portfolio
construction
forum

Active versus passive

Dominic McCormick | Select Asset Management | 07 April 2014

The active versus passive debate is probably one of the oldest in the investment industry. It was recently given another boost when Warren Buffet (one of the most famous active managers in history) suggested in his annual Berkshire Hathaway letter that most investors are better off investing passively and that he intended to put the vast majority of his estate into a very low cost S&P500 Index Fund.

This debate is often reduced to an overly simplistic level that suggests investors have to definitively choose between a passive or active approach only, with each clearly defined with no mixing of the two being possible or desirable. Even Buffet seems to suggest that only certain knowledgeable investors such as him should invest actively, and that most "ordinary" investors should be all passive.

Certain elements on both sides of the debate are apt to approach their case with a religious fervour that can inhibit rational discussion. The discussion itself is often divorced from practical portfolio implications, resulting in major misunderstandings and unnecessary inflexibility.

The central focus of the active versus passive debate is couched in terms of adding value in a stock market context over a market index (typically market capitalisation weighted) – the so-called elusive alpha. Passive supporters include those believers in market efficiency but can also include those who believe markets can sometimes be inefficient, but that it is too difficult to consistently exploit these inefficiencies.

The strongest supporters of market efficiency and a passive approach believe that their most powerful "proof" is that US mutual funds, on average, have underperformed the market index.

However, I believe that average underperformance by the "average" mutual fund (in a majority, but not all categories) proves little about market efficiency or the ability of certain managers to outperform consistently.

Certainly, the whole market is a zero sum game from an outperformance perspective so it is not surprising that average performance is behind the index after costs, given that they are such a large part of the overall market. However, many fund managers are subject to the same behavioural flaws and challenges that impact all investors, but that doesn't mean some cannot overcome these and maintain an edge. Further, participants are subject to many structural constraints in the investment industry – for example, a focus on their own career risk and resulting pressure to hug the index, especially as their funds get larger.

In fact, the premise that underperformance of funds comes from various attributes of the industry and not from poor stock picking skills is supported by a paper, "Best Ideas", by Cohen, Polk and Silli (2010)[1]. They found that US mutual funds' highest conviction ideas did indeed outperform, but that this was offset by their willingness/pressure to hold a larger range of stocks, many of which performed more poorly. In their view, the industry – and investors – would benefit if mutual fund managers held more concentrated portfolios.

Another paper, "Scale and Skill in Active Management" by Pastor, Stambaugh and Taylor (2010)[2] highlights that returns do deteriorate as funds get larger and older. This again suggests that looking at the average of fund performance may not be useful guide to the ability to outperform.

If you throw darts to pick your active fund managers, the chances of outperforming (achieving alpha) are low. Likewise, if you only invest in the biggest, most popular, brand name managers then expecting continued outperformance is unreasonable. But, if you are willing to recognise the pressures that make managing money difficult and understand the constraint of having too much funds under management, investors can do better.

Investors also need to remember that investing is about risk as well as return – but this is not captured in many analyses. Active managers have tended to outperform in poor markets, which suits the risk aversion of most investors.

An interesting recent analysis of Warren Buffet's Berkshire Hathaway's performance shows that while he has delivered significant alpha since 1965, even he has not added any value over four of the last five years. But is this really surprising now that Berkshire Hathaway has a market cap of over $US400 billion? Further, should we expect him to be as good at 83 as he was decades earlier (and partner Charlie Munger is now 90)? We certainly don't expect this of any other mortals in virtually every other field of human endeavour.

I think a lot comes down to one's personal beliefs and experiences. Reading about and talking to smart managers and understanding their strategy and how they achieved their returns can not only help find good fund managers, it can also help define one's own views on the active versus passive debate.

The key question is this – do markets have behavioural inefficiencies that can be exploited by smart managers and can these managers be identified in advance?

In practice, one doesn't need to identify many good active managers, or even identify them in every asset class. There is no rule that says you must be entirely active or passive across portfolios, or that you can't mix the two approaches and change the mix over time. For example, in Australia, it is very clear that small cap managers have consistently outperformed over longer term time frames due largely to the limited research coverage in that area. Passive exposures (especially market capitalisation weighted) make little sense for any long-term holding in this area.

In any case, in the real world of investing, I think it is impossible to actually implement a fully

"passive" investment approach without some at least partially "active" decisions. For example the following issues have to be addressed:
1. Which type of passive - index weighted, fundamental, style-biased - so called "smart beta";
2. What is the starting asset allocation?; and,
3. If asset allocation is passive, how and how often is it rebalanced?

All of these decisions are at least in part "active" and, implicitly, involve incorporating views on how returns are derived, and risks reduced, in financial markets. There simply is no decision-free or risk-free approach to investing.

Indeed, a mistake many investors make is to believe that a more passive approach equals lower risk. While risk is a multi-dimensional concept, a passive approach can often carry more of some of these dimensions of risk. For example, index funds usually have more significant draw downs and volatility than the average active fund.

The other area that needs to be considered is tax, although this is a large topic on its own. Suffice to say that passive approaches are generally more tax effective, although sometimes this benefit is exaggerated because (1) the unit trust structure many investor's use is often not particularly tax effective even if holding passive investments, and (2) tax is less of an issue if for investors in low tax super or no tax pension stages.

