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Comparing the Pair - Update
Super Funds' Indexed vs Active Options

My original Research Note on the 'investment experiment' being conducted by Australian Super between active and passive (indexed) investment options covered returns for periods to June 2017. This Note updates that analysis to June 2021 and includes the results for Hostplus Super's equivalent experiment.

Background

A key issue in assessing the performance of actively managed versus passively managed (or indexed) superannuation products, is the difficulty in knowing what the asset allocation of the indexed alternative would actually have been.

Actively managed sector portfolios will have different risk and return characteristics than indexed assets (assuming that an investible index actually exists). It is therefore certain that the asset allocation of an actively managed diversified portfolio will be different to the asset allocation of a portfolio invested in indexed asset classes, even where 'all other things' – such as the investment objectives and the investment management teams - are the same.

It is therefore **impossible to accurately compare an actively managed diversified superannuation option to its passive or indexed 'equivalent'**, as there is no way of knowing, in hindsight, what the asset allocation of that indexed portfolio would have been.

A common fallback position is to assume that the asset allocations are the same, however this does not reflect actual decision-making processes, and ignores the significance of the asset allocation decision as a major determinant of fund returns.

What Indexed Management Means

An indexed investment approach means that the investment portfolio is constructed in a way that minimises investment related fees and costs (i.e., management fees).

In superannuation funds, investment management fees are minimised by investing in investment strategies that do not involve active management of assets, and correspondingly do not incur active management fees. Therefore, indexed options:

a) Do not invest with active managers in liquid investment strategies such as equities, fixed interest and cash; and

b) Do not invest in investment strategies that incorporate, and only exist as a result of the application of, manager skill - such as Private Equity, Infrastructure, Credit, Hedge Funds, and Direct Property

Low-cost superannuation fund management means more than just the selection of indexed investments in liquid markets. It also means the omission of investment strategies that do not exist without manager skill.

Australian Super / Hostplus Active vs Indexed Experiment
We are in the unique position in Australia of having had two large superannuation funds effectively conducting a scientific experiment of active vs passive outcomes over the last 10 years.

In this experiment, actively and passively managed (indexed) investment options have been offered to actual fund members, with all other variables such as Investment Objectives, Risk Levels, Option Liquidity, and Management Team (advisors, Investment Committee, compliance framework, etc.) being the same. In scientific terms, all of these other characteristics have been 'controlled for' and should not be contributors to differences in investment returns.

AUSTRALIAN SUPER
Australian Super offers both its actively managed Balanced, and passively managed Indexed Diversified options to members. These options are equivalent, with the characteristics of the two products being virtually identical when expressed in terms of the descriptors prescribed in legislation and regulation:

- both have 10 year recommended investment horizons;
- both have the same Expected Frequency of Negative Return (5 years in 20); and
- while different now, both started out with essentially the same Return Objectives:

Return Objective over 20 Years (% p.a.)			
Option	**2012**	**2017**	**2021**
Balanced	CPI + 4	CPI + 4	CPI + 4
Indexed Diversified	CPI + 4	CPI + 3.5	CPI + 3

The investment related fee of Australian Super's Balanced option (0.63%) is higher than that of the Indexed Diversified option (0.11%)[1].

HOSTPLUS
Similarly, Hostplus offers both an actively managed Balanced option, and passively managed Indexed Balanced investment option, also with equivalent characteristics:

- both have 10-year recommended investment horizons;
- both have the same Expected Frequency of Negative Return (5 years in 20); and
- until recently both have had essentially the same Return Objective:

Return Objective over 20 Years (% p.a.)			
Option	**2015[2]**	**2017**	**2021**
Balanced Option	CPI + 4	CPI + 4	CPI + 3
Indexed Diversified Option	CPI + 4	CPI + 3.5	CPI + 2.5

The investment related fee of Hostplus Super's Balanced option (0.99%) is higher than that of the Indexed Balanced option (0.06%)[1].

[1] 2021 Fees and Costs
[2] First published in 2015 Hostplus Annual Report

It is notable that both Australian Super and Hostplus have an **expectation that their Indexed options will produce lower returns** for their members over time than their actively managed Balanced options, even though the investment risks (an expectation of 5 negative returns over 20 years) is the same in each case.

