

The Active-Passive Investment Decision

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Introduction

Passive management is where an investment manager buys all the securities that meet specified criteria without any attempt to pick the “winners” out of that group of stocks. The most common form of passive management is ‘indexation’ where the passive management criteria is that the portfolio holds securities in the same proportion as the specified index (eg S&P 500 index). So if the S&P 500 is up 3%, the passive manager is up 3% in gross terms. Active management is where an investment manager tries to outperform the specified portfolio (most usually an index) by using stock selection, sector selection or market timing. So the active manager’s performance will most likely be different from the index.

Some of the main differences between active and passive are illustrated in the following table:

	Passive	Active
Tracking error likelihood and extent of deviation in performance from index/benchmark	Low	Medium to high
Fees – investment manager, operating	Low	Medium to high
Manager turnover	Low	Medium to high
Trustee governance required	Low	Medium to high
Reselection of manager required	Unlikely	Likely

Warren Buffett, one of the world’s best known and most successful value investors, famously wrote in 1975 that active management is analogous to a fellow sitting down with his friends at the poker table and announcing “well, fellows, if we all play carefully tonight, we all should be able to win a little”. Does this mean to always go passive and that there is never a place for active management? “No” is the simple answer!

Issues to Consider

There a number of issues to consider when considering active or passive management, such as:

1. Efficiency of the market – active management tends to work better when the market is less efficient (where new information doesn’t readily feed into asset pricing) or in the alternative space (such as property, infrastructure) or more complicated investments. However, with significant allocations being made to passive management, will the market become less efficient? If a market is not efficient then indexation results in systematically buying more of the overvalued stocks and less of the undervalued stocks. Also in passive bond investing, the investor ends up lending most to the most indebted companies/governments which is not always wise.
2. The fees for active management can be a multiple of what passive managers charge so the trustees have to be very confident that an active manager can exceed the index by at least the fee before deciding to invest in an active manager. The fee can be a big hurdle for most asset classes but especially alternative investments.

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3. Past performance is no guarantee of future performance – be wary of active managers with a very good track record as their style might have been in vogue over that period. Ensure that their track record is over a prolonged period with the manager being able to display added performance in up and down markets. Picking investment managers by just looking at their past performance is akin to driving a car by looking in the rear view mirror.
4. Be wary of active managers who “hug” the index. These managers vary their portfolio by only small deviations from the benchmark and yet charge higher fees.
5. Have the trustees got enough time to be focussing on active managers? One of the big problems with the lead up to the 2008 financial crisis was that trustees were too busy debating underperforming equity managers without focusing on the bigger issue – their overweight allocation, and mismatch of their liabilities, to equities.
6. For trustees who are engaged in de risking, it might make more sense to have passive investments rather than having to decide which active managers to remove when they hit de risking triggers.
7. It is hard to read meaningful information from performance data. For example, to get statistically meaningful information from past performance, data would in theory require performance history of 20+ years – over this timeframe too many other variables have changed (the firm, the team, the market) to make even such a long track record meaningful. So, with active management it is especially important to have deep and thorough qualitative assessment of a managers capabilities and competitive advantage as well as the insight and patience to see through downturns in performance that are luck rather than skill based. This may not always be possible for Trustees.
8. If trustees decide to choose active managers, they should ensure that their consultant has a strong track record of picking good investment managers in that asset class. Some consultants have a better track record in some asset classes than others. The consultant's history should include performances of managers they rated highly in the past – not just whatever managers look good now. The trustees should ensure that the added performance from the active managers on the consultant's list exceeds the general management cost for that asset class. For example, if a consultant has a track record of picking quality managers who outperformed by 50bps per annum over a period of time, there is little point in choosing these managers if the fees are higher than 50bps. Also usually the excess performance does not include transition costs which can be high when replacing an investment manager.
9. Picking a good manager usually involves looking at their philosophy, process, people and performance. Philosophy is about understanding why a manager is able to beat the market. Much of the answer comes down to process, as it is important to understand whether or not the investment manager consistently maximises market inefficiencies with good processes, avoiding luck and maximising skill. The third element is people, probably the most important one, as the investment management business is all about talent. And lastly, we have performance and the emphasis here should be on ensuring that the performance is consistent with the stated philosophy and process in the context of market developments. The least weight should be applied to performance.

Interestingly, Mr. Buffett recently stated that in his will he recommended (to his wife) that the majority (90%) of his inheritance be invested in a passive S&P fund while the remainder (10%) be invested in short term government bonds.

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Summary

The general rule of thumb is that a passive fund should be the investment vehicle of choice, unless trustees are confident that an active manager can consistently outperform the index, net of fees and expenses.

More information

In addition to discussing the various management styles with their investment consultants, the following links might be of interest:

“Asset Management Fees and the Growth of Finance”, Burton G. Malkiel
<http://www.aeaweb.org/articles.php?doi=10.1257/jep.27.2.97>

“The Active-Passive Debate: Market Cyclicity and Leadership Volatility”, Christopher B. Phillips, Francis M. Kinniry Jr
<https://personal.vanguard.com/pdf/icract.pdf>

“‘Index funds beat active 90% of the time.’ Really?”, Robert Isbitts
http://advisorperspectives.com/commentaries/sungarden_080214.php