15 April 2020

The CPI + 5.0% Challenge

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In our February newsletter we talked about CPI + 5% as a fairly commonplace goal used by advisers and fund managers. In this note we take a quick look at how that goal relates to the multi-asset category of funds.

We will start by looking at how well multi-asset funds have done against the CPI + 5%

In a decade when beta was king and buying just about any asset class got you good returns, multi-asset funds did okay. Just under 50% of funds beat CPI + 5% over 3 years (to Dec-19) and 30 to 35% beat this mark over 10 and 5 years.

31-Dec-19	3-Year	5-Year	10-Year
CPI plus 5.00%	6.78	6.73	7.17
Count	**3-Year**	**5-Year**	**10-Year**
Total Number of Funds	1275	1176	878
Funds Outperforming CPI +5%	634	410	263
% of Total	**49.7%**	**34.9%**	**30.0%**
Average Fees	**ICR**	**MER**	
Multi-Asset	1.46	1.04	

Fast forward a mere 3 months and see what damage the virus has wrought. Less than **3%** of funds beat CPI + 5% over 3 years (to Mar-20), less than **1.5%** over 5 years and less than **7%** over 10 years.

31-Mar-20	3-Year	5-Year	10-Year
CPI plus 5.00%	6.88	6.85	7.15
Count	**3-Year**	**5-Year**	**10-Year**
Total Number of Funds	1275	1176	878
Funds Outperforming CPI +5%	36	17	60
% of Total	**2.8%**	**1.4%**	**6.8%**
Average Fees	**ICR**	**MER**	
Multi-Asset	1.46	1.05	

Another perspective that shows how CPI +5% is a big challenge, is to compare it to traditional markets. See the table below.

20yr	31-Mar-20					
Rank	**Benchmark Index**	**5-Year**	**10-Year**	**20-Year**	**30-Year**	**Asset Class**
1	RBA Cash Rate plus 5.00%	6.60	7.68	9.17	10.27	Cash
2	RBA Cash Rate plus 4.00%	5.58	6.65	8.13	9.22	Cash
3	CPI plus 5.00%	6.85	7.15	7.73	7.58	CPI
4	S&P/ASX 100 TR	1.34	5.15	7.12	n/a	Equities
5	BBgBarc Global Aggregate TR Hdg AUD	3.94	6.12	7.09	8.21	Bonds
6	FTSE WGBI Hdg AUD	4.34	6.26	7.04	8.29	Bonds
7	BBgBarc Global Treasury TR Hdg AUD	4.27	6.24	7.00	8.12	Bonds
8	S&P/ASX 50 TR AUD	1.11	5.08	6.95	8.70	Equities
9	S&P/ASX 200 TR AUD	1.39	4.92	6.89	8.53	Equities
10	S&P/ASX 300 TR	1.40	4.80	6.81	8.47	Equities
11	S&P 500 Hedged NR AUD	5.94	11.91	6.80	11.36	Equities
12	S&P/ASX All Ordinaries TR	1.49	4.80	6.79	n/a	Equities
13	CPI plus 4.00%	5.83	6.13	6.71	6.56	CPI
14	S&P/ASX 20 TR AUD	0.01	4.63	6.68	n/a	Equities
15	Bloomberg AusBond Govt Infl 0+Y TR AUD	2.31	5.89	6.33	n/a	Bonds

These returns are sorted from highest to lowest on the 20-year return column. In this list, RBA Cash Rate + 5% and 4% are No.1and 2. Recall from our last note the history of real cash rates and how they were strongly positive in the three decades leading up to the GFC. Real cash rates averaged 4.70% over that time, with a maximum of 12.7% and a minimum of 1.5%. Add 4 or 5% to that and you are up there with the best.

CPI +5% shows an extraordinarily strong result, placing 3rd in the list. To beat this as a benchmark, you have got to have techniques and processes that add considerable value to the traditional "beta" building blocks used in investment portfolios. It is not an easy task.

Let's take a deeper dive.

We start by identifying how many funds use a CPI-related investment objective.

