THE Frontier Line

Thought leadership and insights from Frontier Advisors

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Asking managers to predict the future

FRONTIER ADVISORS

25 years

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $380B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

Wayne Sullivan

Director of Marketing and Business Development

Wayne Sullivan manages business development activity and has responsibility for the marketing and communication program at Frontier, including brand management, content creation and publication, digital media, and public relations. Wayne has an extensive background in marketing of financial services, specifically in superannuation, having previously held senior marketing and communication roles with Hostplus, Sunsuper and QSuper. He is a past Rainmaker Australian Superannuation Marketer of the Year and has won multiple industry awards for marketing and communication at each of the funds for whom he has worked. He holds a Bachelor of Economics from the Queensland University of Technology, a Diploma of Superannuation Management, and an Associate Diploma in Marketing. Wayne is a Fellow of the Association of Superannuation Funds of Australia.

Asking managers to predict the future

The success or failure of an active investment manager ultimately comes down to whether they can predict the future. Will the assets they choose return more than the market and their competitors? A good fund manager doesn't have to be right all the time; a manager with a strike rate of 65% will generally be in the upper quartile.

To assess which investment managers are most likely to succeed, Frontier conducts around 1,200 meetings with managers each year, travelling to all corners of the globe to find the best of breed. With one of the most experienced research teams in the industry, we think we do a pretty good job – and our results bear this out.

Separate to our formal evaluation program, every year since 2014 Frontier has been surveying fund managers to determine their predictive skills, and their read on a range of market issues. Unlike our ongoing manager due diligence, this annual survey takes a broader look at their crystal-balling. Our survey covers a range of topics from market predictions through to views on the industry and even predictions on the fate of football teams around Australia.

At the same time, we ask our own staff to answer some of the same questions for comparison purposes. The study has a slightly light-hearted objective at its core to spark conversation when we discuss the results at our annual Manager Dialogue, an event where around 140 funds management organisations assemble to hear from Frontier and to share their ideas and observations. Despite that light-hearted nature, and now with six years of data, the results from this survey make for interesting reading.

Industry backdrop

Since 2014 the funds management industry in Australia has been under considerable strain. As superannuation funds increase in size, they are keen to optimise the benefits of their growing scale through reduced fees. In addition, many of the larger superannuation funds are internalising investment management. More recently, fund merger activity threatens to shrink the potential client base of managers significantly. The number of Australian superannuation funds (ex-SMSFs) has dwindled from 268 to 190 since our study began.

But it's not all bad news for managers. At the same time as these structural headwinds gather pace, money continues to flow in to the Australian superannuation system with assets under management growing 57% over the period of our survey history – specifically, from $1.85T at June 2014 to $2.9T in June 2019[1].

Helping to further buoy the mood of managers, returns have been generally strong since 2014 with just one year of the last six producing a median balanced fund (60-76% growth assets) return of under 7% - a strong result in a low inflation environment.

That one year that failed to measure up was 2015/2016 when the median fund, according to Chant West, returned just 3.0% for its members. Of course, there have been challenges around performance for particular managers at various times of this period - the last year was the worst in decades for active Australian equities managers for instance.

Passive management continues to be a point of discussion, although remains less prevalent than in overseas pension markets. And, the search for outperformance in an increasingly competitive and low return expectation environment has shifted the way many investors approach their asset allocation, often away from traditional managers.

So, in light of this background, have fund managers shown skill in their predictive abilities and how has the mood and attitude of fund managers changed, or remained the same, over the last six years?

[1]APRA quarterly superannuation statistics, June 2014 and June 2019.

Predicting performance

Toward the end of each year, when we survey fund managers, we ask them to predict the median return for the next financial year, within generous 5% bands.

Unsurprisingly, most (generally around 60%) settle for the conservative 5-10% band, however the result is often influenced by the performance achieved in the preceding year. On three of the last five years (noting we obviously won't have a result for this year's survey until June 2020) the middle band has indeed been correct. On average, over five years, 46.3% of managers have been able to correctly predict performance for the year ahead – just under half. By extension, more than half have not been able to.

