

Active and Passive Investment Management

- a general discussion

February 2009

Having determined the appropriate investment strategy i.e. the mix between cash, bonds, property and shares, the next step in the investment process, relates to implementation. In this regard decisions are required as to whether tactical (i.e. shorter term) asset allocation decisions will be made and/or whether individual stock selection decisions should be on an active or a passive basis. However, the decision is not an either/or decision. It is often appropriate to implement a mixture of active or passive strategies with the active passive decision being considered at both the asset allocation level and the stock selection level. A separate decision should be made for each.

The purpose of this paper is to provide general background information on the main arguments for and against passive and active investment management, where a decision on the approach is required. In some cases, a decision will not be required as the objectives or specific return requirements will dictate a particular approach.

For many investors the choice between active and passive investment management will depend on their past experiences, personal preference and the theoretical arguments. As with all investment decisions, no approach is necessarily wrong. Both active and passive investment management are valid approaches, under particular scenarios and both are widely used.

"I fully accept that for the vast majority of people who have no understanding of the drivers of long-term investment performance it is eminently sensible to follow a "passive" indexed approach."

Warren Buffet

<p>"Active management" is where the manager/investor follows a process that makes conscious decisions to look to enhance the return above the average or general market. An active manager seeks above average risk-adjusted returns overtime, by taking advantage of the inefficiencies within the market, and anticipating correctly the changing economic conditions and outlook.</p>	<p>"Active asset allocation" is often referred to as tactical asset allocation or TAA. TAA is where the manager/investor makes a conscious decision as to which assets sectors will perform better, than others, in the immediate future.</p> <p>"Active stock selection" is where the manager/investor makes a conscious decision about which stocks or securities, within an asset sector, will do better than the "average" stock within that sector, in the immediate future.</p>
<p>"Passive management" is the opposite to active management. The manager/investor adopts a buy and hold strategy and does not constantly try to "second guess" the market. It also is a term often used to refer to "index" management. "Index" management is where the manager/investor makes investment decisions strictly in accordance with a predetermined strategy to reproduce a market index return. Index management is a sub set of passive management.</p> <p>The objectives of passive management are to minimise turnover costs, defer taxation (in some cases) and therefore provide an above-average risk-adjusted return net-of-tax and expenses return, close to the market return.</p>	<p>"Passive asset allocation" is where the manager/investor invests across the different asset classes in accordance with a predetermined benchmark or long-term strategy and rebalances back to the benchmark.</p> <p>"Passive stock selection" is where the manager/investor invests within a particular sector on a buy and hold basis or in accordance with a market index. Particular stocks are held because they are appropriate to hold long-term or are in the index and not because they are thought to be particularly favourable. In the case of an index it may be done either by:</p> <ul style="list-style-type: none"> • "replicating an index" i.e. all stocks are held in proportion to the index or ; • by "approximating an index" i.e. stocks are held so that the characteristics of the portfolio approximate to the characteristics of the index. <p>It is believed that overtime, the market will take care of itself and dominate returns.</p>

Return theory

First some terminology. If you invest passively in accordance with a market index, the return achieved is the market or index return. This is often known as the "beta" of the market. In contrast, if you invest actively away from the index, or without regard to the index, with the goal to achieve a return above the market beta return, the additional return is called the "alpha" return.

Alpha can be positive or negative depending on whether the investment decisions prove to be correct or incorrect. The sum of all of the alphas of all the investors, must equal zero less the managers' costs, as not all active managers can be successful.

$$\begin{aligned} \text{Total passive return} &= \text{beta} \\ \text{Total active return} &= \text{beta} \pm \text{alpha} \end{aligned}$$

The question is whether a particular investor should seek beta, or beta plus alpha. Knowing that at least half of the investors seeking alpha will not be successful.

The concepts of alpha and beta, is based on Sharpe's capital asset pricing model under finance theory. Implicit in the theory is the investment belief that investors are compensated for taking on market risk i.e. they ultimately receive an additional return above the risk-free rate, over the long-term, for taking on the market risk. Therefore the beta return can also be considered to be the return available from cash and the market risk premium ultimately captured for shifting out of the certainty of cash.

$$\text{Beta} = \text{cash return} + \text{market risk premium.}$$

However, the return premium for taking on the beta risk is variable short-term and is often negative over short to medium periods. It may not therefore be realised, except for over very long periods of time. The beta return premium therefore, accrues, only overtime, to investors that consistently take on that risk.

Unlike beta, alpha cannot accrue for all investors who seek it. If one investor receives positive alpha, another must by definition receive negative alpha. The pursuit of alpha is a zero-sum game in which the gains (rewards) for one investor's skill, are offset by the losses of another investor – and reduced further by transaction costs. It is therefore the relative skill and not absolute skill that is important.

To pursue alpha and therefore justify active management, requires at least three major beliefs/assumptions. That

- manager skill exists and will be persistent; and
- opportunities to apply the skill exist in the market i.e. there is some level of market inefficiency;
- advance identification of managers with a future skill advantage is possible.

