Debunking the Active, Passive Investment Debate

As equity markets around the world extend into an exceptionally long 9 year bull market the debate of Active versus Passive investment rages louder than ever before. This is not a new debate, it is decades old and there is no shortage of commentary, opinion, white papers and expert views, all you need to do is type in a google search and you will find piles of it. But is this even the right debate to be having?

So, are you good enough at picking stocks to beat the market? Is your asset manager good enough? More and more people are choosing to simply invest and get a market return, shunning high fee fund managers for low cost passive or index managers. And why not? US Billionaire and world famous investor Warren Buffet thinks we should all stick with low cost index funds.

What is active and passive investing?

Active Management:

Active investing takes a more hands on approach and requires that someone act in the role of portfolio manager. The goal is to beat the benchmark (such as the S&P ASX200) average return and take full advantage of short-term price fluctuations. It involves analysis and research to know when to buy or sell an asset. Successful active investment management requires being right more often than not.

Active managers believe that because markets are inefficient, anomalies and irregularities can be exploited by those with skills and insight.

Passive Management:

Passive investing is investing for the long term. Passive investors limit the amount of buying and selling with their portfolios, helping to reduce costs. It's a buy and hold mentality and is often associated with index funds that track major indices like the S&P ASX200.

Index managers don't make decisions about which securities to own, they follow the methodology of constructing a portfolio that replicates the index it is aligned to.

Active v Passive

Active investing is the dominant strategy but this is changing. In the US, a little more than a third of all assets are in passive funds, up from about a fifth a decade ago. The shift is gathering pace too with flows out of active funds into passive funds in the first half of 2017 reaching nearly $500b, according to Charles Steins article, 'Active versus Passive Investing on Bloomberg 6 July 17. Vanguard and BlackRock have been big winners and I am sure they will happily tell you that low index investing is the way to go, how can you lose? In Australia the trend is similar. Alex Dunnin of Rainmaker informed the Australian Financial Review in an interview (28/4/2017) that around 12% of all funds under management in Australia were invested in index funds a decade ago. Now that is almost double that amount with more than 20% (in excess of $400b) invested in funds that track an index. He went further to say that if you look at the fund managers' performance, it looks like a further 20-30% is in 'closet' index funds, where the fund manager is pretty much hugging the index.

The trend is changing because research is showing that active managers are unable to consistently outperform the index. Warren Buffet bet that over 10 years a portfolio of expensive hedge funds, run by Protégé who took the bet, would underperform a low cost index fund. He is likely to be emphatically proven right. Research will back him up as it seems that high fees are key determinant for underperformance.

Furthermore, active management has typically underperformed in bull markets and this has been particularly evident in the late 90's to 2000's and in the current bull market that started in March 2009.

What Vanguard and BlackRock won't tell you is that this is cyclical. Active underperformed in late 90's / early 2000's as most didn't or couldn't understand the valuations of many dot com companies so held cash and did not participate in the extraordinary bull market….that then crashed in spectacular fashion. Active managers outperformed passive/index managers over the following years. The same pattern occurred in the lead up to the GFC and during the proceeding market crash. Active managers are underperforming now for similar valuation reasons. In fact, active versus passive investment approaches is as cyclical as value versus growth. Looking at the US, Morningstar produced data comparing the returns of active large cap funds to S&P 500 Index Funds. Its swings and roundabouts but active seems to underperform at times of market exuberance and outperform on the correction. So, over the long term, after fees, it seems the debate for Active or Passive investment is null and void.

Year	Active Large Bland Category (%)	S&P 500 Index Funds (%)
1985	29.52	**30.48**
1986	**17.99**	16.82
1987	2.80	**4.13**
1988	**15.94**	15.52
1989	27.59	**29.32**
1990	-3.37	**-3.27**
1991	**32.56**	29.29
1992	**9.56**	7.01
1993	**12.69**	9.45
1994	-0.81	**0.83**
1995	33.21	**36.72**
1996	22.25	**22.41**
1997	30.15	**32.64**
1998	20.18	**28.15**
1999	18.72	**20.28**
2000	**0.16**	-9.47
2001	**-7.98**	-12.37
2002	**-20.47**	-22.48
2003	**29.21**	27.91
2004	**11.03**	10.30
2005	**6.86**	4.39
2006	14.70	**15.17**
2007	**6.76**	4.95
2008	**-36.93**	-37.27
2009	**28.62**	25.97
2010	14.28	**14.48**
2011	-0.66	**1.59**
2012	15.16	**15.39**
2013	**31.96**	31.68
2014	11.02	**13.06**
2015	-1.12	**0.85**
2016	9.99	**11.39**

Data from Morningstar. Active Large Blend includes funds from the Morningstar Large Blend category that are not index or enhanced index funds. S&P500 Index Funds is represented by the Morningstar S&P500 Tracking Category. Table constructed by Hartford Funds.