The current year predictions are notably bearish with only 54% of managers predicting a return greater than 5%, compared to 72% in the 2018 survey. In fact, 11.3% are forecasting a negative return for 2019/20. This level of pessimism has occurred only once before in this study when in 2015 11.5% of managers predicted a negative return for the year ahead. The result that year was indeed the lowest performance recorded in the life of this study, when the median fund returned just 2.8%[2]. Will we see a similar very low, or even negative, result again for this year?

For the record, fund managers have been marginally better at predicting performance than our team, via this annual study at least!

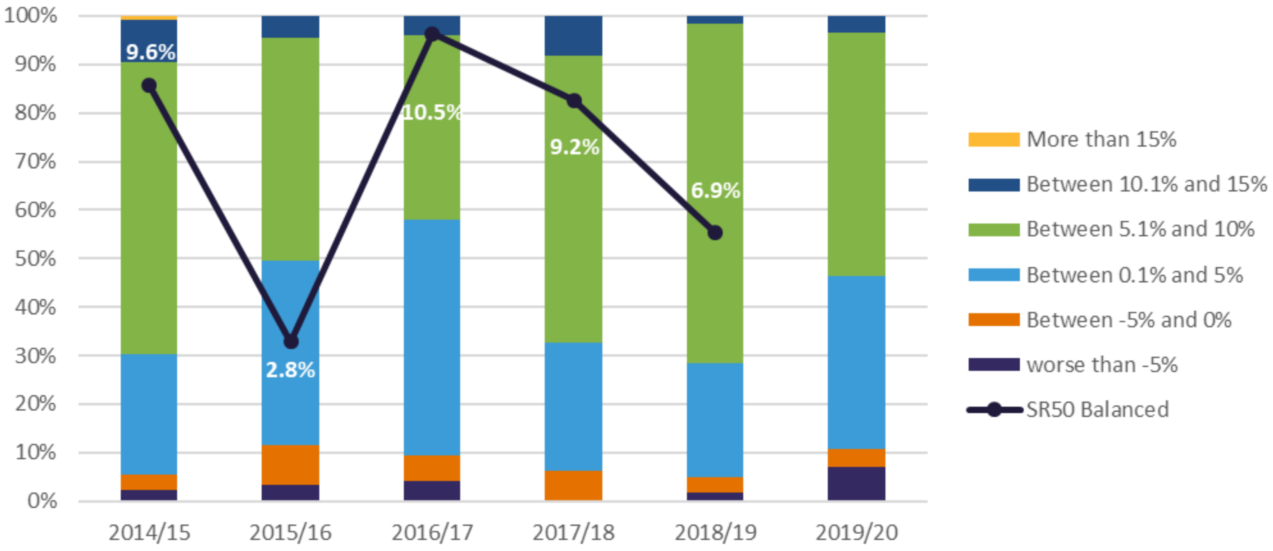
For the year ahead only 48% of Frontierians are predicting a return greater than 5%, and exactly the same level as the managers (11.3%) are forecasting a negative result.

Amongst the fund manager respondents, the asset classes predicted to be the best performing for 2019/20 tend to correlate with the sectors covered by fund managers, perhaps unsurprisingly. This pattern has been quite consistent through the life of the survey with international equities being the most nominated sector each year – albeit alternating between developed and emerging markets.

A new development for 2019, however, is that 16.4% of managers have nominated Private Equity (PE) as the sector most likely to produce outperformance, the second most popular choice. In the first four years of our study not a single fund manager had ever flagged PE as their nominated top performer.

Nominating the best performing asset class is an area where Frontier has consistently had more predictive success than managers during our study. For 2019/20 almost half of our firm, 43.5%, have nominated unlisted infrastructure as the sector most likely to be the best performer for the year. And, like managers, there is some love for PE with 13% of our team expecting strong relative performance there.

