if it does not quite work out as planned?' The better outcomes are more likely to arise when there is greater alignment between how the shares are picked (philosophy and process), and what you are trying to be achieved. In addition, it helps to keep all fees (management and transaction costs) low.