

Active vs. Passive Investing – A Somewhat Flawed & Futile Debate

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Introduction

Being an active manager ourselves, as well as an allocator to both active managers and passive investment products, we are often asked where we sit in the active vs. passive debate. It's a decades-old debate that continues to persist and, while there are passionate believers in both camps, we put forward the view that it's a debate that is somewhat flawed and ultimately futile. In the current context, passive investments seek to replicate the holdings of traditional market capitalisation weighted indices and provide the return of the index less fees; exchange traded funds (ETFs) are the obvious example. Active management on the other hand involves buy & sell decisions made by portfolio managers, based on research and stock selection, in an attempt to outperform the market index and charge a management fee for doing so. A more recent development has created a middle ground known as strategic or alternative beta strategies. They are passive in the sense that they aim to replicate an index, but the indices themselves are not market capitalisation weighted. Instead they might be weighted towards company fundamentals like revenue, dividends, earnings or book value. These indices require more frequent adjustments than market capitalisation weighted indices and have been referred to as 'smart beta' or 'dumb active management'.

While there are a number of advantages and disadvantages to each approach, the active versus passive debate is almost always focused on which approach provides better returns. Can active management outperform the market or should you just buy an investment that provides the market return? Although there has been much research pushed out by both camps, more often than not we hear that the average managed fund cannot consistently outperform the market so you might as well just buy passive index products that charge lower fees than active managers.

S&P Dow Jones Indices produces the widely cited SPIVA® Australia Scorecard. It reports annually on the performance of actively managed Australian mutual funds against their respective benchmarks or market indices over various time frames. The report states that there is no consistent trend in yearly active versus index figures but that they have consistently observed that the majority of Australian active funds in most categories fail to beat the comparable benchmark indices over three and five year periods. As of 31 December 2014 for example, they report that 77.56% of Australian equity funds were outperformed by the S&P/ASX 200 Index over a 5 year period. The average performance of the Australian

equity fund sector (equal weighted) over 5 years to 31 December 2014 was 6.35% (annualised) while the S&P/ASX 200 Index returned 6.75%.

A Somewhat Flawed Analysis

Looking beyond the importance of considering a range of sample periods to draw firm conclusions, there remains notable flaws in this type of analysis. The problem with active manager indices or fund sectors/peer groups is that they often lump together managers with very different objectives and active management styles simply because they are trading the same asset class or market. In the FE AMI Equity Australia fund sector for example, there are geared, deep value, growth, sector focused, high yield, concentrated, ethical and income managers all thrown in together. This problem can be somewhat addressed by cleaning the peer group and creating more filtered and focused active manager indices and S&P Dow Jones does this to a certain extent. The problem is particularly pronounced in broad-based hedge fund indices given the varied and complex nature of hedge fund strategies, however, hedge fund databases do produce indices for specific manager strategies and styles.

We also think this simple analysis is flawed because it ignores the fact that investment management is a skill and skill is not uniformly distributed. Consider a sport like golf for example. Of Australia's population of 23 million people, there might be 22 million with zero golfing ability. Of the 1 million people that do play there might be 800,000 that are good enough to maintain a handicap, 200,000 that are good enough to play competitively, of which a few thousand are good enough to try for national events. At the very extreme there might be say 100 rare and highly skilled golfers that are good enough to compete, play for a living and that we would pay money to watch. The same is true of almost any

activity that requires skill with the exception of skilled professions where the low end of the distribution might be raised or capped because of required education and licensing. But the point remains that skill is distributed to few participants at the high end and many at the low end. Creating an index from the average performance of all 1 million golfing participants is effectively pointless and meaningless.

To say that the performance of the average managed fund cannot beat the performance of the market says nothing of relevance to individual active management styles and strategies and should have no relevance to the decision over whether or not to invest with an active manager or a passive index fund; even if it is true. Why would anyone be interested in finding and investing into the "average" managed fund? Advisers and investors should be looking for those rare and highly skilled managers that have an edge and a consistent track record in applying and exploiting that edge. Any measure that includes the performance of the poorest performing funds is meaningless, except to create an average performance baseline below which there is no point looking.

Intuitively, you would of course expect the average performance of all active investors in a market to equal the market return (less fees) because alpha is a zero sum game. The entire market is owned by all of the market participants/investors. If one manager makes an investment that deviates away from the market portfolio and that leads to outperformance, then there must be an investor on the other side underperforming. One investor's positive alpha is another investor's negative alpha. And all of the alphas should net off to zero so that the return on the average actively invested portfolio will be the same as the market (beta) – before costs.

In William Sharpe's 1991 article "The Arithmetic of Active Management" he proves the assertion that:

"Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement."

This notion of course requires that all market participants are accounted for and any investor who isn't passive (i.e. owns every security in the same weight as the market index) is, by default, active. And keep in mind that active fund managers don't fully represent the "active" component of the market, individuals and institutional investors etc. trading their own account need also be included. But most analyses, like the SPIVA[®] Australia Scorecard, only study professional active managers. It is entirely possible for the average actively managed portfolio to outperform the average passively managed portfolio, either at the expense (and poor performance of) individual investors or via deviations from market like excess cash or derivative overlays that enhance returns. Nevertheless, the argument often follows that if both the average managed fund and a passive index investment will provide the market return before costs then you might as well just buy the cheaper option.

