The Edge of Retail Investors and Boutique Funds over the Big Boys

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The top performing Singapore-focused unit trusts in the ten years to end January 2013 were Nikko AM Shenton Thrift and Aberdeen SP Singapore Equity.

According to research firm Morningstar, the former registered an annualised return of 13.9 per cent, while the latter managed 13.2 per cent a year during that period. Based on those return numbers, a $150,000 invested in Shenton Thrift back in 2003 would have grown to about $550,000 as of end January 2013. Aberdeen would have grown the same amount to about $520,000.

These are admirable results. But remember, 2003 was the year when the US military launched its "shock and awe" campaign against Saddam Hussein's Iraqi forces. As if that was not enough, here in this part of the world, we also had to grapple with the fears and panic surrounding the Severe Acute Respiratory Syndrome epidemic.

Most would find 2003 to be a difficult time to invest in the market. As such, asset prices were severely depressed. But as it turns out time and again, the most difficult times are the best of times to invest.

For comparison, just how did the Straits Times Index do during that same period relative to the top unit trusts?

Pretty similar! A $150,000 invested in the index would have grown to $536,000 for a return of 13.6 per cent a year. The assumptions are that dividends were reinvested back into the index and no transaction costs are taken into account.

The best unit trusts failed to beat the market

Here's how Morningstar calculates the total returns of the unit trusts. It takes the change in monthly net asset value (NAV) – with all income and capital-gains distributions during that month reinvested – and divide that by the starting NAV.

Morningstar does not adjust total returns of the funds for sales charges, such as front-end loads, deferred loads, redemption fees and bid-offer spread when dividends are reinvested. If one were to include all the above transaction costs or charges, the return for an investor in either fund would be lower than the reported number.

In other words, after taking into account transaction costs, even the very best unit trusts in Singapore failed to give its investors a return that matched the market return!

Just on the reported returns alone, without factoring in investors' transaction costs, most unit trusts struggle to beat the market index because of the fees which are charged to the funds annually.

Below is a longer list of unit trusts investing in Singapore:

Most unit trusts fail to beat the index

		Three-Year	Five-Year	Ten-Year
		1/2/2010	1/2/2008	1/2/2003
		31/1/2013	31/1/2013	31/1/2013
	Annual report Net Expense Ratio	Return (Annualized)	Return (Annualized)	Return (Annualized)
Nikko AM Shenton Thrift	0.83	8.7	2.8	13.9
Aberdeen SP Singapore Eq	1.67	10.2	6.7	13.2
Schroder Singapore Trust	1.23	7.4	4.3	11.8
LionGlobal Singapore Trust	1.48	4.3	1.8	11.6
HSBC GIF Singapore Equity	1.9	5.3	-0.2	10.4
Legg Mason WA Singapore Opp	1.72	6.4	1.4	
DWS Singapore Sm/Mid Cap	2.22	11.6	5.1	
DWS Singapore Eq	1.6	8.0	3.4	
Amundi Singapore Dividend Gr	1.46	8.4	4.8	
Manulife Singapore Equity	2.01	7.7		
MyHome Fund HomeGrowth	1.12	6.3		
SPDR STI ETF (periods to 30 Jun, 2013)	0.30	6.1	4.4	11.3
STI		**9.6**	**5.4**	**13.6**

Note: Fund returns did not adjust for charges like front-end sales charge and redemption fees.

Source: Compiled by THL with fund returns as calculated by Morningstar.

As can be seen from the table, the net expense ratio of the Aberdeen Singapore fund as reported in its annual report was 1.67 per cent, while Nikko Shenton Thrift's was lower at 0.83 per cent, according to Morningstar's 2013 report. This difference in fees is probably one reason why Nikko's performance is better than Aberdeen's.

Expense ratios are fees charged to the fund to pay for the fund managers' salaries, the fund management company's operating expenses which include their offices, the marketing costs and the running costs of the funds such as custodian and fund administration fees, among other things.

The higher the expense ratio, the more difficult it is for a fund to outperform its benchmark. Unless the fund manager is able to consistently generate returns that exceed the benchmark by enough to cover the annual fund expense ratio, investors are generally better off simply by buying into the lower cost index funds.

A simple mechanical process beats the index hands down

What about using a mechanical, quantitative process to buy a basket of stocks which are considered cheap based on commonly used valuation metrics?

Price-to-earnings (PE) and price-to-book (PTB) ratios are two such metrics.

PE ratio refers to the ratio of a company's stock price relative to its earnings per share. For example, a company which makes $0.10 of profit for every share that is has outstanding and whose shares are trading at $1 in the stock market has a PE of 1/0.1, or 10 times.

PTB refers to the ratio of a company's stock price relative to the book value of its assets. A company which has assets net of all liabilities worth $1 per share, but whose share price is trading at $0.50 in the stock market has a PTB ratio of 0.5/1, or 0.5 times.

