A-grade funds

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Making money isn't so easy these days, so it's more important than ever to find a fund manager that delivers attractive returns without making you pay through the nose. But given that there are hundreds of managers available, how do you sort the good from the bad - or even just the decidedly ordinary?

AFR Smart Investor's special value test aims to find fund managers in the sweet spot of proven performance and fair fees.

For the third year, and with the help of independent researcher Morningstar, we've produced a report card for more than 200 fund managers. We've awarded top marks to the A-grade funds that delivered the best three-year returns while charging the lowest fees, and bottom marks to the F-grade funds that failed the performance test while charging over the odds.

We began by putting 359 Australian equity funds through our unique value filter. After this process, 29 had earned an A grade, 21 were awarded a B, 16 were on C grade and 14 on D. At the bottom of the class, 17 had their report cards stamped with an F.

It's worth noting that of the 29 A-grade funds this year, 11 were also in the top grade last year. Three of last year's top five are still in this year's top 10: Prime Value Growth Fund - Class B, ABN Amro Australian Equity Fund and Austock Australian Equity Fund. That's a pretty ringing endorsement.
It's also revealing that all the top managers have exposure to large stocks and 11 of them use a growth-style approach. By contrast,

10 of the F-graders are value managers. Value shares are typically the less sexy option but historically they've been solid long-term investments, as well as safe havens.

Having handed out our assessments, we got down to the nitty-gritty with some of the A-graders, who revealed their winning strategies and the sectors and stocks that helped them earn top marks.
Top performers

It's hardly news that the Australian sharemarket has fallen more than 20 per cent, so perhaps it shouldn't be surprising that few managers delivered positive returns over the year to the end of March. Nevertheless, the scale of the poor performance is pretty shocking.

Only three A-grade products entered positive territory: the Prime Value Growth Fund - Class B; the Portfolio Partners Professional High Growth Shares fund bought through the investment platform Synergy; and the same fund bought directly from Portfolio Partners.

Of the 359 fund managers we evaluated, just 15 delivered positive returns to investors in the past 12 months. Of course, share investing shouldn't be a short-term strategy, so we also look at three-year returns.

The fund with the best three-year performance among the A-graders is the BlackRock Wholesale Australian Share Fund (formerly called the Merrill Lynch Wholesale Australian Share Fund). This fund is an intriguing case. Despite delivering a negative return over the past year of 4.21 per cent, it has generated 15.68 per cent a year over three years, while charging only an ongoing fee of 0.95 per cent.

BlackRock Investment Management's Mark Himpoo, who heads the Australian equities team, says of its strategy: "With the market's reliance on companies' earnings guidance in recent years, it has created an opportunity to identify inconsistencies in fundamentals and stock prices, from both a stock-picking and macro perspective."

Runner-up is BT Wholesale Australian Share Pool, which returned 15.6 per cent a year over three years and a negative 3.39 per cent over the past 12 months. Investors pay 0.79 per cent a year to invest with this fund, which Crispin Murray manages.

In third place, the Prime Value Growth Fund netted 15.49 per cent a year over three years and 1.33 per cent over 12 months, Morningstar says. The fund slipped from second place last year and first place in 2006.

Fourth and fifth spots go to the BlackRock Professional Investor Australian Share Fund (formerly the Merrill Lynch Professional Investor Australian Share Fund) and the BT Wholesale Core Australian Share Fund. The two BlackRock funds in our top five are the same product available on different platforms, which affects the cost.

The BlackRock Professional Investor Australian Share Fund has generated returns of 15.19 per cent a year over three years but a negative 4.65 per cent in the past 12 months. Himpoo says: "The structural change in demand for soft commodities continues and the need for relevant inputs has seen us maintain our exposures to Incitec Pivot (IPL) and Nufarm (NUF)."

Meanwhile, the BT Wholesale Core Australian Share Fund returned 15.11 per cent a year over three years but a negative 5.14 per cent last year.

Of course, past performance is no guarantee of future results, but it's revealing to see which managers have a track record of high returns and low fees, such as the BlackRock Australian Share Fund - it's been in the top class for the past three years.

Opportunity knocks

BlackRock and others are cautious about the year ahead, and it's no wonder. The sharemarket has fallen sharply and the high-profile failures of margin lenders Tricom Equities and Opes Prime have added to the jitters. But many market analysts see opportunities and they're sifting through bargain-bin shares they consider well worth buying and holding for the longer term.

The Chinese growth story should continue to buoy the resources sector, and many managers still believe in mining giants BHP Billiton (BHP) and Rio Tinto (RIO).

However, one sector many investors are steering clear of is listed property. It has been on the nose since Centro Properties Group (CNP) revealed its funding difficulties last December. The shopping centre specialist is now trading at a discount to its net tangible asset backing and is facing a shareholder class action, as are the troubled Allco Finance Group (AFG), the former MFS - now known as Octaviar (OCV) - and Centro Retail (CER).

Many analysts agree the sector has too much debt but some are forecasting a pick-up; they say that it has been oversold. Listed property trusts outperformed the S&P/ASX 200 by 3.7 percentage points in March, in what was the first positive month for LPTs since September last year.

So, although there are doomsayers, there are also opportunities for bargain hunters. Some certainly believe the market has hit the bottom, and takeover plays are being made for listed businesses perceived as undervalued.

However, the head of equities at A-grader UBS Global Asset Management, Simon Shields, warns: "While valuations have improved significantly, earnings risks are significant, given a weaker global economy and the [Reserve Bank's] determination to slow growth sharply over the coming year.