The fact that investors are not universally rewarded for taking on alpha risk also means that a different risk dimension is introduced into an investor's portfolio by pursuing alpha. This is both at times when the market is going up and going down i.e. active management will not automatically result in better returns when the market is going down.

Active management

Successful active management of assets, hinges on an investor's ability to regularly select an active manager(s) that achieves a higher and positive alpha return ("adds value"). In this regard, value added is defined in terms of out-performance and success requires sustainable out-performance. Out-performance must be on a net-of-tax (if tax is applicable) and net-of-fees basis.

It can be argued that by objectively studying past performance and behaviour, and more importantly by qualitatively evaluating the capabilities of managers, it is possible to identify managers who will achieve out-performance in the future. Also, by regularly reviewing and changing the managers when required, sustainability can be achieved.

However, in practice, the selection of a manager who will be successful in the future is not guaranteed, particularly in the selection of a manager whose performance will be consistently above the benchmark in the future.

There are a number of reasons why this is the case and these form the basis for the arguments against active management and in favour of passive management. These factors concern the efficiency of the markets and market dynamics, the transaction and management costs, the quality of management and the reward for the risks taken.

Market efficiency

Most developed markets are considered to operate reasonably efficiently. This does not mean that they are correct or perfectly efficient. These markets are considered to be dominated by a large number of well-informed investors buying and selling securities with most of the information in the market is widely available. On this basis it is highly likely that, subject to supply and demand issues, the market price of a security will in general reflect its perceived prospects and therefore its current value. If this was not the case, the better informed investors (i.e. better active managers) would identify the difference and, by their actions (buying the under valued securities and selling the over valued ones), remove the difference. Due to this efficiency, it can be argued that consistent long-term out-performance by any manager is not possible except by luck.

If markets were totally efficient, this would be the case. However, it is not possible for markets ever to be totally efficient. Historical analysis shows that at certain times inefficiencies can exist with regard to:

- small capitalisation shares;
- the smaller markets;
- securities not widely followed by broker research.

Also, the emotions of investors are often stronger than reason. This creates an over reaction bias to positive or negative news.

Consequently, and for these reasons, there will always remain opportunities for some active managers to outperform, by developing a disciplined numerical and/or objective approach to the selection of investments. This raises the questions:

- what proportion of active managers can and will achieve out-performance? By definition not all can, as the average return still has to be equal to the overall market index return less costs;
- will the out-performance exceed the higher costs?;
- will the out-performance be permanent, or offset by underperformance when the market adjusts?;
- will the out-performance be sustained?;
- can the manager be identified in advance?;
- will the investor have the patience to remain with a manager through the inevitable periods of under-performance, while on a path to long-term average out-performance?;
- will the investor be able to identify the points in time when a previous above average manager, is about to “fail”?

The answers to each of the above will be a function of the degree of the inefficiency of the market and the qualities of the investment managers. In addition, the investor’s own decision process for selection and monitoring will be important.

There are a number of other issues relevant to the issue of market efficiency.

- while the portion of assets under passive management remains small, relative to the total market, it will not distort the market and create inefficiencies. However, if a significant part of the market moved to a passive approach, the scope for some active managers to add value would increase. The market needs active managers or buyers and sellers to remain efficient.
- a sudden shift to passive index management, creates a danger of passive management driving the market and artificially inflating the market return. This will ultimately be reversed. This could create inefficiencies within the market. To be successful, passive management requires the market to be efficient. Therefore, a sudden shift to passive management may create market conditions which are unfavourable for it, and in which the better active managers could more easily outperform.

Also, the market efficiency arguments apply mostly to developed markets and then primarily to the larger capitalisation sectors of those markets. In other markets, or in smaller capitalisation areas of developed markets, where information is less or poor and institutional involvement limited, there is greater scope for adding value by proprietary research-generated information. To the extent that this is possible, a passive approach in these areas might miss these opportunities, but then not all active managers can out-perform the market or will have a proprietary research advantage. The alternative is to ensure that the passive management approach adopted includes a focus on the smaller companies.

Management quality

In many markets, fund managers (both domestic and offshore) dominate the market. It follows that this group is representative of the markets and the average manager reflects the average of the market. In this regard therefore, it is relative quality, that is important and not absolute quality, that will lead to out-performance. In reality, you might expect a minority of managers to have the quality to produce out-performance in the long-term, as most will produce both periods of out and under-performance. One of the reasons for this is that if one manager has below average qualities it will ultimately disappear, or will take action to improve its relative position. For this reason alone, achieving a competitive advantage and maintaining it long-term is difficult.

Successful active management, will only apply to active managers who:

- have a clear philosophy on how they can gain a competitive advantage relative to the market and how that advantage can be evolved and maintained, and
- have a systematic process that objectively implements the philosophy, and
- have a management style and structure to support their philosophy.

