Active funds shine with strong returns

Mark Arnold, Chief Investment Officer and Managing Director of fund manager Hyperion. Picture: Lyndon Mechielsen/The Australia

- **DAVID ROGERS**

MARKETS EDITOR

@DavidRogersOZ

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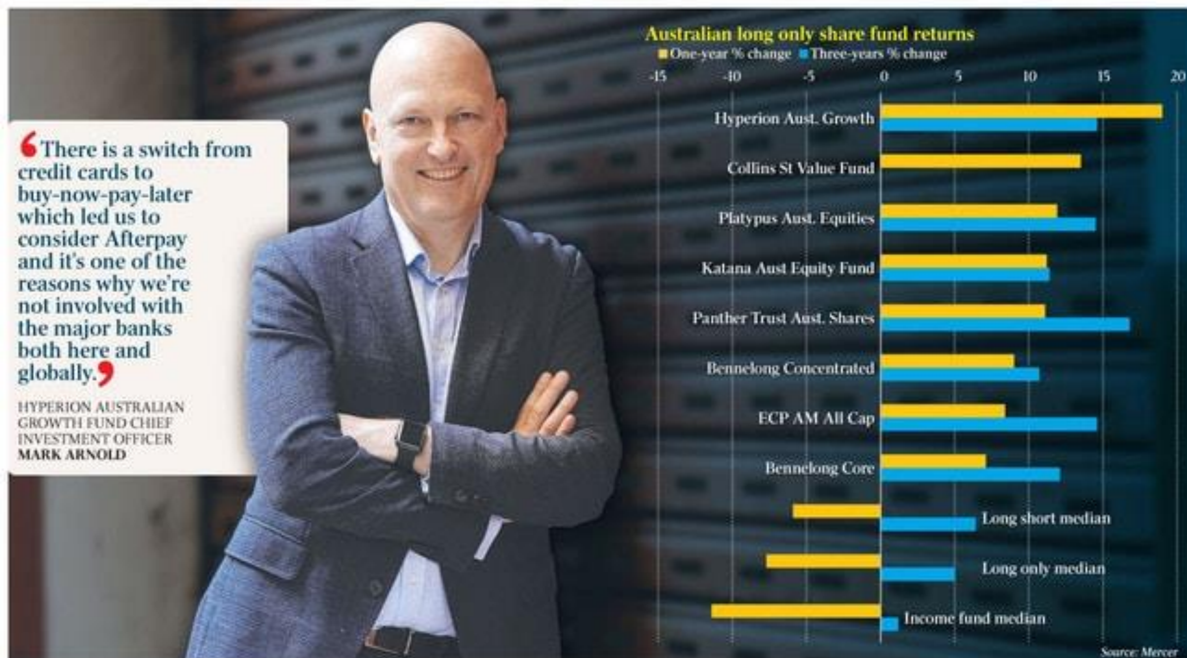
A handful of fund managers were about to navigate the toughest financial markets in nearly a decade to deliver positive returns.

The winning formula came down to simple rules for active funds: hold your nerve as markets are plummeting and don't follow the pack.

Where a 7.6 per cent fall in the S&P/ASX 300 Australian share index in the year to end-June locked in negative returns for passive funds, even after dividends, the top 10 active funds in Mercer's Australian Shares Investment Manager Performance survey returned 13 per cent on

The past financial year was all about stock selection. Depending on the sector or company this had the potential for big losses or gains. And index hugging — which had delivered wins

before COVID-19 — simply didn't work after the market had its worst financial year since financial 2012.



Perhaps surprisingly after a volatile year dominated by the coronavirus pandemic and subsequent policy response, the top-performing funds just moved back in and picked up a few bargains.

Chris Prunty and Tony Waters's QVG Long Short fund topped Mercer's league tables with a 29.3 per cent return before fees. The hedge fund's huge outperformance for the year mostly came down to the ability to stick with existing positions, rather than aggressively trade through the volatility of the coronavirus pandemic and subsequent massive rebound in markets.

"A traditional risk management approach would have cut positions in the pandemic but we were able to ride out the volatility," Prunty says.