It is also noteworthy that the actual volatility of returns of the Indexed options has been greater than that of the Actively Managed options.

Thus, **both superannuation funds are expressing a belief that active investment management of their portfolios adds value by increasing investment returns after fees for the same level of investment risk!**

Experiment Design
Both Australian Super and Hostplus Super have created 'true experimental designs' (technically Post-test Only Designs) which test the effect of an active vs indexed investment approach on members' investment return outcomes.

Costs & Fees
Given that in each case both the active and indexed options are offered by the same super fund (Australian Super or Hostplus), then all costs, other than those associated with the investment approach, should be the same.

As a result, the principal difference in overall costs and fees reflects the differences in investment management fees between active and indexed management.

Returns
The difference in returns to investors between the active and indexed investment options will similarly primarily reflect the **difference in net (after fee) investment returns** between active and indexed management.

Asset Allocations
As noted above, one reason why it is difficult to compare actively managed to indexed investment options is that it is impossible to know what asset allocation the indexed option would have had.

As a result of the experiment, we do know what the equivalent indexed options are for Australian Super and Hostplus's Balanced investment options. Moreover, the actual asset allocations between the actively managed and indexed options are significantly different. This can be seen in the Strategic Asset Allocations for the options at various points in time.[3]

The Experiment
It is widely argued in academic circles , and by certain purveyors of indexed products that active management produces 'below market returns' as a result of active management fees - due to the zero-sum game, and the impossibility of selecting managers who will add value consistently.

[3] See 'Absolute Differences' Research Note

Given this, Australian superannuation funds' indexed options, such as Australian Super's Indexed Diversified and Hostplus's Indexed Balanced options, should, in theory, **outperform** their Balanced options by a significant margin, primarily reflecting the differences in investment fees and costs.

i.e., Australian Super's Indexed Diversified option should outperform its Balanced option by around 50 basis points per annum, while Hostplus's Indexed Balanced option should outperform its' Balanced option by an even greater amount.

Given these arguments for the superiority of indexing, *it would be expected that the index products available to superannuation fund members, and hence the returns actually received, would show* ***clear outperformance*** *of active options by indexed equivalents***.**

Results of the Experiment
The real world results of the experiments are exactly the opposite of what theory (and index promoters) predict. ***In reality, the active managed options offered by both Australian Super and Hostplus have consistently and substantially outperformed their indexed alternatives over the last 10 years***.

Australian Super Investment Option Returns to June 2021 (p.a.)

Option	1 Year	2 Years	3 Years	5 Years	7 Years	10 Years
Balanced (Active)	20.43%	10.01%	9.56%	10.44%	9.63%	9.73%
Indexed Diversified	17.89%	9.29%	9.10%	9.08%	7.99%	7.86%
Active Outperformance	**2.54%**	**0.72%**	**0.46%**	**1.36%**	**1.64%**	**1.87%**

In the year to June 2021, the additional 'cost' of 52 basis points in investment management fees for Australian Super's Balanced option, produced a net increase in members' returns of 2.54%. Moreover, the **actively managed Balanced option has consistently produced significant outperformance after fees of some 150-200 basis points per annum.**

Hostplus Super Investment Option Returns to June 2021 (p.a.)

Option	1 Year	2 Years	3 Years	5 Years	7 Years	10 Years
Balanced (Active)	21.06%	8.93%	8.22%	10.43%	9.45%	9.76%
Indexed Balanced	18.24%	9.39%	9.09%	9.62%	8.51%	9.44%
Active Outperformance	**2.82%**	**-0.45%**	**-0.88%**	**0.81%**	**0.94%**	**0.32%**

While Hostplus's actively managed Balanced option underperformed the Indexed Balanced option over 2 and 3 years, it also exhibits consistent and substantial outperformance of the Indexed Balanced alternative over longer periods.

Returns
How can Australian Super and Hostplus's actively managed options outperform their indexed equivalent given everything that we read about the supposed 'superiority' of index funds?

The outperformance of the actively managed Balanced options is not surprising. It simply reflects the reality that institutional investors are able to select managers who add value after fees, and **do not invest with the average manager!**

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