

Transcript

The Ideas Exchange

Episode 44: A systematic approach to active ETFs

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Jacinta King (00: 00):

Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I am Jacinta King, business development manager, investment products at ASX. And this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

DISCLAIMER (00:20):

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Jacinta King (00:47):

Welcome to the Ideas Exchange. I'm your host, Jacinta King from ASX. You can comfortably say that Macquarie is a household name in Australia as a leading global financial services group, and Macquarie Asset Management is a global asset manager within the Macquarie group and has been providing managed funds to Australian investors for more than 30 years. It's trusted by institutions and individuals alike. And Macquarie asset management manage 938.3 billion Australian dollars of assets globally, and that's as at March this year. As one of Australia's largest and most experienced fund managers, they offer Australian investors access to specialist investment expertise across markets including fixed income, equities, multi-asset solutions, infrastructure and real estate. And today I'm joined by Blair Hannon, ETF investment strategist at Macquarie, and we're going to discuss Macquarie's Innovations in actively managed ETFs. Welcome Blair.

Blair Hannon (01:44):

Thank you, Jacinta.

Jacinta King (01:45):

It's a pleasure. I don't think I've had you on our podcast yet, so we've got a lot to discuss. There's a lot happening at Macquarie as always. As I said, it's a household name. I feel like I know a lot about Macquarie, but in preparing for

today, I learned some more things about the coin and the logo and the history of that and Governor Macquarie. So I'm really keen to delve into some more information with you. So as I mentioned, Macquarie is a seasoned active manager, and Blair, can you please explain for our listeners what we mean by active management and how active ETFs can help an investor build their investment portfolio?

Blair Hannon (02:24):

I think this is worth spending, I think to your point on the history of Macquarie, I'm not that I'm going to delve into that, and this is not what this podcast is about, but just two seconds on some context of who Macquarie is and what it represents for a lot of people. I think to your point, it is a household name. Macquarie is sort of made up of certain parts of the divisions. Most people probably know Macquarie from Macquarie Bank. They might have a mortgage with Macquarie, might use Macquarie's deposits.

(02:51):

But there's an area and the business that I work for in Macquarie is Macquarie Asset Management. So to your point, we obviously manage a lot of money and the parts are that we have a public, what we call public and a private part of Macquarie Asset Management. And that private part is what you might see in the paper sometime. So we have a lot of infrastructure, do a lot of green infrastructure in particular these days. Notable just recently was a big deal where we had some data centres that got sold from Macquarie as well through a business called AirTrunk. So that's the context of the private part.

(03:22):

There's also a huge public part that is when we think about public markets, again, for the context, this is equities and shares and bonds. So those things that are tradable via public markets and which is something that Macquarie's done for decades around actively managing in particular previously managed funds for investors across those fixed income and equity suites. So I think it's always just good to put that in context and goes to that point. So Macquarie's an active manager and we're certainly not going to do the whole active versus passive debate today. Well, I think we'll, again, put some contrast and context around that. But when you think about active management, it is traditionally that's where many investors spent their early time around, I'm trying to build a portfolio, I'm picking stocks that I like or we think about the Warren Buffets of the world or some of those sort of seasoned U.S. investors, Peter Lynch's, these sort of investors that really went across history and time and say, I'm going to fundamentally understand a business. I like that business. I'm going to buy that business because I like it.

(04:27):

So when we think about that, what we tried to put in place, and this has come across not just from Macquarie but from many other managers, is

when you put that package, an active manager in an ETF, it really does democratize the ability for any investor to access what is high levels of expertise in investments. So I think when most people think about ETFs, they think about passive or index tracking strategies. What we've seen in the last sort of five years, and we can delve into this later, is the shift towards having the ability to access active ETFs in a portfolio as well. So if you think just what does active do for you as an investor compared to, again, I'm not trying to negatively say anything about passive, that certainly solves a huge problem for many investors, plays a huge role, but it's more around an active manager can sort of really have a look and understand what's happening in this macroeconomic situations, the geopolitical risk, we obviously have a large U.S. election coming up later this year.

(05:27):

How does that impact your investment? And use that foresight to make a call around what are I going to do with the portfolio and that either is to take more risk, take less risk, how do I want to allocate that portfolio to a certain sector or to a certain geography? So that context is important for investors to think about how they want to pair that across a portfolio. What I think many investors probably use this portfolio because it might have some index tracking ETFs, they might have some shares, but now they have the ability to get access to active ETFs to help build that portfolio out and have a more robust portfolio. So as the ETF market grows, I think it's only beneficial for investors going forward.

