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# Comparing the Pair
# Australian Super's Index vs Active Options
**by John Peterson**

The argument that active investment produces inferior results than index investment appears to be the consensus in the press in Australia.

This also appears to be the belief of Australia's regulators, who have enshrined reducing investment fees – and hence increasing index investment - as one of their primary objectives.

Given this near universal acceptance of the superiority of indexing, and the 'proof' that the average manager underperforms the index that is presented on a daily basis, it would be expected that the index products available to superannuation fund members would show clear outperformance of active equivalents.

**In fact the reverse is the case.**

Consider the results of Australia's largest superannuation fund, Australian Super.

Australian Super offers both the actively managed Balanced option, 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 Risk of Negative Return (5 years in 20); and
- both have essentially the same long term return objective (CPI+4% p.a. and CPI+3.5% for the Balanced and Indexed Diversified Funds respectively).

As expected, the indirect cost ratio of the Balanced option is higher (0.57%) than that of the Indexed Diversified option (0.10%).

Given that both options are offered by the same super fund, then all other costs should be similar, if not identical. (An academic could describe comparing the two products as an experiment, with all other influences controlled for.) Therefore, the difference in overall MERs would reflect only the differences in investment management fees between active and indexed management.

Equally, the difference in returns to investors will only reflect the **difference in net investment returns** between active and indexed management.

Given the argument that active management reduces returns below 'market returns' (due to the zero sum game, etc.) then Australian Super's Indexed Diversified option should outperform the Balanced option by a substantial margin – at a minimum by the 47 basis points per annum difference in investment costs shown in the Dashboard.

**In reality the active managed Balanced option has consistently and substantially outperformed its indexed equivalent**.

**Table 1. Returns to June 2017**

| Investment Option | 1 Year % | 3 Years % p.a. | 5 Years % p.a. |
|---|---|---|---|
| **Balanced** | 13.60 | 10.23 | 12.72 |
| **Indexed Diversified** | 9.95 | 7.36 | 10.33 |
| | | | |
| **Active Outperformance** | **+3.65** | **+2.87** | **+2.39** |

Put simply, in the year to June 2017, the additional 'cost' of 47 basis points in management fees, produced a gross increase in members' returns of 4.12%, leaving a higher return, net of fees, of 3.65%.

Put another way, reducing the investment costs and fees in the Balanced option by $1 by switching to an indexed investment approach, would have reduced net investment returns to members by $7.76 over the last year!

**Comparing the Pair**

If the relative outperformance of Australian Super's actively managed Balanced option over 5 years continues (the Indexed Diversified option has only been available since 2011), the actively managed option would earn an additional $31,900 over 10 years.

By comparison, the outperformance by industry funds over retail funds in the 'Compare the Pair' ads[1] as a result of industry funds having lower fees, is only $15,000.

How can this be? How can Australian Super's actively managed option outperform its indexed equivalent given everything that we read about the supposed 'superiority' of index funds?

In reality, the outperformance of the actively managed Balanced option 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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1 "https://www.industrysuper.com/footer/assumptions"