Active investing

Defining the benefits, challenging the myths

Standard Life Investments

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Introduction

The active versus passive debate is not new. Argument regarding the value of active investment management has spanned several decades. More recently, it has gained renewed vigour as a result of the financial crisis, growing pension deficits and an increased focus on the overall costs of investing and long-term savings products. This is perhaps best exemplified by recent discussion in the UK of defined contribution (DC) pension default funds and proposals that passive solutions become the automatic choice. Consequently, there are many who feel that active investment management adds no value.

We believe many of these judgements, and the related support for passive investing, either rely on highly selective criteria or disregard conflicting evidence. Left unchallenged, these incorrect and misleading assertions could become accepted wisdom and may result in sub-optimal outcomes for investors. Passive investing clearly has its place in the investment mix and for some investors in particular circumstances it will be an entirely appropriate choice. However, a sizeable body of evidence shows that taking an active approach can offer valuable benefits to investors. In this paper, we examine that evidence in detail, look at the key issues relating to passive management, assess the most common arguments made against taking an active management approach and challenge the myths about active investing that have been allowed to develop over the years.

We summarise our key findings below.

- Truly active investing can outperform over the longer term.
- Passive approaches involve several well understood risks which are poorly publicised.
- Passive investing entails a number of hidden costs that mean it is not as cheap as is believed, resulting in unfair comparisons.
- Passive investing is an imperfect and at times unavailable choice for certain asset classes and investment goals.
- Active strategies perform best in those markets with the greatest breadth and with the most independent investment opportunities, making them an essential component when tailoring an overall approach for specific financial goals.
- Active investing plays a vital role in the effective functioning of markets and contributes positively to wider society.
- Ultimately, each approach has its own merits under specific circumstances.

Do active managers outperform?

One claim frequently made by supporters of passive investing is that most developed stock markets are highly efficient and that share prices accurately reflect the vast majority of all publicly available information. Consequently, it is claimed that the opportunity for an active manager to add value through research is minimal and that the average active manager cannot consistently deliver better investment returns than the market after fees. However, this premise is flawed for the following reasons.

Efficient or not?

The claim that developed markets are more efficient is a common one, and is often used to justify a passive approach. However, evidence suggests that this can be a potentially dangerous generalisation. A study described in further detail on page 12 in the section 'The issues to be aware of with passive investing' found that active management performance is uncorrelated with market efficiency. Instead, market breadth and the availability of a large number of independent investment opportunities are the most important factors.

Unfair comparisons

Many studies comparing active fund performance with market indices are immediately flawed due to the inconsistent treatment of fees. Active fund returns are measured net of fees, yet invariably no fees are deducted from the index return. This falsely implies that market returns can be obtained at zero cost. A passive approach involves buying a tracker fund which charges fees, typically 0.1% to 0.75% each year. A more valid comparison requires these charges to be deducted from the index return. Over the longer term, this makes a meaningful difference to returns.

Using averages is misleading

In assessing active fund performance, many proponents of passive investing focus on the average active manager by calculating the arithmetic average performance of active funds. However, this can be misleading. In any given sector there may be a large number of very small funds which, in relative terms, constitute a small percentage of total client investment within the sector. Should a very small fund really be equally weighted with another fund that may hold several hundred million pounds or more in assets?

A more representative analysis would focus on the money-weighted average, not a straight arithmetic average. Small outlying funds can significantly distort the calculation of an average or median return. Research by Premier Asset Management[1] revealed that across almost every sector, the money-weighted sector average active fund outperformed the benchmark over five years to the end of June 2012. The focus should be on where clients actually invest in a sector, not an average fund in which no one invests.

In 2012, when Premier Asset Management conducted its analysis[1], there were approximately 92 funds in the IMA UK Equity Income sector. Three, all managed until recently by former Invesco manager Neil Woodford, accounted for c.40% of this sector's total assets. Indeed, all three held more assets than 84 of the remaining 89 funds combined. This illustrates the flaws in, and dangers of, using average or median funds as a proxy for active management.

"Many studies comparing active fund performance with market indices are immediately flawed due to the inconsistent treatment of fees"

1. Source: Premier Asset Management, "The State of the Universe: 2012, A review of Fund Management in the UK"

Defining 'active' management is essential

Properly assessing the value that active management adds requires clients to consider only the genuinely active managers. While broadly categorised as 'active', in truth, there are likely to be many 'closet index huggers' or enhanced index funds in any given peer group. These supposed 'active funds' will distort the active universe's overall performance.