Jacinta King (06:07):

And you're right, and thanks for clarifying that. We're not here to debate which is better. I always say the one that's right for you and understanding where these different types of ETFs could sit in your portfolio and be used to achieve and work towards those long-term investment goals. So you and I, the work we do there has in particular been a lot of active ETFs coming onto the exchange though, especially over the last few years. So where do you see the future of the ETF market in Australia?

Blair Hannon (06:37):

The best thing about ETFs, and I'm an ETF guy-

Jacinta King (06:39):

I'm with you.

Blair Hannon (06:39):

That's who I am, I mentioned it earlier, it is that democratisation of investing because it opens up the door to anyone via, and obviously in exchange to access any type of investment, now that it's getting, what are we, well over 300 ETFs available on the ASX, you can really buy whatever you're thinking as an opportunity, whether that is broad-based, lower-cost, passive ETFs,

whether that is obviously now we're talking about active ETFs. Thematic solutions.

(07:14):

And if you look to where other parts of the globe have gone with ETFs, there is, when we think about the U.S. there's over 8,000 ETFs I think in the U.S. now. So it's a huge amount of product breadth. So whatever you're thinking about, okay, I want to invest in a certain commodity thematic sector, you're going to have that ability to do that with an ETF. And the power is, and we won't hark back to the benefits of particularly of ETFs, but it works out this way that when you obviously buy a single stock, you need to understand fundamentally think about what is that business doing, have a look at the balance sheets and there is obviously value in doing that, but that instant diversification of buying ETF is really powerful.

(07:54):

So being able to diversify instantly and then if you add more and more ETFs to a portfolio, you're getting that real true breadth of, and we know the virtues of diversification, again, we won't delve into that. But the ability to do that via ETFs is very, very powerful. So I think what I expect to see is that that will continue to grow in breadth. And I'm not saying we're going to have 8,000 like the U.S. And the U.S. has gone down the path now where, and I do hope we don't get here, but they have quadruple leverage single stock ETFs and I think there is some inherent risks around that. So I think as anyone would know, doing your own research on a stock on ETF is really, really important around, and that's the same for do-it-yourself investors for advisors, no what's under the hood.

(08:41):

So as this market proliferates, know what's under the hood, but I think what's going to happen is we will see more specific or more niche index tracking ETFs. So again, we've seen thematics really rise over the last five years, that will probably continue giving the investors the ability to play a certain theme, whatever that theme might be. And you will likely also see more active managers come to the table as well. I think as active managers sort of get their head around how an ETF can help them bring their solution to different types of investors, and that's only a positive, again, but just go back to that point, as that proliferates, as that market grows, the impetus is then even more on the investor to understand what they're investing in and hoping that what they expect they're getting into and what the outcomes of those things sort of somewhat align.

Jacinta King (09:26):

Yeah. And I'd like to spend a bit of time on how you were seeing portfolios being built using ETFs because for example, I read some research which said that perhaps the younger people hitting the workforce are more inclined. Some of our research at ASX, it shows that they're more inclined to take an

ETF as a first-time investment versus the older generation because back then they didn't have the variety or the options available. What are you seeing in that space?

Blair Hannon (09:54):

I've been in market since pre-GFC, which you can tell by, not that people can see this, but by the gray hair. What I've sort of seen at that time is the sophistication of portfolio construction has increased significantly. And that's again the same for an advisor and for a do-it-yourself investor or self-directed investor, whether it's a super fund or someone who's new to investing. And partly that is because the level of content that people like the ASX are giving out, which is great, but there's a huge amount of other podcasts that are out there that are really driving that sort of information flow that previously wasn't available, may have just been in books that weren't very accessible. So that has become much more proliferant and that's very helpful for an investor to get started. And where a lot of that's gone is to ETFs, which is fantastic because again, going back to that point, there's a huge amount of benefits and one of them is diversification and it's very helpful if you can as a first-time investor, diversify really quickly.

