Article

The case for active management of passive investment products

Comparisons between active and passive investment strategies are made with an ever increasing frequency by investment professionals and seem to be one of the investment world's most popular literary pursuits. Increasingly, a combination of both is essential for meeting investment goals and adding value to the investor.

Passive investing involves the tracking of an index, like the S&P500 or a basket of securities, while with active investing, the investor selects individual securities for purchase or sale usually based on fundamental and technical analysis.

This means that active managers seek investment opportunities that will provide returns that beat the market return over the long term. Active investing involves significant investor skill and judgment in making selection and timing decisions, if those decisions are to result in returns that are superior to the collective performance of the market into which the manager is investing. Passive investing is more about faithfully replicating the underlying asset performance. Naturally, active managers charge higher management fees and performance fees compared to passive strategies.

Are active managers really worth the additional fees they charge over what a passive instrument costs?

The whole argument basically comes down to whether active managers earn their fees. Are active managers really worth the additional fees they charge over what a passive instrument costs?

The arguments are furnished with various statistical references to how many managers beat the market index. Such statistical analyses are numerous and widespread and seem to have similar conclusions; that after fees the average manager does not beat the index[1]. This is not really surprising if one understands that the market is in fact the summation of all these managers. Therefore, by definition, on average they cannot beat the average of themselves once fees and expenses are taken into account.

On the other hand, active management proponents site the pitfalls of indexing as 'condemned mediocrity' and mindless deployment of investor capital without regard to fundamentals, with no shareholder activism and an inherent 'buy high sell low' mechanism built into indexing. Indexing is vulnerable to the crowding in and selling off every time a security is added or removed from an index - it forces the index tracker to sell off those securities being removed just as they are being sold off and buy the new component just as everyone else is buying in. Market cap weighted indices are further disadvantaged by holding more and more of securities whose price is rising and less of those whose price is dropping, inherently buying as securities become expensive and selling them as they become cheap.

Both sides have valid arguments and at the end of the day provide a wonderful sparring ring for academics. The whole discussion, however, seems to be missing the practical aspects of investing; what the real investor needs to know. We all know that there are managers with superior skill and the ability to outperform with uncanny consistency. Most of us would be much happier with Warren Buffett, Ray Dalio or Paul Tudor Jones managing our money that simply buying an index tracker and watch it crumble at the next inevitable market crash. This isn't visible in the statistical analysis of active vs passive. There are cases where we do clearly understand the power and value of tracking the index (particularly valuable in a raging bull market such as 2013 -2014).

On balance, the whole argument of passive vs active is rather moot, in that it should not be a binary choice between one or the other but rather when, to what extent and by which manager should each strategy/method be employed. It requires as much skill to select and switch between managers as it does to actively manage a fund by selecting the securities for it.

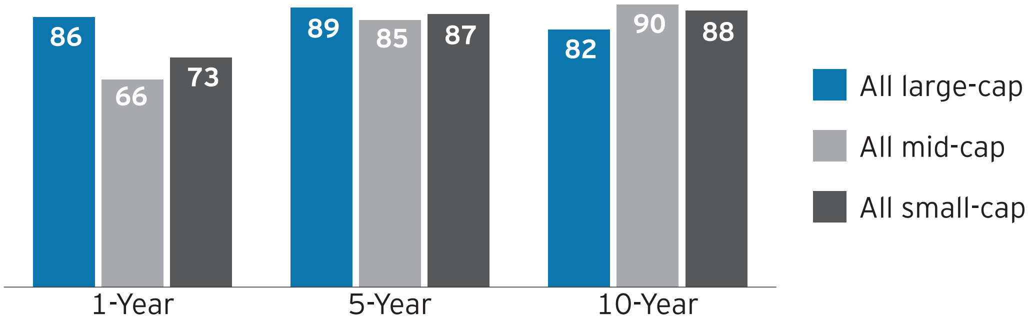
The development of the indexing industry has created a broader investment universe and supplies the average investor with useful tools to achieve their investment goals (Box 1). Achieving them however needs as much skill and diligence as ever, we have seen large and liquid ETFs collapse and recover in minutes this August as the liquidity of the underlying faltered. We have seen skillful managers get caught out by the extraordinary nature of markets recently under zero rates and quantitative easing. The need for professional portfolio management is as important as ever at all stages of the investment process, whichever combination of "active" and "passive" strategies are being utilised. Not only are skillful managers needed to select securities but skillful managers are required to construct and manage portfolios of managers and indices or index trackers. For, just as not all managers are equal in skill and ability, not all index trackers are of equal effectiveness and efficiency.

