portfolio construction forum

Active v passive – why can't we be friends?

Mugunthan Siva | India Avenue Investment Management | 09 August 2017

As humans, we are inherently lazy and look for heuristics or a rule of thumb solution when solving problems. Unfortunately, while this may be convenient, it can be dangerous, especially in an unpredictable and complicated world. This is particularly true when it comes to investing given the variety of factors that influence markets.

When it comes to the active versus passive debate which typically surfaces when markets trend upwards, I am not surprised that many investors think the answer is black or white, and pledge allegiance to one or the other. However, the answer is deeper than that. Active management can be extremely fruitful depending on how and where it is applied. Applying one paint brush to a masterpiece is likely to result in a fairly poor outcome and cyclical swaying to and fro on whether active or passive works best.

Yes, there are many articles/papers arguing against active management, each of which cites empirical evidence. But this is often based on US equities, arguably the most efficient market in the world. Unfortunately, some extrapolate these results across all asset classes and investment markets.

Instead, should we not study the inefficiency of the investment market/asset class in which we wish to invest? Not all markets/asset classes are created equal, right?

I ask myself the following questions when researching an asset class/market:

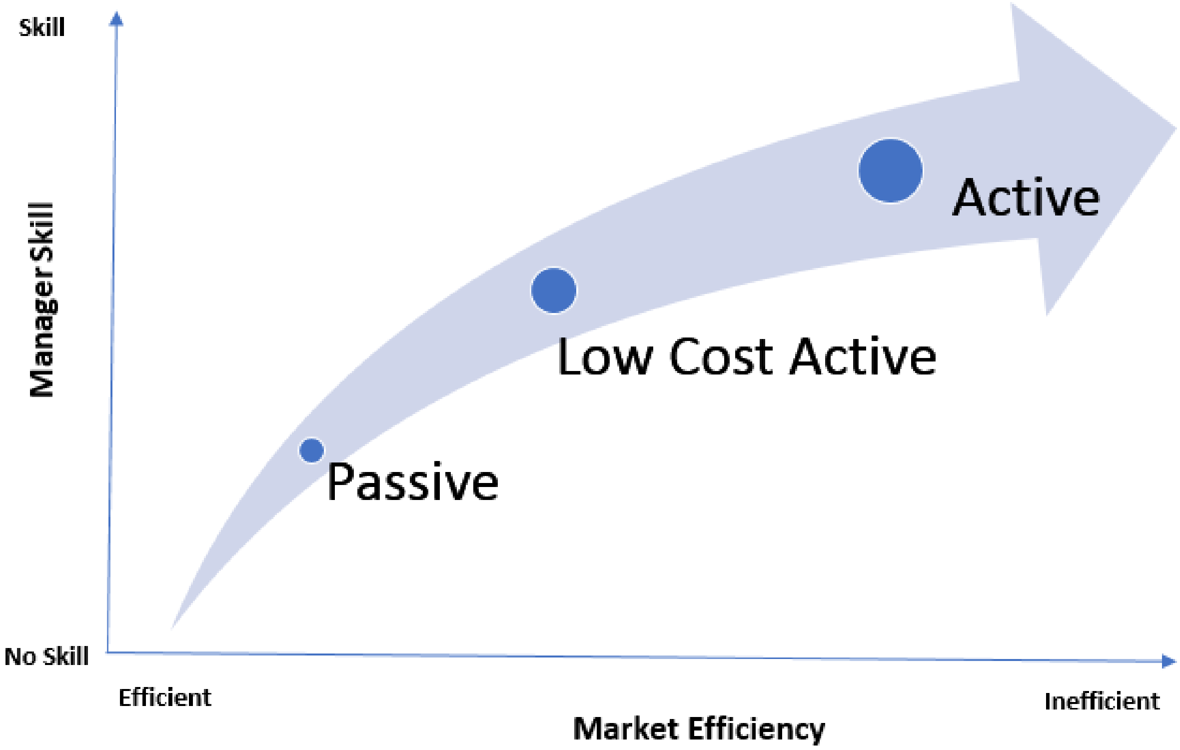
- What is the investor break-up between retail, professional, High Frequency Trading (HFT)? For example, 70% of US equity market volumes are traded by professional traders/HFT[1]
- How well is the market researched? How many brokers and fund managers are researching and fighting for the same ideas?
- Are there any market nuances? For example, how tightly held is the market? Are there foreign investment restrictions, quotas, cultural aspects, etc?
- What is the pace of IPOs/new issuance coming to the market?
- How quickly and easy is it to get information? Does it take a long time for prices to factor in new information?