(10:51):

So when we think back to that portfolio construction piece though, so what we've seen is portfolio construction hasn't changed significantly, but it's got more sophisticated in how they're using the tools that they've got access to. So if you think about it from the base level of a core and satellite portfolio, so again, if you think back 20 years, the ETFs really helped investors build a core because they had access to lower-cost solutions that instantly diversify their portfolio and they could build that out across not just Australian shares, you could get U.S. shares, you could get European shares, you could get access to emerging markets in China. You just had this breadth of opportunity now where previously if you were just a share investor and you had to buy what was available on the ASX, it was difficult. That's really helped. And then as time's gone on, and again more active players have come into the ETF space, the ability to pair that core with a satellite solution, it's more high conviction that probably is less correlated to those sort of indexed solutions that you had at the core, again, is helpful for those.

(11:56):

It might be a thematic ETF, it might be an active manager, it might be a single stock that you really like, but it's usually a smaller weighting that has helped you say, okay, I'm betting on this but I'm not risking betting the house on this. And that I think what we've seen again from where if you think back again, 10, 15 years do it yourself, investors would build a portfolio of 10 stocks that have the top 10, a couple of smaller ones. Now they're getting that real breadth across geographies, across sectors, across themes, across active managers. So I think that's really powerful and I think that will only continue as I just mentioned, thinking about what's going to come next, the ability for

investors to get access to things that if they have a view on something that they can then buy it for an ETF, that's a really powerful solution for them to do that.

(12:41):

And again, mostly with ETFs, you're not just buying one stock, you're buying a range of stocks. So what active managers is going to play a role in that is the ability to access certain areas that maybe they couldn't before. So one of those areas that certainly would be, and this is probably not for those younger investors as you just mentioned, but probably for older investors is the fixed income space. So most investors wouldn't buy a single bond. It's pretty prohibitive in terms of dollar value.

Jacinta King (13:08):

Yeah, I was about to ask you about that. So thanks for discussing that.

Blair Hannon (13:11):

Well think about, I mentioned diversification about 10 times already. If you go and buy one bond and you have to spend, it's well over 100,000 now, and whether that one company... That is the antithesis of diversification. When you're buying a, whether it's an active ETF or a passive ETF, you're getting again a range of bonds that you then can again diversify your fixed income exposure quickly. And then think about how that pairs well with your other parts of the portfolio. I think what I would say and where we've seen is I think active management and fixed income is slightly different. If you think about it from a portfolio manager buying bonds in different countries, making calls on if they prefer Japan or not Japan right now. If they want to lean into the U.S., if they prefer to lean into duration or pull that back is a very different proposition than the passive space where you are just getting what you get that's in the index.

(14:07):

And I think some of the issues around fixed income indexes that aren't as relevant for equities is that when you buy an equities index, when it's market capitalization, so the biggest companies at the top, that's usually a positive in that if that company's got that size, it means that share price is appreciated to a certain degree. In fixed income indexes, it's the most indebted business that's at the top. So there is somewhat saying, well there might be an issue in buying the most indebted business at the top of the, that's your highest weighting in an index. So we probably see active management in the fixed income space as a pretty powerful indicator of the ability to move and change with what is at this point a pretty dynamic macro environment, again, mentioning geopolitics, geopolitics, actual politics around elections, which certainly can shift and change really quickly.

Jacinta King (14:57):

Yeah. And I have a background working in the global space and it's not to be discounted those factors do adjust and change the way that active managers have to and effectively put their portfolios together over those economic cycles.

Blair Hannon (15:14):

It's an area where for an investor to walk down the street and we use what was this example, which is something that Buffett always says, you walk into the shop, understand the business, read a paper, then that's something that any of us can make a call on. We can fundamentally understand that business. Where it's very difficult to understand bonds and understand the nature of bonds. It is certainly a bit more of an opaque area, but it's a really important part of a portfolio construction piece in that it's providing a balance of a portfolio. It is the defensive part, it is providing you consistent income. How that does that I think in the context of an active manager is that they can move around and get around what potential risks are coming out of it that you may not be able to see and move around if you are doing it yourself or doing it through a passive index. So it is a pretty important piece to understand I think when you're delving down the fixed income path.

Jacinta King (16:07):

Thank you, Blair. Now, we mentioned earlier that Macquarie has been offering managed funds to investors for over 30 years. So why now move into the listed space with Macquarie ETFs?

Blair Hannon (16:18):

This is really, it harks back to that point. So we have a huge track record. We've been doing this for a very long time and Macquarie certainly, in this case, not a first mover, but we have consistently heard from clients and investors through the managed funds we have that they'd love to be able to access these strategies via different paths. And in particular, ETFs is a really easy way for many investors and advisors now who have a preference for listed versus unlisted. And there's benefits to both. When you go into ETFs, if you have to trade through a broker, there is a brokerage cost to that, where unlisted, you don't have to pay that. But for many investors, the speed of execution, being able to buy, know what they buy it for, T plus two transaction, you know you're paying in two days and you've got your money back in two days if you sell, that's a pretty powerful way to transact. And many people have done that for many, many years around shares.