A truly active fund should exhibit high 'active share'. This measures the percentage of the portfolio that deviates from its benchmark, and a genuinely active fund would normally display active share in excess of 60%. When comparing relative returns from active funds with high active share, the outperformance delivered by active management is even more compelling. This has been borne out in academic studies. In an update of prior research which revealed similar findings, Antti Petajisto in his study entitled 'Active Share and Mutual Fund Performance' found that high active share funds in the US All-Equity sector outperformed closet index funds by 2.17% per annum (p.a.) after fees and transaction costs over the 20 years from 1990 to 2009. In addition, high active share funds outperformed the index by 1.26% p.a. net of fees over the same period. In contrast, closet indexers have roughly matched their benchmark return before fees, but have consistently underperformed after fees.

Again, however, investors should be careful using averages. While high active share is clearly important and funds exhibiting it have been shown to outperform those with low active share, some actively managed funds are constrained by their tracking error limits (tracking error is a measure of how closely a fund follows the index to which it is benchmarked and effectively acts as a risk 'budget'). For example, some funds have a modest performance target of 1-1.5% in excess of the index return. This objective constrains the fund's risk parameters to a further tracking error limit of typically 1-1.5% which, in turn, could lead to an active share of below 60%. This does not mean that these portfolios are 'closet index huggers' but reflects instead the investment objective and risk preferences of these funds which are less flexible than other more unconstrained portfolios. There are many instances of such lower-risk active strategies performing to their objectives and delivering a positive outcome for clients.

Time horizon is important

The importance of investment horizon should also not be underestimated. Research carried out by Capital Group[2] revealed that the majority of active managers outperformed their benchmarks across all major equity markets, including the US, over periods of five years or longer. Only over very short timeframes would passive funds have outperformed. Active managers take a view on expected trading patterns and the management strategies of the companies they invest in. They therefore typically have longer holding periods in order to allow time for these fundamentals to be reflected in the share price. Clearly, based on these studies and reasonable time periods, true active management adds value.

"The importance of investment horizon should also not be underestimated"

2. Source: Capital Group, "The value of active management in investment portfolios", 2014

Selecting consistent outperformers

Critics of active management often assert that, even if an active approach does outperform passive investing, this matters little if it is impossible to identify in advance who these good managers are. While doing so may not be straightforward, research has shown that it is definitely possible. In particular, various academic studies have highlighted a number of reliable indicators for the identification of successful investment managers.

The identification of superior asset managers has been extensively covered in the article 'Active Management in Mostly Efficient Markets,' published in 2011 by Robert C. Jones and Russ Wermers in the Financial Analysts Journal (volume 67). The section below summarises the key findings of this research.

Past performance

While identifying superior asset managers based on performance alone can be difficult, investment returns could be used as an indicator of future manager performance, but with some important caveats. Past performance needs to be assessed over the medium to long term and returns need to be adjusted to compensate for style/sector biases. Some managers may perform well in particular market environments and (through luck or skill) demonstrate a brief period of strong performance. However, most investors are looking for managers who can 'stay the course' and deliver superior returns consistently. In addition, investors need to take into account the costs of switching managers and to compare any potential improvements in performance with those transition costs.

Macroeconomic and style bias

Accepting the previous point, there may be certain investors happy to rotate their manager selection, seeking to match manager style bias with an expected macroeconomic environment. Style bias (e.g. cyclical versus defensive, value versus growth) is extremely easy to identify and a diverse universe of active managers offers investors the option to express their macroeconomic views or to use a manager-of-managers to do so on their behalf.

Portfolio manager characteristics

There are several characteristics that have been shown, through research, to be indicative of future investment returns and not all are intuitive.

- **Managers with low style bias tend to outperform** (flexibility is key and indicates a robust security selection process). Wermers (2010)[3] conducted a study which demonstrated that funds freed from artificial constraints outperform those with tight sector or stock position limits. Being style agnostic (neither growth nor value orientated) liberates managers to select the right stocks for the right reasons.
- **Experienced managers outperform less experienced managers** (experience of extreme market events reduces risk of behavioural bias). Ding & Wermers (2009)[4] found that the difference in performance between portfolios managed by the most experienced managers relative to the least experienced was a substantial 0.92% annualised.

"Various academic studies have highlighted a number of reliable indicators for the identification of successful investment managers"

3. Source: Russ Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas", 2010
4. Source: Bill Ding & Russ Wermers, "Mutual Fund Performance and Governance Structure: the Role of Portfolio Managers and Boards of Directors", 2009

- **Managers holding high cash levels in their portfolios tend to underperform** (high cash levels indicate poor conviction, full investment the opposite). Research conducted by Edelen (1999)[5] showed funds with high cash levels significantly underperformed those which were usually fully invested. High-conviction managers are more likely to produce high performance.

