

## Investment Philosophy

The investment strategies of Axiome Consultants Limited combine thorough academic research, carefully defined methodology, and skilful execution. The overriding goal is to ensure that as the world changes our products incorporate our best thinking in capturing specific dimensions of returns.

Axiome Consultants has designed strategies to capture diversification benefits and favourable risk/return characteristics for investors. Access to structured wholesale funds provides investors with reliable and consistent exposure to targeted asset classes (e.g., large, small and value) in a low cost and efficient manner.

Research in Australia, New Zealand, US, UK, and Japan provide evidence that fund managers are unable to consistently add value above naive, passive strategies. The research findings in all these countries send a clear message: active management has lower returns than would be expected from passive management.

Upon hearing about the research findings, investors sometimes respond that they are not concerned about the results of the average manager. They plan on hiring only the above-average managers. Further research in the US and UK has addressed that issue and, once again, the conclusions are negative. Managers with good track records are no more likely to have good records in the future than are managers with poor returns.

Ignoring fee differentials, systematic differences in average portfolio returns can be explained by differences in average risk. Portfolio management becomes an issue of asset allocation across the dimensions of risk rather than an issue of "which manager is best".

The generally accepted view of leading academics is that risk can be thought of as having the following dimensions:

- 1) **Fixed interest.** The two dimensions of fixed interest risk appear to be maturity and quality. Low quality obligations have higher returns than high quality obligations. The maturity dimension is somewhat more complicated. Generally, investors concerned about return volatility should shrink away from long-term obligations.
- 2) **Shares.** The two dimensions explaining differences in average equity returns appear to be related to company size and financial health.

"Small" shares are companies with small market capitalisations (price times shares outstanding) and research has shown that small companies have a higher cost of capital than large companies. Value shares are low-priced shares, which are biased towards financially unhealthy companies. "Growth" shares represent high-priced, financially healthy companies.

In essence, risk is related to distress in a very intuitively appealing way. Financially distressed companies have higher costs of capital than financially healthy companies. When they borrow from a bank, they pay higher interest rates. When they issue shares, they receive lower prices. A firm's cost of capital is an investor's expected return. If a company sells off 20% of its shares, the investor gets a claim of 20% of the earnings forever. The return received by the investor is a return foregone by the company. It is hard to believe a stock market could behave any differently. What would the world be like if the largest, safest companies offered the highest average returns? The two dimensions of share returns rightfully appear in all of the shares markets around the world.

### ***The Flaw of Active Management***

The positive relationship between distress and returns drives a spike through the heart of active management. Not many active managers invest in companies with poor earnings prospects and poor management. These are the companies with high costs of capital and higher expected returns. Much of the shortfall from active management could be due to

their selling companies whose costs of capital have increased recently and buying companies whose costs of capital have declined recently.

***Asset Allocation Management***

In a nutshell, academic research points to asset allocation as the main emphasis of portfolio management. Expected portfolio returns are shaped by how much is invested in shares vs. fixed interest. The fixed interest expected return is largely a function of the maturity and quality decisions. The stock portfolio expected return depends on the proportions invested in international vs. domestic shares, in value vs. growth shares, and in small cap vs. large cap shares.

Once a client's asset mix is established, investing is less stressful. There is no second-guessing of the manager because a passive fund always provides the return of an asset class to within tight tolerances. There is no anxiety about market forecasting because the proportion of the portfolio invested in each fund remains fixed.

*In summary, logic and empirical evidence overwhelmingly favour an investment approach based on passive funds. The returns are higher and the fees are lower. The returns of an asset class are assured. The discipline keeps the portfolio fully invested, thereby avoiding the adverse timing pitfall inherent in active managers.*