(17:14):

So there is a preference there for many advisors now to go down that path. And our view was, okay, what we'll do is we'll utilize three of our flagship funds that we've had in the market for 20 years, two fixed income funds and a global equities manager, and we'll put this into the market and see the response because we kept hearing that demand. And I think this would be

the same for many active managers. You hear the demand that this is where investors want to actually allocate their capital through the listed. And the response has been really, really good. So on the back of that, the expectation now is that Macquarie is going to grow. We're going to continue to invest in this ETF business. We launched two new funds in May of 2024, and this is really just the start for us.

(17:58):

We do intend to really grow and continue to invest from our business into the ETF space. So we think it is certainly the way forward. We didn't just do it in Australia, we did it in the U.S. as well. So we've launched an ETF business over there. So for many of your listeners, I suspect ETF users, again, that is only going to be helpful. Maybe they didn't want to fill out a paper application form. Maybe they didn't want to go through an investment platform through an advice. Maybe they want to do it direct, maybe as an advisor that is, they have preference for listed, this is only going to benefit them. Their choice grows, their ability to access really strong investments with really strong track records that they probably know already [inaudible 00:18:40] ETF is now there for them.

Jacinta King (18:42):

Yeah. So you launched three funds November last year and you just mentioned that in May there was another two, but they're core equity, active ETFs. So do you mind if we delve a bit more into those because many ETF investors are using passive ETFs for the core part of their portfolio. So can you first explain how core solutions may fit into an investor portfolio?

Blair Hannon (19:03):

So we just talked a little bit before about the difference between core and satellite. What we've traditionally seen, I shouldn't generalize too much because it's never a perfect science, but is the core of the portfolio with the advent of ETFs had gravitated towards, again, index tracking, passive ETFs with lower costs associated with them, which is helpful. The core is usually the bulk of the portfolio, the satellites then you could take, again making that point, more specific bets and you could pay a higher fee because you're allocating to a higher conviction manager who you believe in. What we also understood is if you look at the core space in Australia, the options for active management were pretty limited in that there wasn't a huge opportunity set essentially to say, okay, I do want to try to outperform. We think about what's the core of active, I really didn't spend enough time on this, but the core of active management is to try to outperform the index. That's what they're trying to do.

(20:00):

So the ability to do that at the core of the portfolio, just it wasn't an abundant choice for investors. So we looked at that as a business and thought how can we help investors? And we had this feedback pretty consistently from

advisors that they were quite happy to allocate to, again, passive at the core. But if they had the option to have alpha seeking ETFs or funds at the core, they would look at that really, really closely. But as we know, and we mentioned this earlier, one of the drawbacks is always active management usually is more expensive than passive. So we sort of went to the drawing board and said, how can we bring a lower cost solution that is also active, that obviously investors that I are want to look at to the table in ETF. So that's what we tried to do. We tried to do that.

(20:53):

And the way that we did that was we tried to offer a really low MER. So what will we consider passive-like MER. So when we talk about MER, the management expense ratio, so are very passive-like fee. But to align ourselves with the success with the investor, we put a performance fee in, which is, again, it's not necessarily unique to ETFs, there's many, many ETFs out there performance fees. But if we think about the innovation here, you don't see many with a really low MER. So something similar to passive and then a performance fee on top. And the point here is if we can offer you as an investor the opportunity to get alpha, and then if we do achieve that alpha, we're aligned with the upside with you, and that's why performance fee comes in. We think that's probably the best of both worlds of active and passive in combination. So you're getting low cost passive in combination with active by trying to seek that alpha as well at the same time.

Jacinta King (21:54):

And these core ETFs are using a systematic approach, which is something that investors may not be familiar with. So can you explain what is systematic investing and how is it being used by investment managers in these kind of portfolios?

Blair Hannon (22:05):

Yeah, I think this is really the crux of the ability for us to be able to do this is in that the fact that we're doing systematic or some people may know this as quantitative. And to quickly sort of, again, contrast and compare a little bit. So if you think about a fundamental manager that is someone who's sitting in a chair going and understanding of the company at a really, really deep level, going and interviewing management, reading every annual report, doing profit and loss statements and understanding what they think the value of that company is and investing. That's what you traditionally have always been around active management.