[1]Research into mutual fund performance, has historically shown little evidence that mutual fund managers outperform passive benchmarks. In 1998, by analysing the performance associated with various degrees of skill in various equity styles for the 1985-1997 period, Eric H, Sorensen, Keith L. Miller and Vele Samak found that a modest amount of stock-picking skill goes a long way and the optimal amount of allocation to indexing declines as skill increases. In 2008, Kenneth R. French found that a typical investor would increase his average annual return by 67 basis points over the 1980-2006 period if he switched to a passive market portfolio. Using data from 1984 to 2006, Fama and French (2010), concluded that few active funds produce a positive return that is sufficient to cover costs, and there are fewer managers generating a positive return than would not be expected on the basis of luck alone.

Box 1. Statistical comparison data between active and passive strategies

According to an S&P Dow Jones Indices scoreboard, a staggering 86% of active large-cap fund managers underperformed their benchmarks in 2014, 89% of those fund managers failed to beat their benchmarks over the past five years and 82% did the same over the last decade. Approximately 66% of international mid-cap funds and 73% of large cap-funds underperformed their benchmarks over the past year.

Percentage of U.S. equity funds outperformed by benchmarks (%)



Source: SPIVA US Scoreboard

Most recently, Morningstar published the Active/ Passive Barometer, in which it compares the returns of active managers against a composite made up of relevant index funds (including Exchange Traded Funds (ETFs)). Their findings show that actively managed funds have generally underperformed their passive counterparts, especially over a longer time horizon.

On the other hand, based on the results, actively managed funds outperformed their passive counterparts on both an asset and equal weighted basis in the mid-value and foreign large blend categories. The report also concludes that investors would have substantially improved their odds of success by favouring lower-cost active funds. The high fees that are charged for actively managed investments in order to pay for the extensive research and analysis to beat index returns make a big difference in net returns. However, the active funds offer flexibility through their ability to use short sales for better risk and tax management. By definition, the average actively managed dollar cannot beat the passively managed dollar net of costs. In any case, a well-executed investment based on an active strategy, is motivated by a high skill investment manager that can add enough skill (alpha) to generate returns beyond the fees incurred.

Average annualised returns (January 2005-December 2014) (%)

		Asset-Weighted Performance			Equal-Weighted Performance		
		Active	Passive	Active-Passive	Active	Passive	Active-Passive
U.S. Large	Blend	6.74	7.68	-0.94	6.42	7.24	-0.82
	Value	6.76	7.31	-0.55	6.24	6.52	-0.28
	Growth	8.05	9.27	-1.22	7.12	8.27	-1.15
U.S. Mid	Blend	7.28	9.28	-2.00	7.10	8.82	-1.72
	Value	8.38	7.82	0.56	7.99	7.49	0.50
	Growth	8.70	9.34	-0.64	7.76	8.54	-0.78
U.S. Small	Blend	7.63	8.52	-0.89	6.93	7.72	-0.79
	Value	7.86	7.93	-0.07	7.04	7.01	0.03
	Growth	8.14	9.13	-0.99	6.92	8.33	-1.41
Foreign Large Blend		5.48	4.32	1.16	4.00	3.79	0.21
Diversified Emerging Markets		8.32	7.70	0.62	7.33	7.97	-0.64
Intermediate-Term Bond		4.96	4.56	0.40	4.04	4.16	-0.12

Source: Morningstar

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