Other positive characteristics include level of education, size of firm, staff turnover, personal investment in portfolio, stability of management team and flat organisational structure.

Portfolio analysis

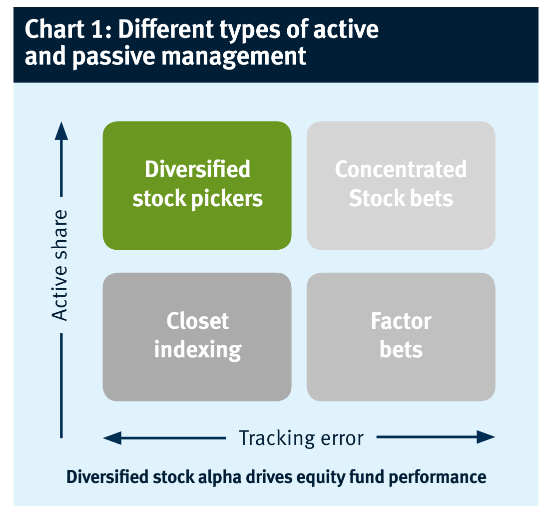
Evidence also shows that particular portfolio characteristics are strong indicators of a successful manager.

- Contrarian managers tend to outperform 'herding' managers as they invest only when their views differ from the prevailing consensus. Wei, Kelsey, Wermers, and Yao (2009)[6]
- Portfolios with high levels of 'active share' outperform those with low 'active share'. Cremers and Petajisto (2009)[7]

In addition, Cremers and Petajisto's analysis indicates that high active share produces improved investment results only if these returns are generated with a relatively low tracking error (a term used to measure the difference between the return an investor receives and that of the benchmark he or she was attempting to imitate). This instinctively makes sense as those funds adopting high active share but managing additional risk will have higher returns per unit of risk assumed.

Chart 1 below illustrates this point. Cremers and Petajisto focused on two of the four key approaches to active investment: high active share and factor timing or bets. High active share aims to exploit non-systematic risk, i.e. company-specific risk, to capture alpha (a measure of excess return). Factor timing is essentially an approach where investments are made on the basis of systematic (market) risk factors such as sectors or industries, interest rates, the oil price, etc. Their study found that individual stock picking in a high active share portfolio typically results in greater diversification than factor timing, consequently reducing tracking error. The positive alpha these funds achieved therefore came with lower overall unit risk.

Chart 1: Different types of active and passive management



Diversified stock alpha drives equity fund performance

In summary, a thoughtful approach to active manager selection is likely to deliver an investment outcome superior to the results of the average active manager. Even if this is a process an individual is not comfortable performing, portfolio management services are available to do this on their behalf.

"Those funds adopting high active share but managing additional risk will have higher returns per unit of risk assumed"

5. Source: Roger M Edelen, "Investor Flows and the Assessed Performance of Open-Ended Mutual Funds", 1999
6. Source: Wei, Kelsey, Russ Wermers, and Tong Yao, "Uncommon Value: The Investment Performance of Contrarian Funds", 2009
7. Source: Martijn Cremers and Antii Petajisto, "How Active Is Your Fund Manager? A New Measure That Predicts Performance", 2009

The issues to be aware of with passive investing

It is often claimed that a passive approach is low risk, but this is highly debatable. In fact, the investment risks are largely the same as for active funds in the same asset class. Additionally, passive or tracker funds often expose investors to a variety of less well-publicised risks.

The certainty of underperformance

Almost by definition, passive funds aim to deliver underperformance versus the index they track due to the impact of management fees. The compounding effect of fees means passive funds often significantly underperform over time. Tracker fees for institutional and retail investors vary considerably: typical rates for institutions might be between 0.1% for developed market indices and 0.75% for some emerging markets. Fees for retail investors would typically be higher.