Are Index Investors Really Passive?

I am not convinced that index investors are truly passive investors. Let's face it, unless you a buying a truly global index you are making a distinct asset allocation decision and that in itself is by definition an active decision. One can go even further by buying sector specific indices such as property which has been a common choice for a long time. Any financial planner using and recommending index funds is helping to make that asset allocation decision for you.

The Rise of ETFs and Market Distortion

Many commentators have alleged that the growth in index funds is creating a valuation distortion in the market. There is a further distortion of the market occurring at the present time and it is staring to raise a more than just a few eyebrows. In a bull market where passive / index investing is outperforming, technology has come to the party to make it easier and cheaper for investors to take a piece of the action. This is achieved through the rise of exchange traded funds or ETF's.

Moody's Investors Service in a press release on 2 Feb 17 noted that the popularity of passive investments, including ETFs and index funds, will continue to outpace active investments and achieve a leading share of the US market by 2024, or sooner. Moody's Vice President and Senior Analyst Stephen Tu went on further to say that "we believe that the passive phenomena is more appropriately viewed as the adoption of a new technology. Investor adoption of passive low cost investment products will continue irrespective of market environments".

The ETF industry has attracted almost US$2.8t in new business since the start of 2008, coinciding with one of the longest bull markets in US history according to Chris Flood's article in the AFR on 15 Aug 2017, 'Record surge into ETFs fuels fears of stock price bubble'. According to Chris Flood, the record inflows into ETFs is fuelling fears that the tide of money is helping to inflate a bubble in the US stock market. Could it have just been all the cash that has been sitting on the sidelines in cash for years needs to go somewhere? There is also the use of 'Big Data' to create many more trading strategies for ETF's. Investors were left disillusioned when the GFC hit and were left wondering what value active management really provided. A growing number of investors are moving into low cost funds and ETFs that track an index probably in protest to against active managers for inconsistent performance and high fees.

Think about this from an Australian perspective. Large cap ASX index managers are likely directing 65% of funds to the top 20 stocks and 40% to the top 8 stocks. The fear is that there is the potential for a liquidity squeeze in the event of a market correction or crash. In my August monthly update to clients I noted - A key risk to the global economy is that of the rising tension between the US and North Korea. As Gideon Rachman of the Financial Times said in his AFR article, Miscalculation could lead to a Korean war, 5 Sept 2017 "These risks would be difficult to manage even with rational, experienced leaders in power. But the key decision makers are a 71-year-old businessman with a volcanic temper and no relevant experience, and a 33-year-old dictator, surrounded by frightened sycophants." So this is a risk to the current bull market among other risks.

An ETF is listed on the ASX and its price will be determined by a number of factors and in theory will always trade at its reported net asset value adjusted for tax and dividends. The reality is that an ETF, LIC etc can trade at either a premium or discount to valuation. In the event of a market correction or crash an ETF will likely trade at a steep discount to valuation as investors run for the exits. The market maker will probably step in to ensure liquidity but it won't stem the flow. The market maker after all has to fund the purchase buy selling the ETF assets. The concern is the untested potential for a liquidity crunch. If the market is falling and you are selling assets to fund the exit of investors then who is buying the underlying shares? Well probably the underperforming high fee active manager who is seeking to take advantage of the misallocation of price and the eventual normalisation of the market price for the assets.

Conclusion?

So what is right for you as direct investor or as a professional advising clients?

An index manager will buy everything in the reference index, the stocks that go up, the stocks that go down the stocks that go bust, overvalued and undervalued companies, companies with good corporate governance and those that don't meet your ethical screen! It doesn't seem like a great strategy to me, it's really an asset allocation decision based on your own investment goals and tolerance to investment risk. An active manager will actively buy and sell stock all day long to try and beat the market. They will buy a trend, a turnaround story, anything to beat the index but as a fund manager gets bigger they become more concerned about risk management. That is where any underperformance versus the index could lead to fund outflows which is bad for business. An active manager then has to weigh up the risk of diverging too far from the index and thus becomes a 'closet index hugger'.

So what does work? Warren Buffet has told us all to go and buy index funds. Yet his portfolio of assets is nothing like an index fund. Warren Buffet, along with most wealthy investors, is a high conviction investor, he doesn't just buy shares he buys the whole company. The real driver of outperformance is your conviction to the investment thesis. When we go back to the active managers who have actually managed to outperform over longer periods of time you will probably find them to be high conviction managers with concentrated portfolios.

We believe in buying assets, not a strategy nor an index, that we can own for the foreseeable future and hold onto them, not trade them, but own them for as long our investment thesis remains intact. We believe in have a high conviction portfolio where it is a competition for assets to gain a spot. By doing this we focus less on short term market and stock movements and look to the medium to long term potential. We believe that this will lead to sustainable and consistent long term portfolio performance you can rely on. We call this passive high conviction investing.

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