Chart 1: Twelve monthly performance predictions



Source: Frontier Advisors, SuperRatings

[2] SuperRatings Fund Crediting Rate Survey (Balanced) June 2016

Asset owners

Although not all of our clients, nor those of fund managers, are superannuation fund investors, a great many are. As such we have posed a series of questions in our survey around who are the **most influential parties** at superannuation funds when it comes to investment decision making. From five possible choices being: CEO; CIO; Board/Investment Committee; internal team; or asset consultant, both managers and Frontierians have consistently nominated the fund CIO as the most influential person. This influence has been steadily growing over time at the expense of the CEO and, from the managers' perspectives, Board/Investment Committee members. Managers feel internal teams are the second most influential group in decision making while at Frontier, our team has placed Board/Investment Committee members in that position and have been steadily applying more weight to this group over time.

The growth of **internal investment teams** across the six years of our study has been a significant evolution for funds management businesses to negotiate, as it has been for asset consultancy firms as well. Each year we have asked managers to choose the answer they most agree with from a series of comments on internal teams.

The comments that *"internal teams will change the philosophy and culture of funds for the better"* and *"internal teams are best placed to research and advise on investments for their fund"* have consistently been the top two chosen comments for managers to agree with over the life of the study. However, Table 1 shows that from our first survey to our most recent, there has been a gradual reduction in these sentiments and an increase in managers feeling that internal teams are *"a major cost for funds and just add to the process"* and that they will *"change the philosophy and culture of funds for the worse".*

While this trend has not been perfectly linear over that time it could reflect the fact that in 2014 the question was being answered from expectations of how internal teams might evolve, as in many cases they were just developing. Whereas now the question is being answered from actual experiences. Alternatively, it may be the case that managers are increasingly feeling pressure and adverse impacts from the emergence of internal teams and that sentiment is being reflected in these results.

Fee pressure is often cited as a major challenge for fund managers. Frontier has been leading the charge for many years on the issue of a fair fee regime with the argument that asset owners should retain more of the benefits of their scale for their members. This stance hasn't always made us popular with managers and it is invariably a point that generates a lot of interest at our Manager Dialogue event. Since 2015 we have asked managers in our survey whether they think super funds focus too much on minimising costs and not enough on maximising returns. Responses to this question have been very clear and consistent over time.

In our most recent survey, more than three quarters (75.5%) of managers feel that returns are being compromised in the quest to contain costs, the highest score recorded during the life of this study. Just 7.6% of managers think that funds should try harder to control costs. These levels have been almost identical in each of the years we have asked this question, ranging from a low of 69.8% to this year's high. In the first four years of our study, pressure from clients on fees was recorded as the biggest issue facing fund managers. This has since been matched or overtaken by the issues of internalisation and consolidation (this question is explored further on page 6).

Table 1: Fund manager answer choices - Internal teams:

	2014	2019
Change the philosophy and culture of funds for the better	30.5%	23.5%
Are best placed to research and advise on investments for their fund	23.4%	17.6%
Change the philosophy and culture of funds for the worse	3.9%	13.7%
Are a major cost for funds and just add to the process	11.7%	17.7%

Source: Frontier Advisors

Fund managers

When asked about their own businesses, fund managers have quite consistent views across periods. Asked to choose one of a series of statements with which they most agree with, managers have felt strongly that they provide *a depth of research and development that internal teams can't match*, ranging from 38.4% to 45.9% over the six years, and that they *should primarily be remunerated on performance*, ranging from 29.2% to a high of 41.7%.

The full set of choices and this year's results are shown in Table 2. Note, managers were asked to choose the statement they most agree with. Some of the comments in the "other" category relate to: long only and capacity unconstrained managers needing to trim fees; needing to provide specialist access to asset classes incapable of being replicated by internal teams; offering increased accountability; providing a depth of research internal teams can't match; and needing to increase complexity that internal teams can't match.