Of the 10,155 funds in the SQM database, the distribution is:

Fund Count	Multi-Asset	Other Sector	Total
CPI-related Benchmark	899	54	953
Other Benchmark	2220	6982	9202
Total	3119	7036	10155

% of Total	Multi-Asset	Other Sector	Total
CPI-related Benchmark	28.8%	0.8%	9.4%
Other Benchmark	71.2%	99.2%	90.6%
Total	100.0%	100.0%	100.0%

So just under 30% of Multi-Asset funds have a CPI-related benchmark. We are going to further examine the subset of funds that have at least a 5-year track record. This brings the fund count down from 899 to 653, with a total FUM of $597 billion.

The table below shows the number of funds by benchmark. CPI + 4.5% and CPI + 5.0% are clear favourites covering almost 40% of these funds.

Benchmark	Multi
CPI	41
CPI + 0.50%	1
CPI + 1.00%	8
CPI + 1.50%	7
CPI + 2.00%	19
CPI + 2.50%	60
CPI + 3.00%	51
CPI + 3.50%	68
CPI + 4.00%	31
CPI + 4.50%	108
CPI + 5.00%	150
CPI + 5.50%	47
CPI + 6.00%	62
Total	**653**

The table below summarises the alpha achieved by these 653 funds as measured against their own official CPI-related benchmark.

Results to Dec-2019 show on average 97.7% of funds best their benchmark over 1 year, 49.9% over 3 years and 36.6% over 5 years. 2019 was a good year.

Dec-19	Fund	Avg Alpha	Avg Alpha	Avg Alpha	% of Funds with +ve Alpha	% of Funds with +ve Alpha	% of Funds with +ve Alpha
Benchmark	Count	1-Year	3-Year	5-Year	1-Year	3-Year	5-Year
CPI	41	9.67	3.90	3.54	100.0%	100.0%	100.0%
CPI + 0.50%	1	7.23	3.04	1.92	100.0%	100.0%	100.0%
CPI + 1.00%	8	5.17	1.89	1.66	100.0%	100.0%	100.0%
CPI + 1.50%	7	6.28	2.43	2.01	100.0%	100.0%	100.0%
CPI + 2.00%	19	6.69	1.55	1.04	100.0%	89.5%	84.2%
CPI + 2.50%	60	4.41	-0.13	-0.58	96.7%	45.0%	41.7%
CPI + 3.00%	51	7.91	1.54	0.96	100.0%	76.5%	64.7%
CPI + 3.50%	68	5.71	-0.01	-0.50	94.1%	41.2%	38.2%
CPI + 4.00%	31	11.15	2.87	2.09	100.0%	90.3%	90.3%
CPI + 4.50%	108	6.41	-1.03	-1.52	100.0%	20.4%	13.0%
CPI + 5.00%	150	7.46	-0.62	-1.25	94.7%	30.0%	14.7%
CPI + 5.50%	47	9.18	-0.51	-1.31	97.9%	40.4%	14.9%
CPI + 6.00%	62	12.31	0.21	-0.88	100.0%	71.0%	17.7%
	653				97.7%	49.9%	36.6%

Again, an additional quarter makes a monumental difference. The table below shows results for the same funds through to Mar-2020. A complete turnaround. Virtually no funds (0.2%) beat their benchmark over 1 year, a mere 6.4% for 3 years and 7% for 5 years. There is red-ink all over this table.

It should be noted that this massive correction likely sets the scene for a **higher possibility** of meeting benchmarks over the next three to five years. Why?

- CPI is likely to be lower – there is the possibility of outright **deflation** over the next 6 months or so and ongoing low inflation due to weak aggregate consumer demand and plummeting oil prices. Talk of an **inflation spike** caused by massive fiscal injections and QE seems premature. The fiscal injections are not a stimulus – they are a **(partial) replacement** for lost income and activity due to virus-induced economic shutdowns. Also, rock-bottom interest rates and massive QE have not sparked inflation in other developed countries over the last 5 years. Coming out of the shutdowns it is likely that consumer confidence will remain fragile, labour markets will take years to regain their former levels of employment and, post a short re-bound period, ongoing average economic growth will likely be lower than it was prior to the pandemic.

- Risky beta is much cheaper than it was – providing some scope for better returns (relative to CPI) in the future as markets recover.

