Confidence in Supply

According to the NZ Companies Office Disclose Register, there are 717 Managed Investment Schemes that are currently open for Application in New Zealand. Further investigation into the FE Analytics database shows 104 investment managers who are attempting to raise monies in New Zealand, with the majority having bases in Australia. That doesn't consider the volume of investment managers who frequently pass through town spruiking their capabilities and outlooks to the institutional investment community.

On average, Heathcote Investment Partners receives 1-2 introductions per week, from predominately offshore investment managers who are looking to raise monies from the kiwi industry. The frequency of these enquiries has increased steadily in recent years, with many attracted to the growing Kiwi superannuation industry and economic and relatively compliant climate. Sadly, there are some who figure that the NZ industry is a soft target for investment capabilities, following their own struggles to gain meaningful traction in more mature markets.

So, what does the future of investment products look like for the New Zealand market? In a word: confusing. It is anticipated that the New Zealand industry will continue to attract numerous offshore product manufacturers who will be armed with independent research, sound performance and the promise of extraordinary results going forward… that is, until they don't.

When performance falters (and it will), the fly-in-fly-out approach to marketing in New Zealand

becomes less appealing to many offshore groups who are rewarded by the monies that they raise, as opposed to monies that they retain. This will coincide with the industry's growing appetite to for exposure to the other 99.8% of global opportunities, as domestic markets become narrower and local managers balance capacity issues against enhancing their profits.

Whilst that means more product choice, it's not great news for intermediaries who are participating in a marketplace that is characterised by heightened uncertainty. Performance in almost every element of investing seems to be more unpredictable than was the case in the past.

Product and technology life-cycles have also shortened significantly, with an increasing volume of competitive product introductions making life-cycle demand less certain. At the same time the vulnerability of supply chains to disturbance or disruption has increased with threats of digital-advice, the ever-present fascination with passive investing, and the business risk that comes with most investment managers. It is not only the effect of external incidents such as wars, geo-political events or terrorist attacks, but also the impact of changes in business strategy that will impact the industry, with an example being large financial institutions who are currently running-the-ruler over their future participation in wealth management.

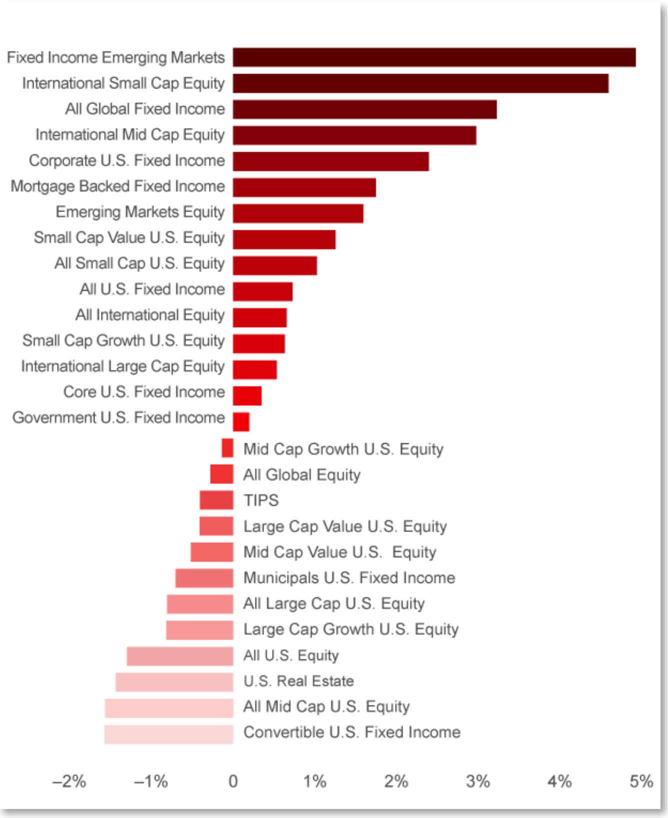
Whilst research houses will provide many important insights into the robustness of a manager's capability, an adviser's need to gain supply chain "confidence" will increase in proportion to the quality of supply chain information.

A useful illustration is the life-cycle of hedge funds over the past decade. With over $3 trillion in assets under management globally, hedge funds are anxiously awaiting a recovery from last year's feeble industry returns of 8.7 percent (HFRI Fund Weighted Composite Index), compared with over 21.8 percent for the S&P 500-stock index. Investors already withdrew $111.6 billion from hedge funds last year, with over 1,100 funds — the largest total since the 2008 financial crisis — closing. This leaves about 9,700 hedge funds remaining, albeit that many of these are due to slick marketing machinery aimed to retain assets.

This has influenced some product manufacturers to change their behaviours through misrepresenting the performance of funds, becoming reckless to try and seek alpha or beat the market, or doing things outside the original investment guidelines.

To demonstrate; consider how your generalist core international equity capability may have recently altered their initial investment mandate, to overweight a specific theme or geography, and the distortions that this has upon the risk profile of portfolios.

If advisers are unable (or unwilling) to select between a good and bad active fund, or don't have the time or resources to monitor an investment manager's philosophical changes, it may be more prudent to simply invest in an index fund, although some indices are better to follow than others.



This may not be the worst idea, as illustrated in the graph. The performance gap between active and passive is particularly weak when it comes to a category like large U.S. stocks, which are perhaps the most widely followed securities in the world. Because there are so many traders and analysts following that market, there are fewer pricing inefficiencies for active managers to exploit, meaning it is harder for them to outperform, especially once their fees are considered. This may be a natural domain for a passive exposure.

In comparison the probabilities of success with an active manager are better in high-yield bonds than government bonds, in emerging markets rather than developed, and in small-cap equities rather than large cap, as these typically have less analyst coverage making it easier for managers to discover mispricings.

To help overcome any accusations of complacency, a few quick checks for advisers include an evaluation of a fund's fees and past performance (compared to a relevant benchmark over a variety of market conditions and economic cycles), an update on how long an individual manager has overseen the fund (and most importantly whether they invest their own money in it) and what degree of active share it has. Active share is a measure of overlap between a fund and the benchmark it tracks. The higher the active share, the less correlation it would have with the benchmark, giving it more value as a diversification tool and creating the potential for outperformance (though this also increases the odds of underperformance).

As more product is introduced to the New Zealand market, it is incumbent on advisers to remain ever-vigilant for new concepts that match investor expectations, whilst being pragmatic about where existing product is in its life cycle. Frequent and honest encounters with investment managers continues to be the best method of understanding whether their capabilities remain relevant for portfolios. In this environment of investment return euphoria, and "encouraged" litigation against service providers, it will be difficult for advisers to argue in favour of complacency when a favourite investment manager fails to deliver. Furthermore, advisers will need to have confidence that the investment manager is committed to supporting the adviser, whilst retaining a consistent predictable approach to investing throughout good and bad days.

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