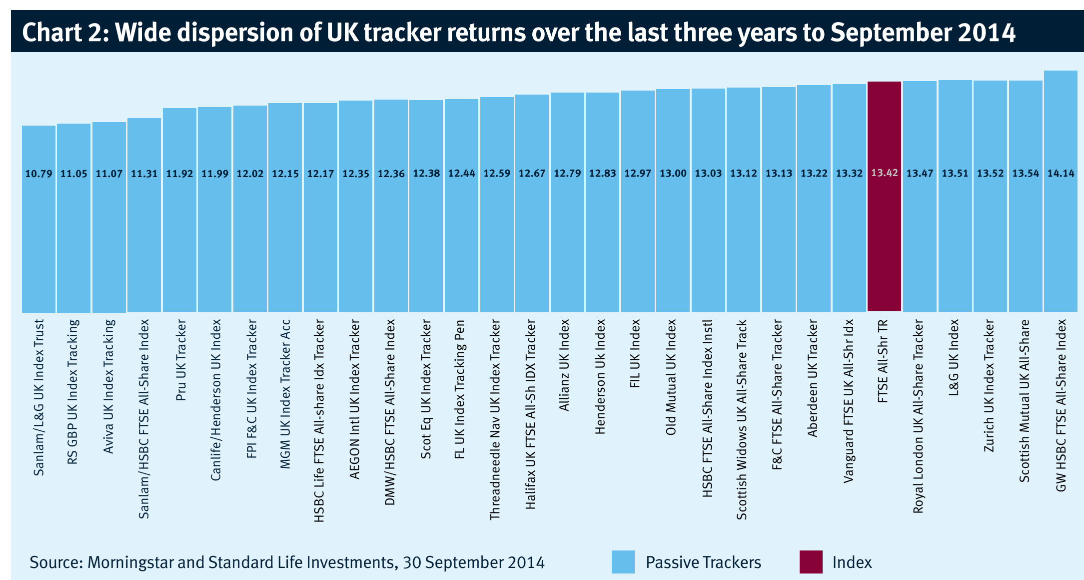
Tracking error

As previously noted, 'tracking error' measures the degree to which a fund fails to exactly match the performance of the index it tracks. For passive funds, this can result from timing issues, poor dealing or low market liquidity.

This performance divergence is one of the most significant hidden costs for tracker funds. A passive investor clearly starts out with an expectation that the fund will reliably track the intended index.

One of the most worrying issues for passive investors is that many funds supposedly tracking the same index display starkly divergent returns. Chart 2 shows the performance of a selection of UK equity tracker funds over three years to September 2014 compared with the FTSE All-Share Index and clearly illustrates this issue. The best and the worst performing trackers differ by 3.4% p.a. over this period. It should not be assumed that passive funds will guarantee investors the performance of the overall market. The extent of potential underperformance can be significant, with the worst fund in Chart 2 below, delivering 2.6% p.a. less than the index return.

Chart 2: Wide dispersion of UK tracker returns over the last three years to September 2014



Source: Morningstar and Standard Life Investments, 30 September 2014

"One of the most worrying issues for passive investors is that many funds supposedly tracking the same index display starkly divergent returns"

Selecting a suitable passive fund manager is therefore not a trivial matter, and just as much thought is required as when choosing an active fund. Given the work involved in both cases, one may ask why do the work to only generate a passive result?

The role of derivatives

There are a number of ways a passive fund can track an index.

- Full replication – where the actual shares of the constituent companies are bought in proportion to their weightings in the index.
- Sampling – where the fund may hold selected stocks or a sample of the market that is deemed to be representative of the index followed.
- Optimisation – another form of sampling, where historical data is used in mathematical models to construct a fund that will track the chosen index.
- Synthetic replication – where the fund holds specific quantities of derivative instruments, such as swaps, to replicate the index performance.

Some investors may be unaware that certain tracker funds use derivatives to achieve index performance. While there is nothing inappropriate about this method, investors need to be aware of when this approach is being adopted, as its use opens up the potential for new risks, which need to be properly managed. The collapse of Lehman Brothers and Bear Sterns, for instance, proved that derivative contracts are only as good as the counterparties behind them. Consequently, such counterparty exposures should be managed very carefully to avoid any undue concentration of risks.

Index design flaws exacerbate risk

Adherence to indices' composition exposes passive investors to flaws in their construction. Perversely, the more successful certain index constituents are, the more risk can build up in the index. This is particularly pertinent for market cap-weighted bond indices. A company gains a higher index weighting if it issues a larger amount of debt. However, the more debt a company issues, the more highly leveraged it becomes and the greater the risk it may default. Active managers discriminate between bond issuers by assessing their ability to repay their debt. If the level of leverage exceeds an acceptable threshold, active managers can choose to sell the bond issue and allocate money to a more creditworthy company. Such 'positive discrimination' is not an option in passively managed bond funds.

Looking in the rear-view mirror?

Passive investment can be described as looking in the rear-view mirror. Most indices are market cap-weighted and therefore reflect yesterday's successful companies, not tomorrow's, making passive investment inherently backward looking.

Built-in momentum bias

Long-term asset growth depends on investing in the companies most likely to succeed in the future. However, most indices are market cap-weighted, therefore passive funds allocate capital according to current market trends. Unfortunately for passive investors, short-term trends tend to reflect the strongest performers of the past, as investors late to the game allocate to those who have been successful. Investing or allocating capital across stocks and sectors on the basis of past share price moves does not necessarily bring exposure to those companies with the best future prospects. In equities, a passive approach can potentially mean that investors miss out on the growth investments of tomorrow.