Mar-20	Fund	Avg Alpha	Avg Alpha	Avg Alpha	% of Funds with +ve Alpha	% of Funds with +ve Alpha	% of Funds with +ve Alpha
Benchmark	Count	1-Year	3-Year	5-Year	1-Year	3-Year	5-Year
CPI	41	-4.55	0.49	0.76	2.4%	75.6%	80.5%
CPI + 0.50%	1	-2.65	1.07	0.25	0.0%	100.0%	100.0%
CPI + 1.00%	8	-5.75	-0.98	-0.48	0.0%	0.0%	12.5%
CPI + 1.50%	7	-4.37	-0.11	0.07	0.0%	42.9%	42.9%
CPI + 2.00%	19	-6.85	-1.69	-1.38	0.0%	0.0%	5.3%
CPI + 2.50%	60	-7.23	-2.85	-2.70	0.0%	5.0%	5.0%
CPI + 3.00%	51	-8.86	-2.60	-2.15	0.0%	5.9%	5.9%
CPI + 3.50%	68	-9.22	-3.61	-3.28	0.0%	0.0%	0.0%
CPI + 4.00%	31	-11.18	-2.81	-2.13	0.0%	3.2%	3.2%
CPI + 4.50%	108	-15.02	-6.54	-5.58	0.0%	0.0%	0.0%
CPI + 5.00%	150	-13.42	-5.79	-5.15	0.0%	0.0%	0.0%
CPI + 5.50%	47	-17.06	-7.31	-6.24	0.0%	0.0%	0.0%
CPI + 6.00%	62	-18.67	-7.67	-6.66	0.0%	0.0%	0.0%
	653				0.2%	6.4%	7.0%

Finally, an observation about the prior two tables. There is a tendency for average alpha to decline as the targeted CPI margin increases. This is particularly true for the 3 and 5 year columns in both tables.

This might make intuitive sense – a higher hurdle is more difficult to achieve and so a higher failure rate should be expected.

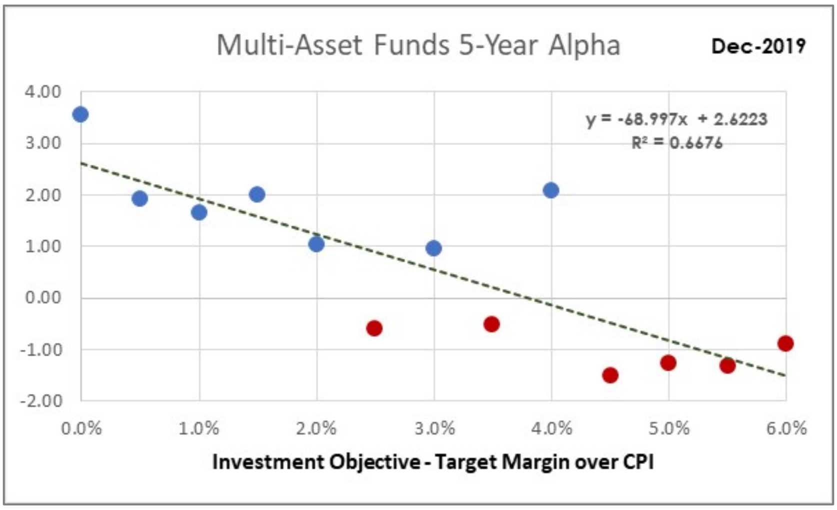
Except that the hurdle rate is set by the managers themselves, not by an external third party. It is rational to expect that managers set themselves a **goal they believe they can achieve** knowing better than anyone else about their capabilities – staff, investment philosophy and style, risk tolerance and many other ingredients to investment success.