Despite the many challenges facing them, managers are a remarkably positive lot when it comes to their own business prospects. When asked if they expect their businesses to grow over the next five years (other than via market growth) the overwhelming majority are optimistic, a trend which has not wavered since our study began in 2014. Indeed, this year 88.5% of managers are predicting business growth between now and 2024. This figure has been as high as 97.3% back in 2016, dropping to a low of 85.7% the following year.

Table 2: Fund manager answer choices—Fund managers:

Should be primarily remunerated on performance	35.7%
Provide a depth of research and development internal teams can't match	41.1%
Will need to trim fees to remain competitive	7.1%
Will reduce product complexity and performance to meet fee targets	5.3%
Other (please provide)	10.7%

Source: Frontier Advisors

Fund managers (cont.)

There are a number of headwinds to the growth of fund managers' institutional businesses, with fee pressure from investors being one. The patterns around these factors was quite consistent in the first four years of our study, from 2014 to 2017, with "*pressure from clients for fees to contract and impact on revenue*" clearly being offered as the single biggest challenge, often by around 30% of managers.

However, in the last two years, two other factors have emerged as being the most significant threats. These are internalisation of investment management by clients, and consolidation of superannuation funds.

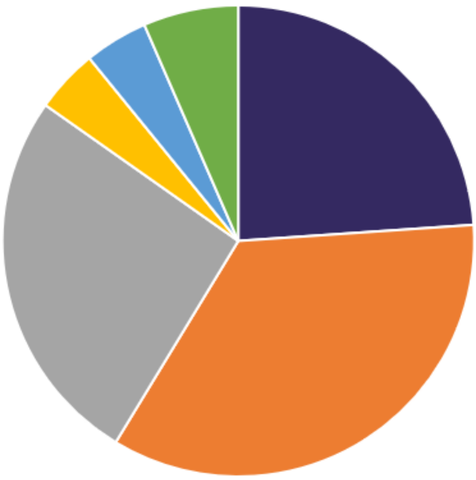
For 2019 consolidation was seen as the most significant issue by almost a third of managers. Just three years ago consolidation was the fourth of six factors with just 8.3% of managers choosing this as the biggest issue for them.

In that same year, 2016, internalisation was nominated by just 13.9% of managers, which has since climbed to 20%. In 2018 internalisation was the most commonly chosen factor.

Fund consolidation is front of mind for virtually all parts of the superannuation industry at the moment and fund managers are clearly no exception. In 2014 we asked managers to predict how many "profit for members" funds there would be in five year's time (there were 198 then). Fast forward to today and there are currently 75 profit for members funds[3], meaning just 20% of managers were right with their prediction about the future shape of the industry.

Interestingly, just 3.9% were suggesting less than 50 - a number regularly predicted in today's marketplace for five years from now.

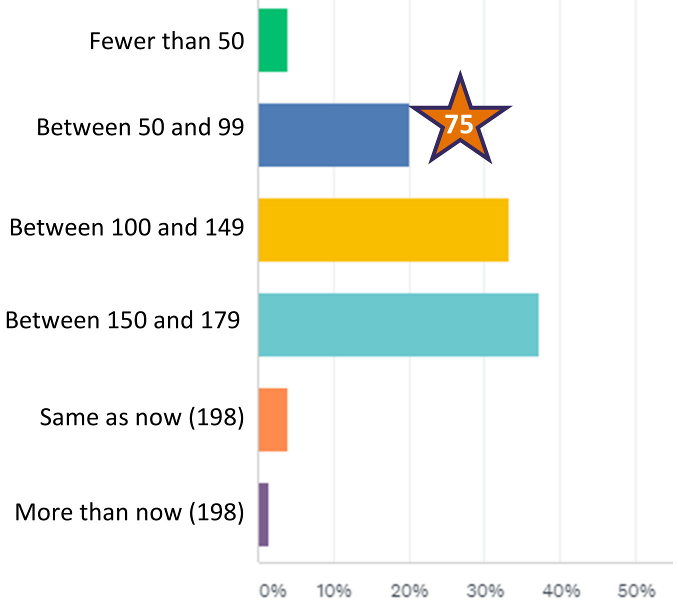
Chart 2: Biggest issue impacting fund managers