"A passive approach can… mean that investors miss out on the growth investments of tomorrow"

If much of those companies' growth is behind them, as can occur when they reach a certain size just through the simple laws of arithmetic, investment outcomes could be impaired. This may not be a problem as long as the winners continue to win, but such a built-in momentum bias becomes problematic when major events affect particular sectors or companies. The 'dotcom' bubble in the late 1990s and the more recent Global Financial Crisis are notable examples.

Passive investing can inhibit portfolio diversification

Rather than diversifying portfolios through holding passive funds, investors run the risk of doing the opposite. Some markets, for historical reasons, exhibit considerable concentration, e.g. certain stocks or sectors account for a large proportion of the index's market capitalisation.

- The Hang Seng Index in Hong Kong, which comprises 50 constituents, is heavily skewed towards financials. These make up 48.7% of the Index[8] market capitalisation.
- The FTSE 100 Index in the UK is dominated by a small number of large sectors and stocks. Respectively, the financials, consumer goods, oil & gas and basic materials sectors account for 24.2%, 17%, 15% and 9.4% of the index. Five companies (HSBC, Royal Dutch Shell, BP, GlaxoSmithKline and British American Tobacco) amount to 29% of index capitalisation[8].

Taking a passive approach to these indices could mean that investors become heavily exposed to particular industries purely for historical reasons, not investment merit. This reduces diversification and potentially involves excessive exposure to sectors that may not warrant investment at that juncture.

Passive – the default choice for defined contribution default funds?

In the defined contribution (DC) market, we have recently witnessed a debate regarding the role of default funds in DC pension fund provision. Consultant statements in favour of passive approaches for the core holdings in default fund solutions have put the issue of active versus passive firmly back in the spotlight. The use of passive components in a default DC fund can be appropriate at specific times. However, their use for all assets will rarely be optimal. While cost-constrained investors may be attracted to a passive approach, there are several reasons why active funds remain an essential component for most DC default funds, not least of which can be a superior outcome after fees.

Passive can be an imperfect option, if it is an option at all

Passive can be an imperfect option: fixed income passive funds are obliged to lend ever more money to ever more leveraged index constituents, exposing investors to heightened risk. Meanwhile, certain asset classes cannot be effectively accessed through passive funds. An obvious example is direct property, where no passive funds exist due to the nature of this form of investment.

Arguably one of the most appropriate asset classes for DC scheme members is absolute return funds given their potential to deliver positive returns, irrespective of market conditions, throughout each member's investment journey. Again, there are no passive vehicles available in the absolute return sector.

"Active funds remain an essential component for most DC default funds"

8. Source: Thomson Reuters, 31 October 2014

Restricting returns from high-potential markets
In our view, taking a passive approach can be a sub-optimal way to access specific markets. In global emerging markets (GEM), for instance, a passive route could be particularly detrimental to returns. Firstly, it is a common mistake to approach GEM equities as a homogeneous asset class when, in fact, they are a loose grouping of individual economies with differing economic cycles. In addition, overall GEM indices tend to be heavily dominated by the BRIC (Brazil, Russia, India and China) countries. These countries' indices are, in turn, heavily concentrated in specific sectors, such as energy, materials and financials, and often have high exposure to unattractive businesses, such as state-owned enterprises. Emerging market indices are therefore rarely representative of these regions' economies and stock markets. In other words, passive investors may not be getting the true underlying exposure they hope for or expect. Consequently, to access the best that emerging markets can offer, investors should consider allocating capital to actively managed portfolios. These have more flexibility to take deliberate and considered positions (sometimes off-benchmark) in order to find the best opportunities across investment cycles.

Increasingly, many of these regions' highest growth companies are not found in local indices at all. Many companies increasingly choose to list overseas, mainly to access deeper and more liquid capital markets. Companies such as Vipshop, Alibaba and Baidu are all listed in the US, making them off limits to emerging market tracker funds. In contrast, active funds investing in the region retain the flexibility to invest in such stocks, as their mandates generally allow managers to hold those companies deriving a significant proportion of earnings from emerging markets no matter where they are listed.

Vipshop – the leading Chinese 'flash marketing' e-commerce business
Vipshop floated in 2012 and chose to list on the US NASDAQ exchange. In its early days, only four analysts officially covered the stock. However, so infrequent was the commentary that it was effectively only consistently covered by one. Since listing in March 2012, the shares have risen 3,898% as at 31 October 2014[9]. Over that time, analyst coverage has grown to 20 and yet our GEM equities team believes that the company is still only in its infancy in terms of fulfilling its commercial potential.