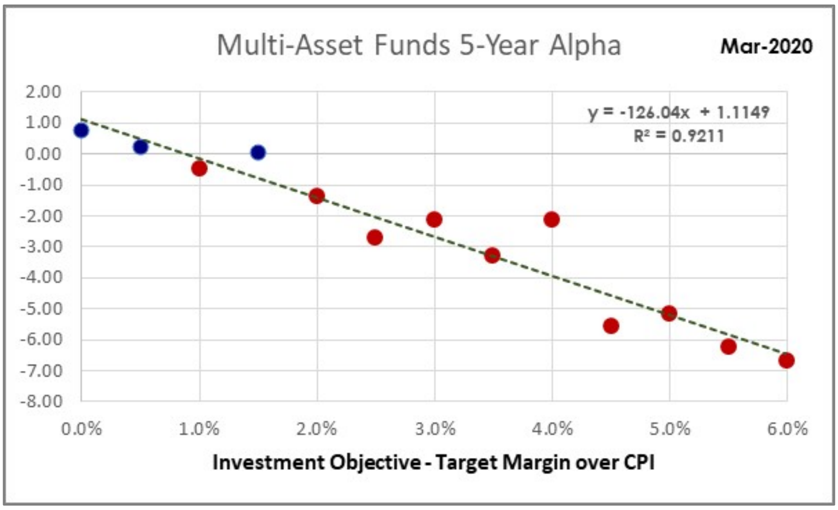
Consequently, the rational **average alpha expected** by managers in aggregate should at least be a positive number (preferably net of fees). The data presented in this note is not supportive of that theory.

There are many possible explanations for these results. It may well be that managers overestimate the level of their own skill and set their objectives too high as a result. There is behavioural finance research that is consistent with that idea. Others would argue that it shows that active management doesn't work

At SQM Research, we believe in the value of active management and feel these results show that active management is difficult, not impossible. **True active alpha exists** (unlike unicorns) but it is a scarce commodity that is difficult to identify and challenging to extract.

The two charts below are very sharp illustrations of the effect. A significant negative relationship between higher targeted CPI margins and actual alpha outcomes. The red dots represent negative alpha. The tightness of the relationship is particularly strong in the Mar-2020 figures, with a correlation of 92%. The Dec-2019 figures show a still material correlation of 66%.

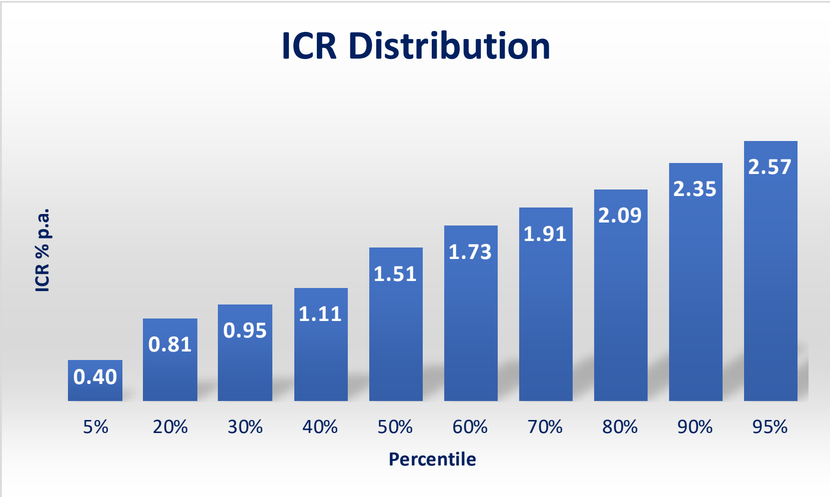




Fees and costs are a very important consideration in this discussion.

The Multi-Asset category has relative high fees and cost as represented by average ICRs and MERs.

In the chart below, the distribution of ICRs across multi-asset fund, 50% of the funds have an ICR ranging from 1.51% to 2.57%. These types of charges have a significant impact on the net-of-fee alpha statistics detailed in this note.



SQM Research rates a number of multi-asset funds in a segment that has been growing materially for us in the last 12 months.

Our higher-rated funds with a 5 year or longer track record have performed well relative to the broad universe, as the table below shows.

Mar-20	Total Return	Total Return	Total Rank	Total Rank
Fund	**3-Year**	**5-Year**	**3-Year**	**5-Year**
Allan Gray Australia Stable	1.52	4.30	**58.2%**	**95.5%**
Affluence Investment Fund	2.22	5.14	**74.7%**	**98.0%**
Cor Capital Fund	6.09	4.73	**99.8%**	**96.4%**
Macquarie Multi-Asset Opportunities	5.95	4.54	**99.7%**	**96.1%**

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