Source: Frontier Advisors

- Internalisation of investment management by clients
- Consolidation of superannuation funds
- Pressure from clients for fees to contract and impact on revenue
- Ability to attract and retain talent
- Markets
- Regulation

Chart 3: 2014 predictions on fund consolidation numbers in 2019



Source: Frontier Advisors

[3]APRA Quarterly September Statistics, June 2019

Asset consultants

During the life of our study we have also asked managers for their views on asset consultants. When choosing from a set of comments, and asked for the statement they most agree with, managers have more recently opted for the notion that "*consultants protect funds from highly adverse performance and governance issues*" as their primary response with around 40% supporting this comment. In the early years of our study this was more likely to be the third chosen comment behind statements on performance and research. This trend may well be linked to an increased importance assigned to governance matters since the Royal Commission into Financial Services.

When asked about the most important attributes of a good asset consultant, the rankings of attributes has not changed over six years, but the weight apportioned to them has evolved substantially.

While the quality of personnel remains the most important attribute, this is now seen as less significant than previously with increasing weight given to both the depth and coverage of manager research. Table 3 below lists the evolution of answers around important attributes of asset consultants over the life of the study.

In terms of their view of Frontier, independence has been nominated as Frontier's most important comparative advantage with 51.8% of managers choosing this factor in 2019. This has climbed steadily year on year from 26.6% in our first survey. Quality of personnel was nominated by 23.2% of managers this year, a factor that has generally been ranked either the first or second most important comparative advantage for Frontier in each of the six years. Again, the appeal of independence may likely have climbed post the Royal Commission and a heightened focus on the importance of aligned interests between advisor and investor.

Table 3: Most important attributes of an asset consultant

Attribute	2014	2019
Quality of personnel	42.6%	33.9%
Depth of manager/product research	17.8%	26.8%
Coverage of manager/product research	7.0%	12.5%
Thought leadership	13.9%	14.3%
Independence	5.4%	7.1%
Other	13.2%	5.4%

Source: Frontier Advisors

The final word..

Predicting short term, annual, performance is clearly unreliable and hence our focus needs to be on much longer term horizons.

It is interesting to observe the impact of biases in the forecasts of future performance where we see managers typically nominating their own sectors as the likely outperformers in future periods. We like the optimism and belief in their own models and processes. However Frontier, unconstrained by any self-interest, has been more successful than managers at identifying where outperformance will likely come from, in terms of asset classes.

Our study has also provided an interesting picture of how fund managers views toward internal investment teams and the structural factors that impact funds management business have evolved over time.

Although the sentiment toward internal teams remains generally positive, this mood has shifted as funds' aspirations to bring more investing activity in-house have moved to reality. This mood shift may also reflect the growing pressure facing fund managers not just from internalisation but from fund consolidation, which has occurred at a much faster rate than most had predicted at the beginning of our study.

But, as the volume of funds continues to flow into superannuation, and into institutional investing more broadly, there will always be opportunities for well-run, innovative and fairly priced funds management businesses to partner with investors. Frontier will continue to enjoy the opportunity we have to work with both asset owners and fund managers as the industry continues to evolve.

Better at investing than sports-betting

Predicting the fortunes of markets and performance is obviously difficult, but to add some levity to our research findings, each year we ask managers to predict the fortunes of football competitions in Australia. Managers have consistently fared better at this pursuit than Frontier, clearly an indication of the focus and single-minded application we apply to our professional task.

On balance, however, both parties should probably stick to forecasting financial rather than sporting outcomes.

For the record, when surveyed in May, managers were favouring the Roosters (15.4%) and the Rabbitohs (13.5%) in the NRL. In the AFL, only 5.7% gave Richmond a chance, while 18.9% fancied Collingwood. Almost one quarter (24.5%) of managers were backing the Cats to win the flag. As for this happy author, both of his teams are still alive at the time of writing.

#GoTiges #GoRabbitohs.

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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