(22:44):

Where quantitative systematic comes in and it's really seen a strong rise as computing power has increased. It is, it's leaning into data in a different way than say a fundamental active manager would, but still using the same fundamental data that an active manager, again, a fundamental active manager would in that. If you think about all the things that an active

manager would look at, they look at return on equity, the PEs of them, they would look at the balance sheet, they'd understand the profit and loss. I just mentioned that.

(23:14):

The way that systematic can do that, they can do that. They can do it at much, much greater scale because all that data comes in. They then look at that data and build what are called alpha signals. So essentially, look at the data that you're getting from the balance sheet. Is that company likely to potentially outperform over the next year, the next three years, next five years? And when you pair that with other parts of data and what we call unstructured data, so looking at the language that you get at the AGM, and this is really powerful where these large language models can sort of really work, and this is the advent of AI is going to really help this space significantly. Pairing those two things together gives you the ability to have much greater scale across the market to say, instead of being a fundamental management going, I can understand 10 stocks, 20 stocks really well.

(24:06):

If you're using a model and a data input model through systematic, you can understand a thousand stocks really well and really quickly. The powerful part is though is you need to have those signals built in that give you the opportunity to try to outperform. So it's very easy for us to say, let's just put it into AI and compute it and hope for the best. That's inherently not going to work. Someone would've figured that out already with the Chat GPT. You really need a long history of doing this. Macquarie has over 30 years of doing this in that they've built these robust signals to indicate that when you pair that data together, that's going to give you a signal that outperforms. Macquarie uses around 65 to 70 signals at the moment to figure out if they're going to outperform.

(24:50):

The important part here again is, and we hark back to the point on those core ETFs, when you're a fundamental active manager, if you believe in a stock and you think that this is going to be the one, you're likely to have a pretty high weight in that portfolio. So you go back to those high conviction managers.

(25:07):

When you're a quantitative manager, you can really sort of pick and choose with what's called tracking error, which we won't dive into necessarily, and the intention might be outperform by 1% of the index or 2% of the index. You can be quite a bit more scientific around what you're trying to do. And that comes with smaller bets. So if you had have a stock and the index weight of that stock is 2%, in a systematic strategy, you might only take that stock at 2.5%, or if you don't like it, you might take it 1.5%. So it's small bets over and above the index. That gives you the ability to outperform by a smaller

amount rather than those bigger bets that what you'll find with many active managers.

(25:48):

So look, quantitative is pretty new for many, again, self-directed investors, even for many advisors because it's really been institutional only for many, many years. But what it really is it's one of those things where, again, fundamentally we can go into Woolworths and figure out if we like that stock, we can look at the balance sheet. Quantitative is just not possible for the everyday investor. It's really not possible for an advisor. We don't have the computing power, you don't have the history, you don't have the, unfortunately not me, a PhD in mathematics to work these things out. So it's a new area for many investors. But again, it's been something that's been running in the background for institutions for well over 30 years. And it goes back to that point I made earlier around democratisation, the ability to bring this for an ETF means any investor can access, whether it's a quantitative strategy, whether it's other parts of active management expertise, which is, again, the powerful part of ETFs, I think.

Jacinta King (26:41):

It's very interesting the science behind it, for me, I find. And I do think it's fascinating. And we're probably all watching going, how is this technology and AI impacting us now and into the future? But it is something that's been around for a long time in various forms. So it's just shifting and changing and hopefully for the better. But unfortunately that's all we have time for. So I do have to wrap it up there.

(27:04):

But if listeners would like to know more about Macquarie's ETFs and off those five products that you're offering, you can head to their website, etf.macquarie.com. And you can search for more information about those products and other things. Don't forget, you must also look at those product disclosure statements and target market determinations for the funds. They're also found on the website before. So make sure you look at those before making a decision to invest. But to wrap it up in summary, I feel like the key takeaways from our discussion today, Blair, is that actively managed ETFs have a team of investment professionals that can make changes to the portfolio as markets change. Systematic investing offers a science-driven approach to investing. And generally these kinds of products have become more readily available on ASX with the likes of Macquarie's suite of products. So thank you very much for your time today, Blair, we appreciate you joining us.

Blair Hannon (27:59):

Thanks Jacinta, really appreciate it.

Jacinta King (28:01):

And thank you to all of our listeners. As always, please join in again next month to the Ideas Exchange.

CTA (28:09):

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