Recently, certain asset management houses known for their GEM expertise have actually had emerging market sector classification removed from some of their funds, as less than 80% of portfolio holdings are actually listed on emerging market exchanges. Clearly, they too think the GEM opportunity set extends far beyond just the index.

Is growth in passive an opportunity for active?
The growing popularity of passive funds means the opportunities for active investors improve. Increased flows into passive funds mean more capital is invested in an indiscriminate but highly predictable manner. This creates a more fertile environment for active investors given the greater pricing anomalies available to exploit. According to Lipper[10], assets held in tracker funds have grown considerably over the years. In Europe, assets managed passively (ETFs and index trackers) have increased from 4% in 2003 to 12% in 2013, while in the US, passive assets under management increased from 11% in 2003 to 25% in 2013.

"Passive investors may not be getting the true underlying exposure they hope for or expect"

9. Source: Thomson Reuters, 31 October 2014
10. Source: Lipper, Thomson Reuters, 'European Fund Market Mid-Year Review 2013'

One of the great ironies of the debate is that the growth of passive investing arguably increases the probability that active strategies will outperform and be able to add meaningful value to investors over the longer term.

Developed markets and active management

It is conventional wisdom that developed markets are perceived as more 'informationally efficient', leaving fewer alpha opportunities for active managers. Consequently, a passive approach to developed markets is often recommended. However, in our view, active management can be appropriate for various developed markets. A study carried out in 2011 by Robeco[11] found that the top-performing active managers outperformed more in US equity markets than in Asian markets. In other words, they found active management to be uncorrelated with market efficiency. Instead, market breadth, i.e. the number of independent investment opportunities available to investors, was found to be the most important determinant of potential active management outperformance. Importantly, the study also found evidence that market breadth is dynamic and changes over time. For instance, the late 1990s 'dotcom' boom increased US equity market breadth, as the surge in flotations boosted the number of independent investment decisions available to active investment managers.

Cost – the knockout blow?

Passive funds' low headline fees have become their primary selling point. However, low cost does not necessarily equal good value. Many funds incur various hidden charges which can blur significantly the cost differential between active and passive portfolios.

Narrowing cost differential

The growth of passive investment has not gone unnoticed and the fee differential compared with active strategies has, in fact, narrowed over recent years. The emergence of 'clean' share classes in active investing, following the Retail Distribution Review, has also helped. In the UK, the annual fee on the iShare FTSE 100 tracker ETF is 0.4%. As previously noted, a true cost comparison should be made on a net-versus-net basis. Passive investors cannot 'buy the index' at no cost. They need to buy an index fund with an ongoing charges figure (OCF) ranging from 0.1% to 0.75%, depending on the provider used.

Table 1: Median expense ratio for passive equity index funds

US large companies	0.49%
US smaller companies	0.58%
EAFE large companies	0.56%
Global equities	0.50%
Global emerging markets	0.64%

Source: Morningstar, 2013

"One of the great ironies... is that the growth of passive investing arguably increases the probability that active strategies will outperform..."

11. Source: "Take a Deep Breath: New Research on Active Management", Joop Huij, Rolf Hermans, Robeco Asset Management, 2011

Beware of hidden costs

The OCF is not the only cost of mutual funds. As previously mentioned, many costs are incurred but are not transparent.

- Passive funds need to trade constantly in order to track changes in the weights of index constituents, incurring significant cumulative dealing costs (bid-offer spreads, broker commissions etc.).
- In less efficient markets where liquidity is low, as in many emerging markets, dealing spreads can be significant.

All mutual funds, both passively and actively managed, pay these costs. However, many active managers will have a long-term investment horizon with less trading as positions are held for an extended period, which minimises trading charges. They must give the companies they select time to realise the benefits of their corporate strategies, or at least have these benefits recognised more broadly by the markets. In addition, all active funds, even those which trade more often due to their style, need to cover the expense of the trade from the excess return they generate.

This means that all trading decisions should be justified by the return potential. No such cost-benefit analysis is carried out by passively managed funds. The key point is that any comparison between the annual costs of a passive fund and those of an active fund must be done on a fair and equitable basis. Considering only the full costs of active funds and ignoring many of the hidden costs of passive investment misrepresents reality.

In summary, we believe that overall costs should be evaluated in conjunction with the outcomes they achieve. For passive funds, this will usually entail performance below that of the index. For active funds, there is the ability not only to potentially beat a given index after costs, but also to target both a specific return level and risk profile.

"Any comparison between the annual costs of a passive fund and those of an active fund must be done on a fair and equitable basis"

The importance of security selection

The value of active investment is derived from three main components.

- Security selection – choosing securities the manager believes will outperform.
- Tactical Asset Allocation (TAA) – adjusting asset class weights to exploit short-term opportunities.
- Strategic Asset Allocation (SAA) – long-term allocation between different asset classes.

