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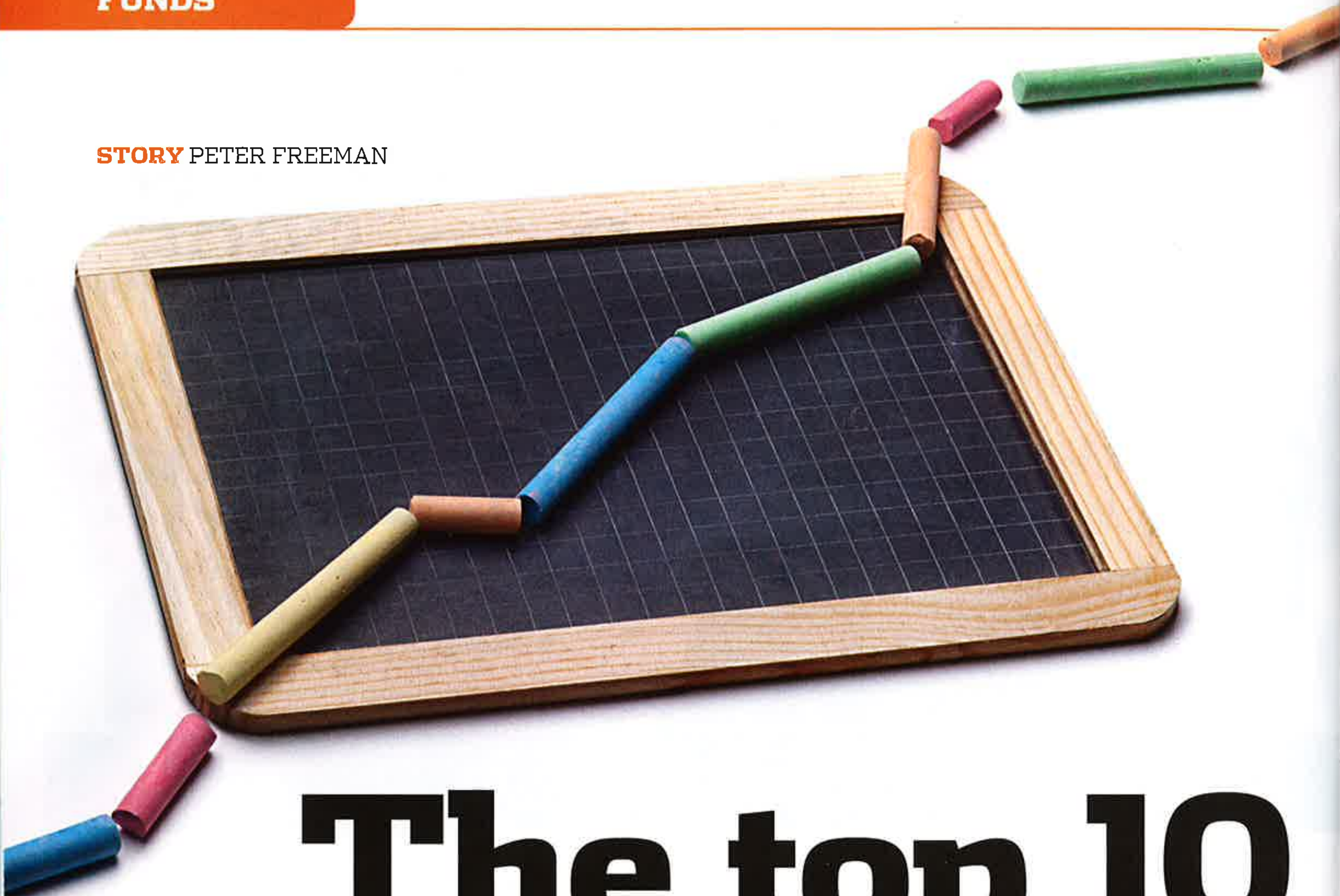

The top 10

Share funds didn't do well last year but it's important to look at longer-term returns for a more useful guide

LAST YEAR AUSTRALIAN share funds were put to the test yet again with even high-quality funds often struggling to generate positive returns. Given the fact the overall sharemarket, as measured by the S&P/ASX 200 Index, fell by 2.57% in 2010 this uninspiring performance is hardly surprising.

Even when dividends are included the index's total return for the year was just 1.57%.

As in the past, however, the key challenge for investors is to look past short-term results in an effort to target share funds that are likely to deliver superior long-term returns.

"Returns over the longer term are a more useful guide to fund selection than recent short-term performance," says Justine Gorman, funds analyst and head of Australian equities with Standard & Poor's Australia.

While Gorman favours using five-year rolling returns – the average annualised returns over the previous five years – she says a snapshot of returns at a particular point of time is also a useful guide to past performance.

These are the figures *Money* used to identify the top 10 local share funds over the seven years to the end of 2010. The returns are shown in the accompanying table and are after all fees but before tax.

Compiled using Morningstar data, the table covers funds that invest in local shares, are currently open to new investors, have at least $10 million in assets, and require a minimum investment of no more than $25,000.

There are a number of general points that can be made about the figures.

One is the fact that none of the top 10 is classified by Morningstar as a so-called value fund.

As Phillip Gray, editorial manager with Morningstar, explains, value funds tend to put the emphasis on analysing companies to assess whether their shares are currently undervalued relatively to their intrinsic value.

These shares generally pay good dividends, which means value-style funds are underweight in the mining sector and so are less exposed to the resources boom. A well-known example of a value fund is the Perpetual Industrial Share Fund (PER0011AU).