Risks

In order to generate out-performance, manager risk must be taken. In order for a prudent investor therefore, to accept the higher risk they have to decide what is an appropriate additional level of return to compensate them for it. By definition only a proportion of above average managers will be able to achieve this additional higher return requirement.

Also, the pursuit of out-performance will lead to a pattern of under-performance as well as over-performance, relative to the market and consistent above market results will only emerge in the longer term.

This makes it difficult to identify how much of the value added by the manager was due to “skill” and how much was due to “luck”. Even the best active managers will at times achieve poor results and vice-a-versa.

From a risk/return perspective, it is questionable whether the additional returns sufficiently reward investors taking on active risk.

Transaction costs

Passively managed funds involve fewer transactions and therefore have lower transaction costs, lower market impact costs and lower custody costs relative to active management.

A major contributor to the under-performance of the average active manager is the costs incurred in buying and selling securities in pursuit of above-index performance. Costs in this context relate to brokerage and the market buy/sell spread. This reduction in performance is likely to be of the order of 0.5% to 0.75% per annum for a typical equity portfolio. As professional investment managers are responsible for the vast majority of transactions in the market, it follows that the “average” investment manager will under-perform the market index over the long-term by the same margin. It also follows that a portfolio constructed to track the index will perform, on average, slightly better than the average active manager, because as an index tracking portfolio it will not incur the same level of transactions costs.

For active managers to outperform the index (and outperform index tracking portfolios) consistently, they must overcome the transaction cost hurdle by making decisions that are of above average quality. Not all active managers will be able to do this by definition, and those that can may not be able to do it consistently over the long-term and over all parts of the economic cycle.

Management costs

Manager fees for index tracking management are generally lower than those for active management. The lower fees arise because passive managers do not need to maintain the same expensive research facilities. Passive management is mechanical.

The difference in management fees between passive and active management is likely to be somewhere between 0.2% per annum (for a very large fund) and 0.7% or 0.8% per annum for smaller funds.

In addition to manager fees, investors must also consider associated costs such as audit and consultant fees. These will also be typically higher for active management.

Taxation considerations

Taxation implications may also be a factor to the active-passive decision for direct investors who are taxpayers i.e. those that do not use products or managers. This arises because increases in the underlying share prices from direct passive management do not arise from trading activities and are therefore not taxable as income. Therefore, for these investors, active management must overcome the higher costs and the need for value added and must generate sufficient added value to offset the long-term tax consequences of active management and trading gains.

For managed products however, this is now less of an issue in New Zealand as both passive and active products can be set up to have the same tax structure.

Volatility

While the concept of the potential for greater variability of passive returns is true, when an active manager does add value the active process itself can, and often does, introduce additional volatility, so it is not certain that passive management will always be more volatile.

Passive management

The advantages and disadvantages of passive management are naturally counter-arguments to those of active management. The main objections to passive management lie with emotion and greed. Some investors cannot accept the concepts of:

- receiving only "market" performance, or
- that, through thorough research, undervalued securities cannot be identified, or
- the requirement to invest in an identifiable poor stock, just because it is in the index, or
- doing nothing when the market is going down, or
- that managers don't know what they are doing.

The main argument for index-tracking stock selection is that the average active manager has not and does not appear to be able to consistently outperform the representative market indices. Passive management therefore delivers market index performance at lower cost and must by definition be above the average manager on an after-fees basis, particularly over the long-term.

The merits of passive management for many investors are still not widely accepted. Amongst other reasons, active managers must promote the merits of active management, at the expense of passive management, to protect their income stream.

So, should it be passive or active?

First, it should be reiterated that, the "active versus passive debate" is not an either/or question. It is a question of what is best in particular circumstances. As both approaches lead to a different pattern of returns, it is a question of which approach provides the pattern of returns that is more appropriate for the investor's liabilities and which is consistent with the governance structure of the investor.

It is also an issue that should be considered primarily on the basis of principles and beliefs and not on the basis of short-term returns, or on the basis of hope. In most cases, the right answer for an investor depends on issues such as:

- **timeframe.** Over what timeframe will the capital be invested or the returns evaluated.
- **available time.** What time does the investor have to undertake due diligence of managers and to monitor outcomes etc.
- **skills.** What skills does the investor have, or can efficiently buy in.
- **outcomes.** What outcomes does the investor want? For example, what pattern of returns relative to the market and to other investors and to the cash rate (say), are ideal?
- **risks.** What risks is the investor prepared to take, in the pursuit of extra returns?

Appendix – Characteristics and decision process

The characteristics of each approach are:

	Passive management	Active management
Return outcome:		
• Variability of total absolute returns	high	medium to high
• Income return	equal to market	variable
• Capital growth return	equal to market	variable
• Out-performance of market	no	possible
• Under-performance of market	no	possible
• Outperform average investor	yes	possible
Costs:		
• Portfolio turnover	low	high
• Transaction costs	low	higher
• Custody costs	low	higher
• Manager fee levels	low	higher

Decision frame work

A decision framework to help clarify the decision process is set out below. Investors should also consider their current arrangements and the nature of their liabilities.

