Beating the world's best investors

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Where can practitioners take on the world's best investors and win? Actually, in quite a lot of places.

Term deposits

Let's start with fixed interest where it turns out that beating Bill Gross isn't too hard. Why? Because we can buy term deposits (TDs) and he can't - or at least, not at the same rates or with a government guarantee.

As a result, TDs give us government guaranteed out-performance. We can trot down to a Westpac branch and invest in a five-year TD yielding 2.85% per annum.* That is a massive 0.8% per annum above the going rate on a five-year government bond, or 4% over five years. Poor old Bill can't match that - not after fees, not if investing in government guaranteed assets. The best fund bond managers in the world don't reliably produce that sort of alpha.

In December 2011, government guaranteed five-year TDs were yielding 6.0%, a massive 2.2% above government bonds at 3.8%. That was 2.2% of guaranteed out-performance. At the time, I urged practitioners to lock those returns away for their clients for as long as they dared. The fundies tut-tutted. Five years on, we can check the results.

Totally unsurprisingly, the 6% per annum return from TDs smashed the returns of even the top quartile bond fund managers over the same period. In one of the great bond bull markets in history, top quartile managers earned 4.9% per annum over the five years ending 2016.* Now, that isn't a bad result - beating the enormously efficient bond market is tough... unless you invest in the enormously inefficient TD market.

Today, we can get 0.8% above bonds by going to Westpac. But that's lazy, this is an inefficient market. We can do much better than that. Rabobank is offering 3.3%pa* for five years - almost 1.3% per annum above government bonds. Bargains like this just don't exist in the bond markets.

For practitioners (and their clients) who stick to areas where they have a genuine advantage, the chance of outperforming even the best government bond funds over the next five years is very, very high.

Imputation credits

A recurring theme in this blog is that by and large, fund managers just don't value imputation credits. Local fund managers all but ignore them because they don't show up in the performance tables and, more reasonably, international investors don't care because they don't receive them.

While most Australian managers pay lip service to imputation, occasionally they lay their cards on the table. Vanguard recently announced an increase in their weights to international equities in their diversified funds at the expense of Australian equities claiming:

> "Regardless of the perceived benefits of franking credits, which are debatable and vary by investor, concentration is a key risk, so reducing home bias provides substantial benefits in creating a diversified portfolio."

Debatable? Really? The last time I prepared my tax return, imputation credits were very real – and very substantial. My estimate is that they were worth 1.4% per annum to an investor in the All Ords Index.

As for benefits varying by investor, well, that is debatable, too. The pre-tax benefit of imputation credits are identical for all domestic investors. After-tax benefits vary. However, to dismiss imputation on this basis is like dismissing the impact of 1% higher performance because it too varies by investor on an after-tax basis.

Because so many fund managers ignore imputation, there is a very good chance that investments carrying high levels of imputation credits have a good chance of being undervalued. Australian banks are a classic example where the fund managers generally ignore imputation in their valuation methodologies.

This is not to say that all investments carrying high levels of imputation credits are bargains. Far from it. It's just saying that this is a good place to look. It's another place where practitioners have a clear advantage over the best institutional investors.

ENDNOTES

1. Infochoice, SPIVA Dec 2016.

This is a general comment and not a recommendation to purchase any securities.

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