What type of investor does a more passive approach suit?

There seems to be a common belief, encouraged by Buffet, that all unsophisticated investors should go all passive. However, even passive investors need a level of discipline (or complete apathy) to stay the course with their investment plan - something that many unsophisticated investors lack.

I therefore believe a passive approach best suits those investors who:
1. truly have a long-term investment horizon (at least 10 years and ideally 15 to 20 years);
2. will review their investments infrequently and will only do so in the context of that long-term time frame; and,
3. have no desire to make ongoing investment calls themselves.

Undisciplined, unsophisticated investors almost certainly won't put up with the volatile ride that a diversified passive approach entails, with even a modest exposure to growth assets. It therefore doesn't make sense to blindly go down the passive route if there is a chance that the investor will panic and give up in difficult markets. I think that this issue will become even more prominent as investors increasingly gain their passive exposure through ETFs, with the easy trading temptation this fund structure provides.

I believe that many unsophisticated investors are more likely to stick with a portfolio through difficult times when they believe they have active managers responding to, and dealing with, the challenging environment (even if such a response might detract value in the short term).

© PortfolioConstruction Forum 2014

At worst, they can switch between active managers and still retain exposure to the same asset classes. On the other hand, those wedded to a passive approach have no such adjustment options so they may be inclined to give up on the passive approach at the wrong time.

Can one determine certain times or asset classes where it is more appropriate to have greater or lesser exposures to passive investment versus active? While I don't believe this is particularly easy, there are times when more passive over active may make sense:

- when markets are very cheap in an absolute sense – this is when a passive approach can sometimes do better as active managers tend to focus on quality and retain some cash and these often do not fully participate in an initial recovery;
- when one is dynamically allocating to an asset class but expects to hold the position for a relatively short period of time;
- when an asset class is particularly well covered and efficiently priced, and offers limited opportunity to add value from active investment; and,
- when one struggles to identify an active manager or it is not worth the trouble to do so (perhaps because the exposure is a very small part of a total portfolio).

There is clearly a place for both active and passive in portfolios without ending up with an incoherent investment philosophy. Indeed, the willingness to use passive funds enforces more discipline on one's active managers – ensuring that one uses managers when, and in areas that, one has most conviction that they can add value.

In some ways, the active versus passive argument is like many in the investment industry. It waxes and wanes depending on who has the best recent performance. But, experience shows that looking at and reacting to recent performance is perhaps the worst way to invest. Thus, a period during which active managers generally have done poorly versus passive may be a good reason to consider more active managers. Similarly, after a period over which active managers have generally outperformed in recent times, it may make sense to reconsider passive exposure, particularly if you are comfortable that the asset class is valued attractively or reasonably. At the very least, that is a time to more aggressively scrutinise active managers' future ability to add value.

Thousands of papers have been written on the case for and against active management. However, I suspect this active versus passive argument can never be decisively won by either side. If it was perceived to have been won decisively by the passive case and we all become passive, vast inefficiencies would open up, creating the ability for even dim witted active managers to outperform. On the other hand if we were all active, competition would be so intense that it would become extremely difficult for anyone to outperform consistently. Passive would then once again come to the fore.

It is interesting that Buffet suggests that 90% of the portfolio should be in an S&P 500 Index

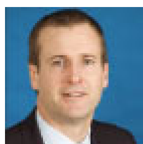
© PortfolioConstruction Forum 2014

fund (the remainder in cash) and that this policy will be superior to those attained by most investors. While reluctant to criticise one of the world's greatest investors, this recommended portfolio fails the simple diversification test. Firstly, while the US economy and market could be as successful as it has been over the last century, there are no guarantees. Investors had high hopes for the German and Japanese economies in the early 1900s but lost pretty much everything by the middle of that century. While no means forecasting the demise of the US, there is a strong chance that the US will cease to be the world's largest economy within the next 10 to 15 years and, perhaps, the world's largest capital markets sometime after that. Surely it makes sense for all investors to adopt a more global perspective in building even "passive" portfolios. Of course, some "active" decisions will likely be involved in what that global mix should be.

Secondly, it has become very clear that starting valuations matter, even for long-term returns. On a range of measures - Schiller PE, price to book, etc, the US stock market is in the upper levels of its longer-term average valuation levels, suggesting poor or very modest long-term returns going forward. This is something that cannot be ignored by investors contemplating placing money in markets today, even perhaps particularly applicable to, allocations into passive funds.

1. Cohen, Randolph B. and Polk, Christopher and Silli, Bernhard, Best Ideas (March 15, 2010). Available at SSRN: http://ssrn.com/abstract=1364827

2. Pastor, Lubos and Stambaugh, Robert F. and Taylor, Lucian, Scale and Skill in Active Management (January 31, 2014). Available at SSRN: http://ssrn.com/abstract=2318788



Dominic McCormick is Chief Investment Officer and Executive Director of Select Investment Partners. Dominic has worked in investment management and financial services for 27 years and co-founded Select Asset Management in 2002. He has overall responsibility for investment strategy and research for Select's range of multi-asset, multi-manager portfolios, investing across the spectrum of traditional and alternative investments.

© PortfolioConstruction Forum 2014