In contrast, growth-orientated funds put the emphasis on targeting shares in companies that are experiencing strong earnings growth and, in general, reinvest their earnings rather than use it to pay out higher dividends.

Funds that invest this way tend to generate

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AUSTRALIAN SHARE FUNDS - THE TOP 10 PERFORMERS

FUND	APIR	FUND SIZE	MIN INVT	MER/ICR (%PA)	RETURNS (%PA)		
					1YR	5YR	7YR
Prime Value Growth	PVA0001AU	$127m	$20,000	1.44%	3.37%	7.38%	13.78%
Hyperion Aust Growth Cos	BNT0003AU	$108m	$20,000	0.97%	-1.30%	8.05%	13.58%
CFS Ws Geared	FSF0043AU	$1053m	$20,000	1.97%	-1.92%	-0.63%	12.74%
ANZ Select Leaders	ANZ0235AU	$18m	$1000	2.65%	1.63%	8.12%	12.58%
Aviva Elite Opps	PPL0115AU	$46m	$20,000	0.70%	4.27%	7.81%	12.47%
Celeste Aust Equities	VIM0001AU	$16m	$25,000	3.168%	2.66%	7.38%	11.98%
EQT Flagship	ETL0068AU	$140m	$5000	1.05%	-1.34%	6.43%	11.74%
UBS Aust Shares	SBC0817AU	$1194m	$20,000	0.80%	-3.52%	6.62%	11.68%
Arnhem Aust Shares	ARO0011AU	$524m	$20,000	0.85%	-2.08%	5.30%	11.72%
BlackRock Aust Sh Plus	PWA0015AU	$88m	$1000	1.50%	-2.63%	4.83%	11.67%

Source: Morningstar as at 31-Dec-10. Ranked by seven-year returns (after fees but before tax). To be included a fund had to be open to new investments, have at least $10 million in assets and have a minimum investment requirement of no more than $25,000. Specialist small to mid-sized company funds were excluded.

more volatile returns. An example is the BlackRock Australian Share Fund (PWA0014AU).

In the case of the top 10 performers in the table, the Arnhem, BlackRock and Hypernion funds focus mainly on investing in growth stocks, including the big mining companies, while the remainder adopt a blended approach of investing in both growth and value stocks.

A second general point to note is that the top performers not only include major fund managers, such as BlackRock (formerly Merrill Lynch) and the local offshoot of giant Swiss financial group UBS, but also much smaller boutique firms, such as Prime Value, Hyperion Asset Management, Celeste Funds Management and Arnhem Investment Management.

Third, the top performers are a mix of funds that invest broadly across the shares that make up the S&P/ASX 200 and those that adopt a much more focused, high-conviction investment approach.

Celeste mainly specialises in investing in shares in small and medium-sized companies and, in line with this, directs part of the assets of its Australian Equities fund into its Small Companies Fund.

Another fund whose returns can be very volatile is the Colonial First State Wholesale Geared Share Fund, which also comes in a higher-cost retail version that has a $1000 minimum entry.

"Gearing can give a big boost to returns but it also magnifies losses when the market falls," says Gorman of S&P Australia. "A geared fund is only suitable for those that can handle a lot of volatility."

As for high-conviction funds, Jonathan Philpot, a wealth management partner with accountancy group HLB Mann Judd, says these can add real value but shouldn't be used as the core of an investor's portfolio.

"In the case of Australian equities I prefer

The key challenge for investors is to look past short-term results

The former, which include the ANZ Select Leaders Fund and UBS Australian Share Fund, are very diversified and so are less vulnerable to performance volatility, while the high-conviction funds, such as the Hyperion Australian Growth Companies Fund and Arnhem Australian Equity Fund, deliver strong returns if they pick well but can suffer a major setback if even one of their stock selections goes bad.

the core to be made up of broadly based share funds or index funds, such as exchange-traded funds," he says.

"High-conviction funds can then be added in an attempt to generate additional returns over the long term."

Philpot says investors interested in local share funds should first work out their appropriate asset allocation before trying to pick which funds to use. "Deciding how much of your money you want to invest in local shares and the other broad categories of assets is the crucial first step."

Gray of Morningstar makes a similar point, arguing that share fund investors first need to go back to basics. This process includes understanding why you are investing, how well you can manage risk and what your time horizon is.

As for choosing which funds to use, filtering them by long-term performance can be a useful starting point, but you then have to try to work out whether a fund's good past performance is likely to be sustained.

Philpot says financial advisers generally rely on the research groups, which carry out in-depth studies of a fund manager's people and processes, to help with fund selection (see separate report, above). **M**

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Quality, not just quantity

Individual investors who don't use an investment adviser usually will need to pay to access their own research. While there are a range of research groups that study funds, most concentrate on selling services to institutions and their advisers. One that also provides a specific service for individual investors is Morningstar.

It does this through its Premium Membership service, which costs $599 a year but is available at an introductory rate of $299 for the first year. The service, which also covers direct sharemarket investing, includes a section where Morningstar analysts assess and then rate the vast majority of managed funds on offer.

In the case of the top 10 funds identified by this report, all but the Prime Value Growth Fund is rated. Of those that are, the Arnhem fund is rated "highly recommended", the Hyperion and Aviva funds are rated "recommended", and the rest "investment grade". None of the funds was relegated to Morningstar's fourth and fifth ratings of "hold" and "avoid".

While any qualitative rating system has its limitations, being able to access the views of a respected research group before making your final decision definitely reduces the risk of making the wrong choice.