

Role of Vanguard Investments in MLC's Australian equity portfolio management

Introductory comments from Eric Smith, Vanguard's Chief Investment Officer

We enclose an article written by Amanda White, Editor Investment & Technology magazine, published in their February 2005 edition called "Behind MLC's world-first index of active management". Amanda reports on a significant development in MLC's Australian equities strategy, which embraces the separation of execution and decision-making in portfolio management.

MLC has appointed Vanguard Investments Australia Ltd to track the performance of a customised benchmark which is based on a combination of MLC's active managers' portfolios. Using this 'emulation' approach, MLC's active managers are not disrupted because of cashflow management issues, as Vanguard manages all cashflow into (and from) Australian equities. MLC's clients benefit from reduced turnover, receiving improved net returns through lower capital gains tax, brokerage and market impact.

Vanguard worked with MLC to develop an appropriate benchmark approach – capturing the active returns while avoiding potential conflicts between the active managers and ourselves. We are pleased to be able to assist MLC in achieving its Australian equity investment objectives, utilising our scale and skills in the implementation of an optimised approach to track their benchmark.

Eric Smith
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7 February 2005

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INVESTMENT & technology

Issue_03 February 2005

Behind MLC's world-first index of active management

When MLC completed its Australian equities review at the end of last year it introduced a world first by awarding index manager Vanguard the management of a benchmark made up of its active manager's positions. **AMANDA WHITE** reports on MLC's equities strategy, which embraces the separation of execution and decision-making in portfolio management.

AS PART OF ITS LATEST Australian equities configuration MLC has awarded Vanguard the management of a home-made benchmark that is based upon an aggregate of its active managers' positions. If you like, it could be viewed as a true multi-manager benchmark, with positions from each manager taken into account, and updated, albeit in a delayed manner, on a regular basis.

Believed to be a world first, Vanguard will manage a benchmark that is very close to the aggregate portfolios of MLC's active managers, which will be a low turnover portfolio that replicates that benchmark as it changes.

The main purpose of the Vanguard mandate is to keep stock turnover down without diluting the insights of the active managers.

Chief investment officer at MLC, Chris Condon, says this approach means that active managers are not disrupted because of cashflow, which in turn allows MLC to use a wider set of managers.

"We apply the cashflows we receive and pay, to the Vanguard portfolio first," Condon says. "So the active managers are not forced to buy or sell, their mandates are not effected by cashflow."

Because different managers buy and sell at different times, by Vanguard managing the aggregate portfolio it is a bit like a permanent transition manager, in that the mandate crosses stocks.

"The main purpose is to reduce transaction costs, market impact, and turnover from tax realisation of CGT," Condon says. "We expect the Vanguard mandate to have zero impact on tracking error overall."

Eric Smith, Vanguard's chief investment officer, says while active managers are dominated by decision making, and so buying and selling, Vanguard is exclusively dedicated to execution, not decision making.

This mandate, he says, allows MLC to achieve its objective of improving its net delivery.

"There are potential inefficiencies in having all your managers managing in isolation of each other. In Australian equities there is a fair bit of overlap

for active managers," Smith says. "This gives MLC scope for improving the delivery without diluting the active component."

MLC and Vanguard have had a relationship for about 17 years, well before Vanguard had a presence in this country, and the two worked closely on the concept of the mandate. As with the other MLC mandates, Vanguard's main aim will be to concentrate on keeping the turnover low.

"We have had a very extensive relationship, and any element of indexing that MLC has then Vanguard is doing it, including international and Australian equities and listed property," Smith says. "Costs and tax are a big



Chris Condon ... mandate's main purpose to reduce costs

consideration in the way we manage those indexes, it is not just replication, but we focus on keeping turnover below benchmark."

Vanguard has been engaged to capitalise on its trading optimisation techniques for the mandate, which are a combination of off-the-shelf and internal tools. It will capture crossing, and have the active manager's trades wash against each other.

"Active managers are about internal decisions that deliver actions, our actions are all client-driven decisions. So we do a lot of executions, our clients are typically balanced clients, so we do a lot of on market activity," he says. "The nature of our business means we do a lot of execution."

Vanguard manages about \$19 billion for balanced fund clients in a cashflow management-type role, and Smith says this mandate is not unlike the management of those monies.

"This has moved the same idea of rebalancing balanced funds into something sector specific, Aussie equities, and doing it at the security level," he says.

Smith says for Vanguard it is just like managing any other index, and the manager has no real idea how MLC constructs the benchmark.

Condon says the benchmark is an "aggregate of the active managers' positions" but MLC filters the active manager's information before Vanguard gets its hands on it.

"We construct an index based upon an aggregate of active managers' positions and do some value adding to that with the purpose of disguising which managers are doing what," he says. "So as far as Vanguard is concerned the mandate is informationless, Vanguard is not in the business of active management."

In addition the benchmark is updated fortnightly, so all the information is lagged.

MLC would not reveal how much it pays Vanguard, other than to say the fee was "index-ish", nor would it reveal the size of the mandate other than to say it is substantial. But Condon did say MLC compensates its eight active managers for allowing MLC to use the information of their active positions.

Smith says for Vanguard this is a valuable new piece of business, and while this mandate is specific to MLC the manager will talk with others about it.

However, he says the strategy works for MLC because of its combination of managers, which are predominantly low turnover, and their size.

"This is not suited to say quant strategies because the rate of trading is too high and the drivers of decision making are short term," Smith says. "It is more suited to a manager like Maple-Brown Abbott which is a low turnover strategy based on long term decisions."

Vanguard is working on strategies beyond just vanilla indexing, in the same way that BGI and State Street have diversified their businesses, but Vanguard will not move into active management.

"In Australia Vanguard is strictly an indexer," Smith says, "but we are not just a commodity delivery." ■

A more radical proposal for the operation of multi-manager funds

A more radical separation of execution and decision-making in portfolio management has been suggested in academia, but never acted upon. In fact Barr Rosenberg first suggested the idea in a paper "Institutional Investment with Multiple Portfolio Managers" as far back as 1977. The idea was picked up in 1992, and then revised in 1999, by the founder of the Boston-based provider of risk models and software, Northfield Information Services, Dan diBartolomeo. DiBartolomeo, who also teaches a course in Advanced Quantitative Techniques at the Boston Security Analysts Society, suggested that large investment funds that employ multiple active managers would be better off converting to a system of centralised management. In such a scheme, the current managers would take the role of advisers to a centrally operated fund. He suggests that active managers run a paper portfolio with all trades issued electronically to a centralised trading desk. Under this approach only consensus information is ever acted upon, and substantial cost savings would accrue from a reduction in cross trades. DiBartolomeo indicates that the analytical and technological advances have removed some of the impediments to such implementation, and that financial market conditions have increased the attractiveness of such an arrangement, since Rosenberg first prophesied the idea. While MLC has no intention of using paper-only active management, Vanguard's Eric Smith says the study by diBartolomeo was the subject of much discussion during the construction of the mandate.