Asset allocation dominance

Proponents of passive investing highlight that the majority of long-term return and risk experienced by an investor is derived from SAA decisions, not security selection or TAA. Given this is the case, why bother with active management instead of concentrating on superior SAA?

It is true that SAA decisions have been an important part of the returns generated by active funds historically. These decisions are made with a long-term perspective, change infrequently and involve deciding what percentage of a portfolio to allocate to fixed income, equities, real estate and other asset classes. More frequent TAA decisions can also be made which involve relatively small adjustments to the SAA to capitalise on shorter-term opportunities across asset classes, offering a valuable form of active added value.

Security selection still matters

Active managers also seek further value from active security selection. While excess returns attributed to security selection might initially appear relatively modest, it is important to remember that many investors are likely to have long-term investment objectives. The power of compounding means that only a 1% annual excess return from security selection would significantly increase the long-term value of a portfolio. Over 20 years, the portfolio valuation would be 22% higher, or 35% over 30 years.

Which of the active management return components, TAA or security selection, add the most value? A 2010 study[12] sampled US mutual funds, balanced funds and international equity funds over a 10-year period and confirmed that market movements are the primary reason for the variability of performance. However, once this contribution is netted out, it concluded that TAA and security selection are roughly equally important. In other words, studies confirm that security selection remains extremely important as a source of excess returns.

This conclusion, and that of other studies, reinforces the importance of bottom-up security selection in the investment process, particularly when deployed within a portfolio construction framework designed to maximise active share.

"Studies confirm that security selection remains extremely important as a source of excess returns"

12. Source: "The Equal Importance of Asset Allocation and Active Management" Ibbotson Associates, 2010

The use of active & passive components in a portfolio

Differing investment objectives

The decision whether to use an active or a passive approach is not a simple one and, ultimately, each has its own merits under specific circumstances. Investors have different risk tolerances and return requirements, and it is clear that there are specific market conditions or strategic portfolio construction considerations that may warrant the use of both active and passive components.

Investors and advisors should consider the specific investment objectives with the goal of deciding whether a static long-term SAA will deliver the desired result, or if a more dynamic approach is required. The latter almost certainly leads to more active componentry. The strategic approach can, however, easily embrace both styles of management. The most obvious next step is to use active management for those asset classes where no sensible passive offering exists, e.g. direct real estate and absolute return. For other asset classes, the decisions are less straightforward. For both active and passive funds, detailed due diligence is required to ensure each fund manager selected will deliver the desired market exposure and meet any performance objectives. We see the following considerations as key to assessing the suitability of active funds in an overall investment solution.

Meeting more complex objectives

If all that is required is replicating the return from a particular market, then the use of passive funds may be most appropriate. However, evidence shows that taking a passive route does not necessarily assure that outcome given the wide variation in returns achieved by these funds. Due diligence is still needed.

However, investors increasingly target more specific goals.

- Some investors look for excess returns.
- Others want stable returns with a reduced level of volatility.
- Increasingly, there is a focus on portfolios that embed socially responsible investing (SRI)/environmental, social and governance (ESG) considerations into investment decisions.
- Investors are increasingly seeking the best possible return within a specific overall risk range to maximise long-term risk-adjusted returns.
- Frequently, investors want to protect the real value of their portfolio.
- Alternatively, they desire a particular rate of capital growth in order to meet a future financial liability.

Active has a prominent role to play

It is highly unlikely that complex investment objectives can be fulfilled by passive funds. Consequently, many of these important investment priorities will either exclusively, or most effectively, be achieved through the adoption of an active approach. A significant part of the portfolio may still be held in passive funds, but the inclusion of an active component should be viewed as entirely complementary. This 'mix and match' approach shows how both active and passive portfolios can be used as components of an overall solution to secure a specific return objective with an acceptable level of risk.

"It is highly unlikely that complex investment objectives can be fulfilled by passive funds"

What role?

For clients taking a strategic approach to disaggregating their sources of return, one solution may be to use passive funds to provide cheap access to market beta (i.e. achieve exposure to aggregate market direction and risk), while further allocations may be made to active funds in order to capture alpha. Here, investors want to know in which markets active managers are most likely to generate excess returns and therefore merit higher fees.

Specifically, active investing is well-placed where it can:

- benefit from markets with many independent investment opportunities, or asset classes which either do not lend themselves to passive approaches or where there are no solutions available (e.g. absolute return funds and real estate)
- be used in areas where passive funds are a sub-optimal way to gain exposure to the asset class (GEM equity funds are a case in point)
- enhance diversification, especially when adopting an unconstrained approach.