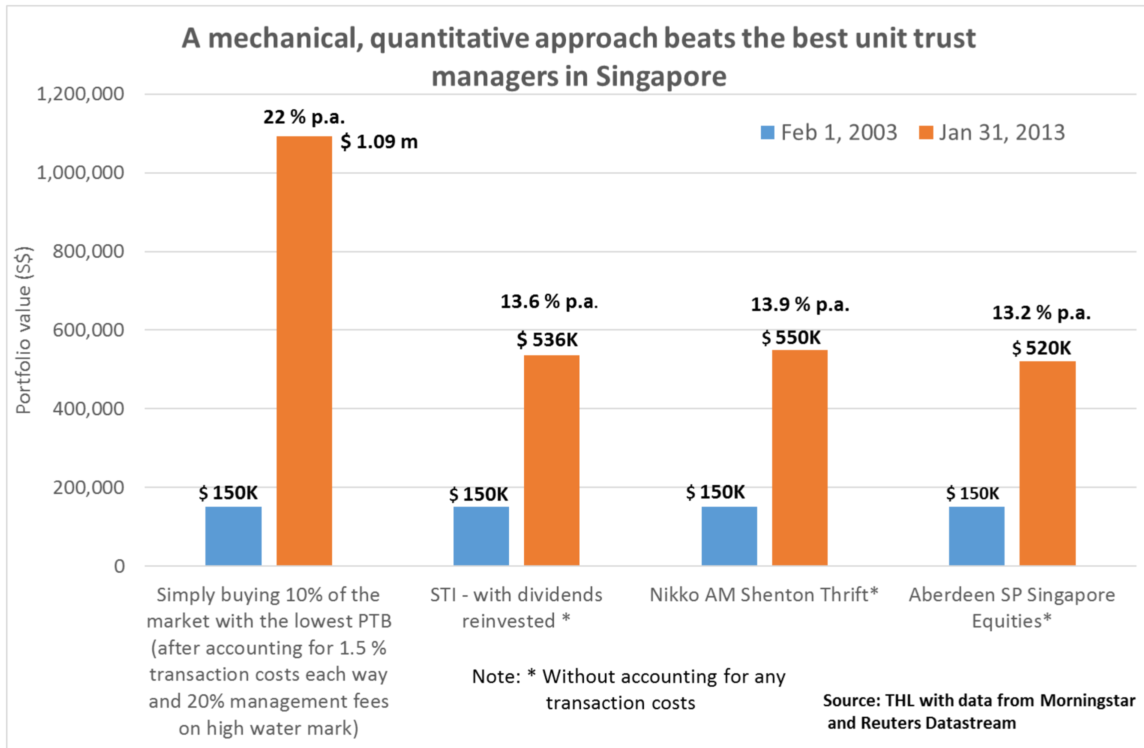
Generally speaking, the lower the ratio, the cheaper the stock.

Let's consider the PTB ratio. A strategy of simply buying the 10 per cent of the Singapore market with the lowest PTB, and rolling the money to the next basket of low PTB stocks the following year, would have yielded a return of 22 per cent a year during the same 10-year period.

At this rate of return, the initial capital of $150,000 would have ballooned to about $1.09 million by early 2013. This is after accounting for 1.5 per cent transaction costs for each trade, and an annual performance fee of 20 per cent on high water mark for the manager who is executing the strategy.

Increasing transaction costs to 3 per cent for buying and another 3 per cent for selling the stocks in the portfolio, with the same 20 per cent management fees applied, would reduce the return to 19 per cent a year. The end portfolio would be at $853,000.

That still beats the best unit trusts hands down. See the accompanying chart.



Why does such a simple strategy work?

Well, because the low PTB stocks are generally down and out stocks. They could be in an unglamorous industry, or are going through a rough patch in their business cycle.

Investors are always looking for the next exciting thing or the next novel idea in the market and are willing to pay a high price for it. And they tend to ignore the "dogs" of the market, or find it difficult to buy them. As a result, these companies end up trading at a fraction of the value of their underlying assets.

But in this world, nothing stays constant. Poor performing companies will restructure and start to perform better. Or, for some, their assets are taken over by competitors. In most instances, these companies will revert to the mean, or to the category of average performers. A stock which moved from a down-and-out state, to an acceptable state, would typically see a big jump in its share price. This explains the persistent outperformance of low PTB stocks versus the rest.

Fama and French, the US university professors who first discovered this phenomenon of low PTBs being the best predictor of future outperformance in share price, attributed the superior performance of the "dogs" portfolios to higher risk. Being "dogs", they have more uncertain earnings stream and some may even have problems surviving. Investors who buy such companies are thus assuming a greater risk and therefore have to be compensated for it, they argued.

However, if one takes a portfolio approach, i.e. buy a big basket of such stocks, even if a handful of the companies don't recover from their slump, the impact on the portfolio will be minimal. Often times, the gains from the other stocks in the portfolio will more than make up for the handful that have disappointed.

It is just our irrational fear of owning a basket of out-of-favour stocks which is deterring us from reaping the benefits of what study after study have shown to be a very lucrative stock investment strategy.

Now back to the question of why most big unit trusts fail to beat the market. Besides their higher expenses, their size is their other handicap. Because of the large amount of funds that they manage, big fund houses can only buy big capitalisation stocks whose shares are more liquid, i.e. frequently traded, and can absorb their fund flows. As we all know, big cap stocks generally trade at a premium.

But even if they could, big funds are unlikely to hold this type "dog" portfolios. Professional fund managers are humans too and many make the common cognitive errors of being attracted to what's hot, rather than what's not. Furthermore, they are highly motivated to try to minimize their career risks by simply buying the "safe" and well-known companies.

Consequently, big funds are less able and less likely to take advantage of the mispricing that happens more frequently in the small and medium cap space.

That leaves the space free for savvy retail investors and the smaller and nimbler boutique funds to help themselves to the rich pickings.