Asking myself these questions creates a framework to determine whether a market is conducive to alpha generation or not. Of course, this does not guarantee that active management will work. Identifying the skill set of an investment manager is paramount to determining whether to go active or not. This requires a deep understanding of how the fund manager and analyst team identifies new ideas. Some investment markets can be highly conducive for active management, but the asset management industry may be in the nascent development stage, making it hard to identify whether the investment manager has sustainable skill to outperform over time.

How many times do you hear regurgitation of the news when talking to a fund manager? Oaktree Capital's Co-founder and Co-Chairman, Howard Marks points to a concept known as first and second level thinking. First level thinking is described as simplistic, superficial and based on consensus or well-known information by the market. Second level thinking is deeper, more complex and takes several insights into account, notably what is not priced in by the market. I'd argue it's second level thinking that differentiates active managers with skill. (Perhaps next time you speak to a fund manager, it would be worthwhile testing this hypothesis.)

Understanding when and where to apply active management boils down to a combination of identifying inefficient markets and asset classes, and skilled investment managers operating within the relevant ecosystem. Doing this increases the chances of success because the probability and magnitude of attaining alpha increases as skill and market inefficiency increases. Figure 1 illustrates this relationship.

Figure 1: Potential for alpha increases as skill and market inefficiency increases

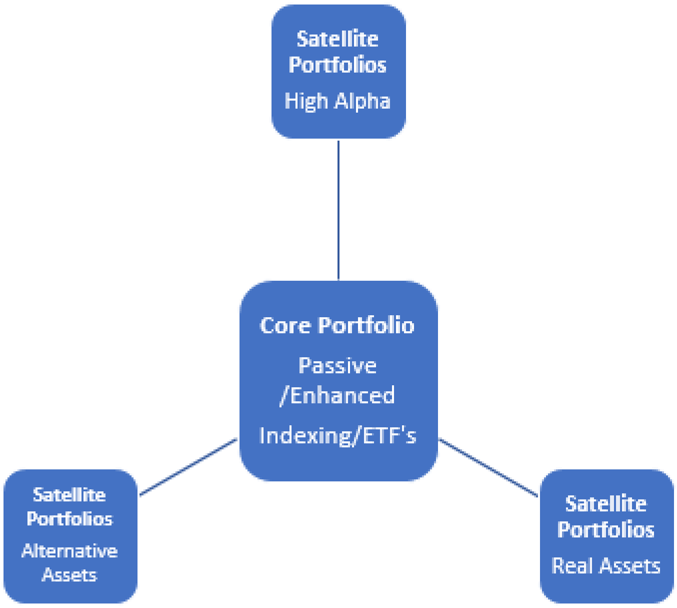


Source: India Avenue Investment Management

Continuously tracking these two parameters using this framework, while establishing an alpha fee budget, enables an investor to get the most out of the fees they pay to managers. Fees paid to managers in markets that are inefficient and where skill can be identified should consume more of your fee budget compared to efficient markets and/or lower skill. One way to measure this is to examine alpha generated relative to management fees charged. Taking this approach ensures a cost-benefit type approach is taken to optimise the outcome. Then you can populate a portfolio with a mixture of passive, low cost active and active strategies.

Figure 2 depicts how a combination of passive and active strategies can be optimally used in a portfolio to generate a better bang for buck.

Figure 2: Portfolio construction using active and passive funds



Component	Cost	Allocation	Role	Logic
Core	Low	High	Implementing asset allocation cheaply	Implementation of asset allocation views. Significant contribution to portfolio return
Satellite	High	Low	Unique, Diversification, Portfolio Enhancing	High alpha strategies in inefficient equity and fixed interest markets. Non-indexable asset classes.

Source: India Avenue Investment Management

Unfortunately, simply applying broad statements to an area as complex as investing seems to focus on convenience for the gatekeeper or practitioner, rather than the best outcome for the client. So when it comes to the active versus passive investment management debate, my answer is... do the work to find out where it makes sense!

(For more on the first level vs second level thinking, I encourage you to read Howard Marks' memo on this.)

ENDNOTES

1. Active Management: The existential question, Empirical Research Partners, *Portfolio Strategy*, January 2015.

Mugunthan Siva is Managing Director at India Avenue Investment Management. He was previously Head of Portfolio Management for ANZ Wealth in Australia.