"We expect the market to remain hostage to the ebb and flow of sentiment from the fallout in tighter credit conditions for some time yet," Shields says. "While the bulk of the market's decline is likely to be behind us, these risks continue to point to a vulnerable market for some time."

F-grade funds

For some fund managers, all the research in the world hasn't produced returns to justify their fat fees. The F-graders charge annual fees of at least 2 per cent, yet they've returned less than 11 per cent a year over three years, along with negative returns of 7 per cent or more over 12 months. You would have been better off putting your money in the bank or under the mattress.

Among the worst performers over three years, while charging high fees, are the Investors Mutual Industrial Share Fund (bought via the Skandia investment platform) and the Lazard Australian Equity Fund (bought via the Skandia or AMP platforms). The Lazard fund is also among the worst performers over 12 months, returning a negative 13.06 per cent and 12.08 per cent, respectively, on the different platforms, and just above 8 per cent a year over three years.

These two Lazard funds charge 2.17 per cent and 2.25 per cent a year in fees, respectively, but that pales in comparison to the 2.85 per cent charged by the IML Australian Share Fund, available through the ING platform. The fund, which also charges a 3 per cent exit fee, has returned just 8.22 per cent a year over three years and a negative 8.09 per cent over 12 months.

The fact that Investors Mutual, Perpetual (PPT) and Lazard all appear in the bottom grade holds a lesson for investors. These are big names with good reputations as top-rank managers; however, like everyone else, they have good and bad years. A manager's particular style of investing may mean they miss the boat on technology or resources shares. But charging hefty fees for poor performance is difficult to excuse.

Fund managers cost investors more if they're accessed via a platform, master trust or wrap account. You have to pay platform fees, plus the annual fund fees. Yes, you can download reports for your tax returns easily but is that enough to justify the cost?

There are also other reasons for higher fees. Some cap funds under management to improve performance, charging higher fees to compensate. Others charge performance fees on top of management fees, and there are those who charge entry and exit fees.

Of the 17 F-grade funds, eight charge an entry fee of 4 per cent or more and six charge exit fees of 3 per cent or more. The IML Australian Share Fund, bought via the Perpetual platform, charges a whopping entry fee of 4.5 per cent and an ongoing fee of 2.15 per cent but has returned just 8.82 per cent a year over three years and fell 7.31 per cent in the past 12 months.

Again, past performance is no guarantee of future returns, good or bad, and these funds won't necessarily underperform again. But they won't attract savvy investors looking to pay fair fees for good returns.

Methodology

AFR Smart Investor and Morningstar adopted the same strict methodology for this year's value test as in the past two years.

Step 1: The field of managed funds was narrowed by choosing only open, retail unit trusts investing in large-cap stocks that had three years of performance data to March 31.

Step 2: Funds were sorted into quartiles based on three-year performance data (the top 25 per cent of funds falling into the first quartile, the next 25 falling into the second quartile, and so on).

Step 3: Funds were then sorted into quartiles based on fees, either the management expense ratio or indirect cost ratio. (The cheapest 25 per cent of funds fell into the fourth quartile, the next cheapest 25 per cent into the third quartile, and so on).

Step 4: Finally, funds were grouped according to AFR Smart Investor 's special value test:

A: Highest returns (top quartile), lowest fees (bottom quartile).

B: Highest returns (top quartile), fairly low fees (third quartile).

C: Fairly high returns (second quartile), lowest fees (bottom quartile).

D: Fairly high returns (second quartile), fairly low fees (third quartile).

F: Lowest returns (bottom quartile), highest fees (top quartile).

MARK HIMPOO

Head, Australian equities

BLACKROCK

BlackRock Aust Share Fund

A-Grade, ranked 1st and 4th

Performance drivers over 3 years

An overweight resources position is the cornerstone of any portfolio that did well over this period. This, plus industrial-stock-specific positions, enabled the fund to outperform its benchmark.

Performance drivers over 1 year

BHP Billiton (BHP) and ¿Rio Tinto (RIO) are beneficiaries of China's industrialisation and resulting supply constraints. The flow-on for commodities such as energy saw us position the portfolio to take advantage of the rising values of oil and gas reserves - for example, Oil Search (OSH). Service providers in resources, such as WorleyParsons (WOR) and Leighton Holdings (LEI) also added value. CSL (CSL), via the tight intravenous immunoglobulin market and the successful launch of Gardasil, was a major contributor.

Stocks held today

We remain optimistic for BHP and RIO, although we're conscious of the volatile nature of positions in a macro environment of uncertainty. The changing landscape of energy demands has implications for gas prices and reserve values, for which we believe Queensland Gas Company (QGC) is well positioned.

CRISPIN MURRAY

Group head of equities

BT FINANCIAL

BT Wholesale Aust Share Pool

BT Wholesale Core Aust Share Fund

A-Grade, ranked 2nd & 5th

Performance drivers over 3 years

Our conviction around key stocks in the resources sector has been positive for portfolio performance. Despite predictions of slower global growth, we remain positive about Asian growth prospects. The demand/supply dynamics of the resources industry continue to provide support for the portfolio.

Performance drivers over 1 year

Rio Tinto, BHP Billiton and OilSearch have been our strongest performers. And being

underweight in some of the negatively performing property trusts, including Centro, has also contributed.

Stocks held today

We are interested in stocks that have de-rated well beyond any objective assessment of the risk to their earnings - financial stocks such as QBE Insurance Group (QBE) and insurance and funds management company AMP (AMP) are two examples. And we are also interested in stocks that have been affected by slowing global growth, regardless of the fundamentals - the resources sector, for instance, has ongoing supply pressures.

LEANNE PAN

Senior portfolio manager

PRIME VALUE ASSET MANAGEMENT

Prime Value Growth Fund