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RIGHT ON TARGET

In a bid to identify the funds that deliver top-notch performance for a rock-bottom price, *AFR Smart Investor* has put more than 100 Australian share managers through a unique value test. **Toni Case** reports on our results.

Contrary to what you might believe, you don't have to pay an arm and a leg for top-class performance from a managed fund. Dozens of fund managers deliver great returns at bargain prices, as *AFR Smart Investor's* inaugural value test reveals.

Take note: our fund rankings will differ from those you usually find. The criteria we've used to sift through the large number of retail managed funds for sale is rarely applied. Indeed, funds that typically fare well in league tables – which celebrate performance above all else – mightn't do so well under our methodology.

With the help of independent research house Morningstar, we have scoured the market for Australian equity retail funds that have achieved exceptional performance over the past three years – at low cost. Our unique filter highlights those that deliver maximum bang for your buck.

But if a managed fund achieves decent returns over the long run, does it really matter what it costs? It sure does. You might loosely compare high fees to inflation – a cost that eats away at your wealth. As Morningstar spokesman Phillip Gray puts it: "A high-cost fund has to kick the ball so much higher over the goalpost than a low-cost fund on an after-cost basis."

In other words, why choose a fund that is already handicapped by high fees?

Hitting the mark

Our "bullseye" funds are those that score top points on performance at comparatively low cost, measured by their management expense ratios (MER). You can find the full list in the fold-out section, after page 34. The bullseye category consists of 10 individual fund managers but 16 funds in total. That's because some managers, such as our highest-ranked manager Prime Value, have two funds that are on target – the company's Growth fund as well as its Imputation fund. Likewise, the Merrill Lynch Growth fund and its Australian Shares fund appear separately, as do Portfolio Partners' Elite Opportunities Trusts (professional and personal) and High Growth Shares Trust. The Deutsche Australian Equities Alpha fund hits the bullseye three times because it is available both through the fund manager and via administrative platforms BT PPSI and Skandia GIS.

The other top-rated funds are ABN Amro Australian Equity fund, Barclays Australian Share fund (available through the BT PPSI platform), Super Members

NO.1: PRIME VALUE
Growth fund and Imputation fund

Leanne Pan and Han Lee have hit a high note with investors as soaring returns from two of its funds – the Prime Value Growth fund and the Prime Value Imputation fund – propel the team's funds into the first and second spots.

Pan is a member of the Camberwell Chorale in Melbourne and sung at a performance of *St John Passion* by Bach at Easter. As portfolio manager of both funds – the Growth fund averaging 34.19 per cent and the Imputation fund 32.77 per cent over the past three years – Pan surely has a lot to sing about.

Pan and Lee, the managing director and chief investment officer, have been working together for years and both manage the funds. Key contributors to the performance of the Growth fund over the past three years have been shareholdings in Monadelphous, PCH Group, Orica, BHP Billiton, Rio Tinto and Zinifex.

The performance of the Imputation fund, in contrast, has been propelled by holdings in Record Investments, Alinta, Jubilee Mines, Noni B, Bradken, Consolidated Rutile and Monadelphous. There is often a 20 to 30 per cent overlap of stocks between funds.

Pan admits that the resources boom and what she labels "the China story" have been major themes for both funds. However, rather than being overly exposed to mining stocks directly, the team prefers companies that service the mining sector, such as Monadelphous and PCH Group.

Surprisingly, it wasn't until last year that the Imputation fund started building a larger position in the banking sector, and it recently began buying shares in ABB Grain. Pan mentions that Adtrans and ARB Corporation are being monitored by the Imputation fund for possible purchase later in the year.

As a boutique manager, Prime Value doesn't give a hoot what the benchmark does and the managers back their investment philosophy by personally investing in their own funds.

"It is hard to put us in a box," admits Pan. "We continually look for attractive situations in unloved sectors." Biotechnology is one sector of particular interest at the moment.

Investments' (SMI) Australian Share fund, Russell Australian Share fund, IOOF MIM Australian Equities fund and Fiducian Australian Shares fund.