The limitations inherent in tracking a specific index mean passive investing is not always an appropriate choice. Active approaches are less prescriptive and allow discrimination between the genuine high-potential investment opportunities in a market. Viewing the active versus passive debate through a narrow 'either-or' prism risks failing to recognise the many sources of value active management can deliver to a wide array of investors.

"Active approaches are less prescriptive and allow discrimination between the genuine high-potential investment opportunities in a market"

Why markets need active investing

Beyond the investor and portfolio-specific considerations, there are also a number of wider issues to consider when examining the role and importance of active investment. Active investing is particularly important to the orderly operation of markets and, indeed, can provide benefits for society as a whole.

Ensures efficient allocation of capital

Without active investors undertaking fundamental analysis it is less likely that capital allocation would effectively discriminate between those companies which deserve it and those which do not. An inefficient allocation of capital within markets would have serious long-term consequences for overall economic growth and the prosperity of society. Passive investment has no regard for the actual merit of its investments. With an active investment approach efficiently allocating capital to those companies identified as more likely to be successful, the most deserving companies receive the financial support they require, capitalising on their growth potential. This process should increase the overall returns from markets over the medium to long term to the benefit of investors.

Hold management to account

A company should be managed in the interests of the majority of its shareholders. Globally, investors are becoming increasingly focused on companies' ESG policies. While there is further room for improvement, active managers are increasingly highlighting questionable management decisions publicly.

Like active managers, passive investors also have the option to vote against management at corporate meetings. Critically, however, they lack the 'stick' wielded by their active peers: the ability to disinvest if management resists change. This threat can be an important incentive for management teams, yet index considerations mean that passive investors are required to remain invested irrespective of their views on any specific corporate policy. Consequently, active investment can help to protect the interests of the majority by providing the critical oversight required to protect the company, investors and the wider community.

"Active investing is particularly important to the orderly operation of markets and, indeed, for society as a whole"

Conclusion

- Truly active investment outperforms a passive approach over the medium to longer term.
- It is possible to identify in advance those active managers likely to outperform.
- Passive investment involves hidden risks and requires diligence when selecting a manager.
- Passive costs are also underestimated, and comparisons with active funds are frequently not made on a fair, like-for-like basis.
- Many asset classes and investment approaches can only sensibly be accessed through actively managed approaches.

Active investment and the role it plays for investors continues to be put under the spotlight. Proponents of passive approaches usually do not differentiate between a wide array of active investment styles – for example many of the 'closet benchmark hugging' funds that are included in their analysis are not truly active. Those funds adopting high active share and therefore taking a more focused approach to the merits of the individual stocks held have been shown to provide significant alpha generation net of fees.

Fees can have a material impact on realised returns over the long term. However, low cost does not necessarily equate to good value over the long term. Not all of the costs associated with passive funds are immediately obvious to investors, and the cost comparisons frequently made between the two approaches are often misleading. When choosing between an active and a passive fund, investors should look beyond the headline annual management charge or ongoing charges figure and aim to understand all charges levied by each. Notably, too, passive investing can entail significant risks to investors due to index biases. The potential concentration risk and possible lack of diversification that could result can seriously impair investor outcomes. In addition, passive strategies are often simply not suitable for certain markets or asset classes, while their inherent backward-looking bias also leads to a related momentum dependence.

In contrast, active management's greater focus on company-level dynamics and stock-specific risk helps managers to concentrate on those companies displaying the most attractive investment merits. This frees managers to look right across the market, rather than restrict them to an index that may be a narrow subset of the overall market. This less-constrained approach allows managers to tie up less capital in large index-weighted stocks and encourages higher active share. A greater focus on stock-specific risk can therefore mitigate any potential concentration in 'index proxy' stocks and enhance diversification. This flexibility, not enjoyed by passive alternatives, can be a highly important feature in protecting and growing investor wealth over the long term. The need for active management also goes beyond the more everyday investment merits. Active investing is vital in bringing about wider fundamental market and societal benefits through:

- maximising wealth creation within society for individuals and institutions
- protecting the rights of all shareholders and driving social and environmental advances.

As can be seen, in direct contrast to the somewhat simplistic arguments often offered by supporters of passive investing, the underlying reality is much more balanced and nuanced. Cost is obviously a consideration, but not the only consideration, with the debate more accurately needing to become one focused on cost versus the long-term value provided. Clearly, passive investment products have their role to play in shaping overall investment solutions. However, what is key is understanding to which investor circumstances and market conditions those attributes are best suited. Active investment strategies can and will continue to make their own significant contributions to optimising long-term investment outcomes.

"Active investment strategies can and will continue to make their own contributions to optimising long-term investment outcomes"

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