QVG's returns were equally split between longs and shorts — a typical hedge fund approach — so the short book was a big contributor to returns. One success on the short front was Speedcast, which collapsed.

Now, as second waves of the coronavirus threaten to restrain economic growth and challenge business models of travel, tourism and entertainment companies, and uncertainty about the longevity of fiscal stimulus also looms, the year ahead could also come down to stock picking.

Asked whether the positive environment for active funds is likely to persist, QVG's Prunty says it is a great environment for long-short funds that could aggressively position toward some sectors and away from others, but only those active managers that are "truly active" will add value.

"It's the funds that are closet index-huggers that are going to continue to struggle," he says.

“If your game is overweight banks, underweight resources or vice versa — the two big bets in the Aussie market — that’s a very hard way to make money. Even if you succeed at that game, it’s such a modest value-add that it’s hard to justify your fees.”

QVG Long-Short fund has had a bias towards technology and offshore growth companies on the long side and a bias against domestic cyclicals on the short side.

Among long funds Hyperion Australian Growth fund topped the pack with a 19 per cent return before fees in the year.

“It’s fairly disrupted world we are facing with low growth, low inflation, low interest rates and low equity market returns as well,” says Hyperion Asset Management chief investment officer Mark Arnold. “We don’t think passive investing will do as well as it has done for the past two decades.”

Hyperion also ranked sixth over five years with a 13.3 per cent return in the period, and it had a tracking error of 9.8 per cent, meaning it was truly active and didn’t hug the index at all.

“We have a very robust set of businesses in the Australian large cap portfolio because our mission is to protect and grow our client’s capital sustainably over the longer term,” Arnold explains.

“The businesses in the portfolio aren’t that sensitive to economic conditions so they can still grow their revenues and profits even when the economy has a downturn.” While Hyperion mostly shuns cyclical stocks and has a number of what would typically be called “growth stocks”, it is more focused on “structural growth” and “long-term value” stocks.

“It’s important to be able to calculate a long-term intrinsic value and it’s really hard to do that if you have a commodity-type business, where the price of the commodity can move around substantially over time,” Arnold says.

“We want companies with a competitive advantage.”

The portfolio has no resources or banks, but it does hold Macquarie Group.

Indeed, Hyperion thinks the major banks are going to struggle over the next 10 years.

“It’s going to be really hard for them to grow their loan books because we think credit demand will be quite low and with low interest rates there’s a lot of pressure on their net interest margins, and also we think their fee income will get eroded over time with new entrants increasing competition,” Arnold says.

Hyperion has significant exposure to the healthcare sector in Australia. CSL, ResMed, Fisher & Paykel Healthcare and Cochlear are among core holdings.

In the March quarter sell-off, the fund used capital raisings in the sector to boost its exposure.

“Our portfolio construction system is based on estimates of intrinsic value for these businesses 10 years from now,” Arnold says. “So if the share price falls, the forecast return

over the next 10 years goes up. When those stocks were sold down, we took advantage of that and added more of them to the portfolio."

James Hardie was one of a couple of new stocks the fund added after the March quarter sell-off.

"We had previously reduced cyclicality as much as we could, but James Hardie also has structural growth and after looking at it for years we thought it was a good time to get exposure," Arnold says.

Hyperion is also a big backer of the tech sector — particularly the software segment because of its increasing importance for consumers and businesses alike.

"We see them as really modern businesses that can take advantage of technology and innovation and we think that in a low growth world it becomes very important to be able to take market share and have a really strong value proposition," Arnold says.

Afterpay was added to the portfolio as it recovered from a huge March-quarter sell-off.

Hyperion had long been reviewing the payments industry, but only this year became comfortable that Afterpay would withstand a recession. And with its product going viral in the US, the fund manager judged Afterpay's value proposition was very strong despite a lack of profits so far.

Collins St Value Fund managing director Michael Goldberg says he just did what he's always done.

"We took a view as early as 2017 that there were some dark clouds on the horizon for the Australian consumer and economy," Goldberg says.

"We repositioned as far back as then to be more defensive and reduce our exposure to the domestic consumer."