You'll find profiles of five of our top-rated managers – those who have turned in the best annualised three-year performance of their bullseye peers – on these pages.

The fund managers explain how they gave such a good showing and outline their expectations.

Fund manager Prime Value takes the No.1 spot. Prime Value's portfolio manager Leanne Pan discusses the Growth fund's stellar 34.19 per cent average return over three years at a low yearly cost of 1.44 per cent.

Pan says the team strives for a 15 per cent return every year, regardless of what

Methodology

Step 1: *AFR Smart Investor* and Morningstar isolated all the open, retail unit trusts that invest in large-cap Australian stocks and had three years of performance history to February 28, 2006.
Step 2: Funds were placed into quartiles based on returns over three years (with the top 25 per cent falling into the first quartile, the next 25 per cent falling into the second quartile, etc).
Step 3: Funds were also placed into quartiles based on management expense ratios (with the cheapest 25 per cent falling into the fourth quartile, the next cheapest 25 per cent into the third quartile, etc).
Step 4: Funds were then grouped according to the following parameters to come up with final rankings:

- Highest returns (top quartile), lowest fees (bottom quartile).
- Highest returns (top quartile), fairly low fees (third quartile).
- Fairly high returns (second quartile), lowest fees (bottom quartile).
- Fairly high returns (second quartile), fairly low fees (third quartile).
- Lowest returns (bottom quartile), highest fees (top quartile).

Of the 134 eligible funds, 16 funds fell into our top rank (yellow) – what we have called "bullseye" funds – and 14 fell into the bottom rank (white), or "missed the mark".

the underlying market achieves. The firm's Imputation fund turned in an impressive 32.77 per cent with a 1.44 per cent MER.

Matthew Ryland, portfolio manager of second-place winning manager, the Merrill Lynch Growth fund, explains how its 30.21 per cent average three-year return (also with a 1.44 per cent MER) can be partly attributed to holding stocks with businesses in fast-growing offshore markets.

ABN Amro is the manager with the third-highest return. Head of Australian equities at ABN Amro Asset Management George Clapham notched up 28.83 per cent for an annual fee of 0.8 per cent. He says this has been achieved by holding a small number of stocks for a relatively long period. The strategies of managers from Portfolio Partners, fourth, and Barclays, fifth, are also featured.

However, our value test hasn't just identified the star performers. We have also reversed our criteria to find funds that are charging top-shelf fees but delivering bottom-class performance. We highlight 14 such funds on our dartboard ranking system (see fold-out pages). You might consider that these have well and truly "missed the mark" – and have some explaining to do.

It's all about style

It's important to remember that the techniques managers use to pick stocks will suit some markets over others. So it's expected that managers will shift up and down the ranking tables from year to year.

For example, it comes as no surprise to see a string of growth-style managers holding the top spots. Fund managers like Merrill Lynch, ABN Amro and Portfolio Partners target stocks with high earnings growth – in other words, the type of companies that perform well in strong market conditions as we've seen over the past three years.

If you sort the data by five-year returns instead of three-year returns, style-neutral and value managers hold sway – fund managers such as Tyndall, Perpetual, Investors Mutual and Sandhurst Trustees.

Since value managers seek unloved stocks trading at bargain prices, they exhibit strong performance when these sold-off companies come back into favour.

Growth manager Merrill Lynch remembers the treacherous stock-picking conditions after September 11. "It was the worst market for growth stocks," Ryland says.

Today, growth managers are revelling in

being at the top ranks as their style of stock picking comes to the fore.

The lesson here is that while performance figures vary, the fees you pay are fixed. By paying a lower fee, you are guaranteed to get more for your money. It's a risk-free return.

Structure impacts too

Before we heap criticism on all funds charging higher fees, however, there are reasons some managers charge a heftier fee than others. Funds offered via investment platforms such as master trusts or wrap accounts, for instance, are often pricier than funds purchased outside a platform. Ask any platform provider why they charge extra fees and they'll tell you it's for the extra ease and convenience of investing through them.

