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We're good together – active managers embrace passive investment

For a discipline priding itself on its rational scientific approach, with an almost Whiggish assumption of ever greater knowledge and clarity, the general discourse of investing can frequently be characterised by the more argumentative and speculative fields it frowns upon. The same debates, uninformed by history, have a habit of resurfacing – and just as often the same counter-arguments are repeated. A case in point is the active versus passive management debate.

Since the lows of October 2011, global equity markets have performed very strongly until the most recent sell-off. Using US equities as an example, represented by the S&P500 price index in local currency, equities had risen by over 200% percent to late May 2015. Concurrently, implied volatility on this index as measured by the VIX "fear" index had fallen to lows only slightly higher than the historic lows immediately preceding the crisis of 2008. There have been some dips along the way; however, equity markets have been on an almost relentless steady and upward trajectory until the beginning of 2015. When viewed against longer term US equity market history, this has been a bull market of unusual duration.

Some would argue the beginning of the bull market can be traced back as far as 2008; however, there have been some significant reversals since then, notably the middle of 2010, the aforementioned 2011 period and perhaps the latest sell-off. Notwithstanding those interruptions, if we take this longer term view, then the period between the crisis of 2008 and the beginning of 2015 definitely one of the longest bull markets in US equity market history.

As often happens during the latter stages of bull markets, predictions of the demise of active management have intensified; even active versus passive debating forums have sprung up. However, history does not always repeat. Theoretical advancements and technological innovations often work in tandem to drive the development of new products and strategies to meet the needs of clients. A significant recent innovation becoming more prevalent; initially amongst retail and increasingly institutional investors, and strengthening the case against active management, has been ETFs and their variants.

Of course, there is some substance behind these calls; empirical evidence suggests most active equity managers struggle to add meaningful value after fees during strong bull markets. The oft cited bi-annual S&P Active versus Passive Scorecard (SPIVA), which makes reasonable adjustments for survivorship bias, style and fund size - attests to the poor results delivered by active US equity managers across market capitalisations. Equally disconcerting for active global equity managers, the results are slightly better but probably not enough to justify paying for active management. Although these results are more relevant in relation to retail products, the publication of this data steers general discussion towards passive management and ultimately influences opinions of the merits of active managers more broadly. In the institutional space comprehensive data is harder to come by; however, most databases such as eVestment indicate active equity managers have been more successful, mostly in less efficient markets, in outperforming their benchmarks after fees.

Consequently, estimated fund flow figures in the retail space, published by Morningstar, suggest that US active equity cumulative net flows for the year to December 2014 have been hugely negative compared to positive net flow numbers for passive. The net inflows for active international equity have been positive but they have still been surpassed by their passive counterparts over the same time horizon. As above, comprehensive data for active equity managers of institutional funds is more difficult to find; however, narrower surveys suggest a similar trend. Nevertheless, viewed cumulatively, the vast majority of assets remain actively managed and it appears we are still far away from the point where passive becomes more than 50% of the total assets managed. PricewaterhouseCoopers forecasts that by 2020 only a little more than 20% of global assets will be passively managed.

The game is not over for active managers. Encouragingly, empirical evidence suggests that those managers who strenuously construct a concentrated portfolio or one that diverges from the index but which remains somewhat diversified in terms of sector exposures, resulting in proximate units of risk consistent with more broadly constructed funds, have historically outperformed their benchmarks after fees. Further, when periods of volatility rise and dispersion between stocks increases, as is expected when markets and central banks adjust to a more normal interest rate policy, then active equity managers tend to do better relative to their passive counterparts. This is particularly the case in sub-asset classes considered less efficient. The best of these managers significantly outperform the benchmark on a repeatable basis.

The quote

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Perversely, the rise of ETFs and passive investing more generally may work to exacerbate t the cyclical benefit of active equity management in a regime of heightened volatility and stock return dispersion. If a significant number of investors crowd the passive index management trade this will create inefficiencies; the upside and downside trends of these markets will become more extreme, resulting in opportunities which may be exploited by the aforementioned active and concentrated managers. The Grossman-Stiglitz paradox argues essentially the same point positing that if all market participants ceased conducting research to determine price discovery and started to buy indices, exploitable inefficiencies would develop. Some investors believe that the recent lack of dispersion between stock returns is indicative of this trend. As ETFs gain a greater market share - although they are far away from being dominant - then the opportunities for active and concentrated managers, particularly for those managing on behalf of institutional investors, are likely to increase.

Although the active and passive management debate has again intensified, and technological innovations have helped to change the dynamic somewhat, certain active management strategies continue to do well; particularly during more volatile markets. The continued rise of ETFs is unlikely to swamp active management; it is more likely to help the best of the active managers prosper. FS