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Julian Morrison
head of research relationships and national key accounts
Allan Gray Australia

Sometimes, less is more

Keeping it simple can lead to better outcomes – just ask Allan Gray Australia

If there's one thing that everyone knows about investing, regardless of their income or their financial literacy, it's that to outperform cash you have to take on some risk; much like death and taxes, it can be difficult to avoid.

But, contrary to popular belief, beating cash doesn't need to be complicated.

And that's exactly what Allan Gray does – relishes in the contrary.

It also takes a cue from Albert Einstein, who famously said: "Everything should be made as simple as possible, but not simpler."

For Allan Gray head of research relationships and national key accounts Julian Morrison, the simplicity of the Allan Gray Australia Stable Fund is its biggest drawcard.

Benchmarked to the Reserve Bank of Australia cash rate, the fund's core objective is to outperform cash with less volatility than the Australian sharemarket.

"In trying to do that, many other strategies and funds that are available would be considered absolute return funds or cash plus funds, and many of the strategies employed in those funds are more complicated. It's worth considering whether complexity is necessary to achieve that," Morrison says.

"Funds may use derivatives, they may use options within that space, have long-short strategies and so forth. Each of these has their benefits, but we think one of the strongest features of the Stable Fund is its simplicity."

Rather than using derivatives or gearing, the Allan Gray Australia Stable Fund uses cash as the defensive mechanism and selected Australian shares are used to add the majority of upside, according to the fund manager's contrarian approach, which finds value in shares that others overlook or undervalue.

In doing that, Allan Gray is conscious that all investments are going to get challenged at one time or another, regardless of what they are.

"When that happens, we think it's important for all financial advisers to have a clear understanding of the fund and what's driving its performance so they can explain it to themselves and their clients, and we think that can be a lot more difficult with a more complicated approach and structure," Morrison says.

It's this careful balance between cash and domestic stocks that helps the fund in its aim to achieve a more stable return than a complete allocation to shares.

"Often funds will take a more complicated approach, or they will passively combine a set of different asset classes, hoping they will all balance each other out," Morrison says.

Allan Gray takes a different approach, he says, with the fund able to be fully invested in cash, but able to allocate up to 50% in ASX-listed securities; it all depends on valuations.

"We will look to selectively add attractive shares when the price is low and shy away from them when they run up in price," he explains. "Then it's a matter of looking at all the opportunities we see and determining how many of those we should have versus cash, given the risk versus value we see in shares."

As at May end, about 32% of the fund was invested in shares, including Alumina, Newcrest Mining, Woodside Petroleum and Asaleo Care. A further 68% was allocated to cash and money market instruments issued by the big four banks.

When the market is high, the fund will typically have a much lower allocation to shares, while exposures are built up when the market is low.

Following this simple process, during 2020 when Australia experienced one of history's larger market drawdowns, the fund achieved a one-year return of 2.9% net of fees. This, when the RBA cash rate benchmark saw a return of just 0.3% and the S&P/ASX 300 Accumulation Index returned just 1.7%.

Since its July 2011 inception, the fund has returned 6.1% annualised, versus the cash rate's 2%. This is despite the Chinese stock market crash of 2015, global markets' loss of trillions in August 2015, the unexpected drop at 2018 end and, of course, the COVID-19 crisis of 2020.

"If we look at the worst-performing periods for the broad Australian share market… the fund has performed considerably better than the market during drawdowns," Morrison says.

It's partially due to the defensive allocation to cash but is also due to the difference in equities holdings in the fund compared to the market, he adds.

"That's evident when we look at a few of those drawdowns, the fund has actually had a positive return rather than negative. Our relatively limited position has been beneficial for some of our clients who are aiming for a more stable profile," he says.

So, while investors have benefited from strong performance and attractive returns, they've also benefited when things weren't so rosy – and in more ways than one.

The Allan Gray Australia Stable Fund charges a base fee of just 0.25%; less than some conservative, passive strategies. And, while it does charge a 20% performance fee, this is subject to high-water marks to ensure no double charging, meaning the team must rectify any underperformance before it can charge investors again.

"One of the philosophies we have in regard to fees is that performance fees can strongly align interests between fund manager and client," Morrison explains.

"Obviously if you charge a high base fee and a high performance fee, it's hard to align those interests. Our premise is to charge a much lower than average base fee for an active manager and then to charge a performance fee when we deserve it, when we outperform."

Over time, Morrison says, this has worked for clients; "When we're not delivering, they're not paying significant fees."

It's an important factor for any investor, let alone those that are more conservative; the last thing you want when you've taken a financial hit is for a side of high fees to be served.

So, how can financial advisers position the fund within client portfolios for maximum impact?

While careful to point out he's not a financial adviser himself, Morrison says feedback from advisers suggests the relative stability of the fund makes for a strong core of a portfolio.

"The fund aims to outperform cash while mitigating downside risk, so some advisers like to use it at the centre and add more aggressive investments around it," he explains.

Others have positioned it within a broad defensive category, while some may use it as the entire exposure for a client with a particular risk profile.

Meanwhile, some advisers are using it within their equity exposure as a de-risked exposure. "They know it's not going to be higher than 50% but it will have some exposure to equities, so it may work well for clients with some sensitivity to risk," Morrison says.

As global uncertainty and regular market volatility wears on, there's clearly a multitude of uses for the fund – the question now is how you'll use it. **FS**

The quote

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Watch the video on www.fsitv.com

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