Platforms let you view your investment returns real-time on a web browser, download accountant-friendly reports at tax time and drag up pie charts of your asset allocation. If you feel that this extra convenience justifies the higher fee, so be it. If not, then buying a fund on a platform is probably not the way to go.

Interestingly, only three out of the 16 funds in our bullseye category are offered via a platform, whereas seven of the bottom 14 funds are purchased on a platform. It's obvious, therefore, that some funds purchased on a platform are penalised compared with those that aren't. If you are confused as to which funds are offered on platforms, the platforms that appear in our ranking table include BT PPSI, Skandia GIS, BT Investor Choice, Colonial First State FirstChoice Investments, ANZ OneAnswer and Skandia OIS. Fund managers IOOF, Fudician, Optimix, Advance, SMI, Sandhurst BMF and United also administer funds only via platforms.

Also noteworthy is the number of nil entry fee (NEF) funds that have "missed the mark". NEF funds don't charge investors for entry into the fund, but will often bump up the ongoing MER. Five of the bottom 14 funds are NEF funds, charging investors 2.35 per cent to a staggering 2.61 per cent yearly in management fees. Of course, the priciest fund in our coverage, the NEF Colonial First State Imputation fund offered through the ING OneAnswer Investment Portfolio platform, is both an NEF fund and is offered via a platform. Little wonder that it costs a lot.

Savvy investors learn to avoid NEF funds, but also sidestep entry fees by purchasing funds through discount brokers that rebate the entry fee, or via online investment websites such as John Fairfax Holdings' subsidiary Direct Access (www.tradingroom.com.au/managed_funds/index.jsp), Neville Ward Direct (www.nevward.com.au) and Fundbroker (www.fundbroker.com.au). If you invest via a financial planner who charges commission, you'll be hit with an entry fee, although most will rebate at least half. Fund managers usually charge the full whack.

Other reasons you might pay higher MERs include a multi-manager approach or socially responsible – ethical – investment strategy. Challenger, whose Socially Responsive Investment fund appears in our list of funds that have missed the mark, argues that its MER incorporates the extra cost of screening companies on social and environmental characteristics. Also, it doesn't allow stocks with uranium exposure, so it missed recent big returns from Rio Tinto and BHP Billiton.

The final issue worth noting is the performance fee. Two of our highest-ranked fund managers, Portfolio Partners and Prime Value, both charge investors a performance fee, meaning they take a cut of any returns achieved above a watermark level.

All Portfolio Partners' funds, for instance, take 20 per cent of any returns more than 5 percentage points above the S&P/ASX200 Accumulation Index on a yearly basis. The Prime Value Growth and Imputation funds take 20.5 per cent of returns above the S&P/ASX300 Accumulation Index each year. These funds try to keep their MERs low in lean years but charge extra when they beat expectations.

Si advice

Don't gauge investment performance alone when selecting a managed fund. Consider fees. Remember that if you invest via a platform, purchase an NEF fund, or buy an actively managed fund over an index fund, the MER will be steeper.

It's also worth noting that while top-performing managers have posted 26 per cent-plus returns over each of the past three years, the S&P/ASX 200 Accumulation Index has made 26.12 per cent. Clearly, prosperous conditions made for easier stock picking.

However, most managers warn that domestic market valuations look stretched relative to offshore stocks, and fears of inflation, rising interest rates and geopolitical risks plague confidence. Next year's top managers will have less latitude for error. **Si**

LEANNE PAN
PORTFOLIO MANAGER
PRIME VALUE

In the Growth fund, we maintain an overweight position in mining services stocks and remain positive on big miners, such as BHP and Rio. We also look at selective biotech stocks. We look for attractive situations in unloved sectors. With the Imputation fund, we take dividend yield and franking into consideration. We had been underweight in the banks for a long time and since last year we started building a position. Historically, we have remained cautious of utility-type stocks and we don't hold any stocks in telecommunications and technology or infrastructure.