Active Share

One aspect that these types of analysis ignore is "active share" and they therefore fail to separate truly active managers from highly benchmark oriented managers. Active share measures the difference between a fund's holdings and the holdings of its benchmark index. A fund manager with a low active share score would be holding a portfolio that closely mirrors that of the market index

i.e. the share of their portfolio that has deviated from the market portfolio is low. A fund manager with a high active share score would be holding a portfolio that looks very different to that of the market index. Using United States actively managed domestic mutual fund data, Cremers and Petajisto (2009) and Petajisto (2013) showed that:

- Historically, high active share funds outperform their reported benchmarks
- The benchmark-adjusted return of high active share funds is higher than the benchmark-adjusted return of low active share funds

They defined high active share as an active share score above 60%. Any active manager with a score below that was considered highly benchmark oriented or a 'closet indexer'.

In their "Think Active Can't Outperform? Think Again" (2015) white paper, Invesco conducted a study of 3000 mutual funds across 17 different Morningstar equity fund categories. Using the same 60% active share score threshold as Cremers and Petajisto they instead looked at the performance of active management over five different market cycles. Their results showed that during the five market cycles, in aggregate, more than 60% of high active share fund assets outperformed their benchmarks, after fees, in a variety of measures – excess returns, downside capture and risk-adjusted returns. On an asset-weighted basis, 85% of high active share funds outperformed their benchmarks over the period 10/1998 to 09/2002 and 82% over the period 04/2000 to 10/2007. The two cycles in which less than 50% of high active share funds outperformed their benchmarks (42% and 45%) were defined by very strong equity bull markets.

AQR's Frazzini, Friedman and Pomorski question these findings in their "Deactivating Active Share" (April 2015) paper. They used the same sample as

Cremers and Petajisto (2009) to re-evaluate the empirical evidence of Active Share's return predictability. They found that high active share funds tend to have small-cap benchmarks while low active share funds tend to have large-cap benchmarks. But they were unable to find reliable statistical evidence that high active share funds have achieved higher returns or alphas than low active share funds. Among the high active share managers, there will be winners and losers, but as a group they do not systematically outperform the benchmark oriented managers.

Although there is conflicting evidence, the data suggests to us that there are active managers who obviously can outperform their benchmark and that there is a much higher likelihood of outperformance by managers who exhibit the following three attributes;

- Skill (or an identifiable edge)
- High active share
- A larger or less efficient investment universe

The existence of these three attributes obviously doesn't guarantee outperformance, but without these three attributes the potential for an active manager to outperform is very low.

This would go some way to explaining why, according to the SPIVA[®] Australia Scorecard, the asset class in which active managers underperform more than most is fixed income/bonds. In the 12 months to 31 December 2014, 94.12% of active bond fund managers underperformed the S&P/ASX Australian Fixed Interest Index. The passive SPDR S&P/ASX Australian Bond ETF has 75 holdings of which roughly 90% are government or government related debt issuances. By comparison, the US listed SPDR Barclays Aggregate Bond ETF has 2,392 holdings of which only around 35% are treasuries. It would be difficult to find an edge and

create high active share in Australia's relatively small, concentrated, underdeveloped and informationally efficient listed fixed income market.

Fees First, Performance Second

Although the active versus passive debate is usually framed around which approach beats which in terms of performance, here in Australia we seem to have an almost myopic focus on fees. Proponents for passive index investing will tell you that, if the average managed fund underperforms the market by the amount of their fees, then you should use ETFs because they are certain to provide the market return at a very low cost. What we need to remember is that if there are active managers underperforming then there must be active managers outperforming and all investments provide returns and quote performance net of fees. If an active manager is outperforming the market, that outperformance is net of (or after) fees. Yes, the higher the manager's fees are, the more they are eating away at their own performance. But regardless of the management fee charged, you are better off than you would be if you were simply tracking the market. If the ASX 200 Index returned 10% over 12 months and your ASX 200 tracking ETF paid 0.20% in running costs, your net return would be 9.80%. If you disregarded an active manager simply because their management expense ratio was running at say 1.50% but they produced a net return of 12% then you are 2.20% behind where you could have been on that investment.

Of course, historical outperformance is never guaranteed to persist and a higher management fee is by no means a guarantee of higher returns. But the decision to use a passive investment over an active manager should not be based solely on the fact that passive investments are cheaper.

Market Conditions

We also point out that active management and passive indexing will often outperform or underperform each other depending on market conditions. During the prolonged market downturns of 2001-02 and 2008-09, the percentage of active managers that generated better-than-market returns increased. What can be observed is that individual stocks and/or sectors trade differently than their indices during market dislocations that provide the more skilful active managers with greater scope to generate more alpha. In other words, when there are specific winners and losers, the opportunities are greater for active managers in comparison to periods when all stocks win or lose at the same time; after all, separating winners from losers is the ultimate objective for active managers. Invesco's aforementioned white paper shows that 70-80% of active share funds outperformed their benchmarks in two market cycles that contained an extended market downturn. In calendar year 2008 (bringing with it some of the more extreme events of the Global Financial Crisis) the percentage of active managers in the FE AMI Equity Australia fund sector that underperformed the ASX 200 Index was 34.51% and the fund sector's average performance exceeded that of the benchmark. That figure is significantly less than the 77.56% of Australian equity managers who underperformed the ASX 200 Index in the 5 years to 31 December 2014 per the S&P Dow Jones SPIVA® Australia Scorecard.

Cash

The other factor at play here is cash. An index tracker, by its very nature, is fully invested all of the time; it holds no cash (as a strategic allocation). So when the market it tracks is heading south, it will track it all the way down. Active managers on the other hand often hold some cash (or 'dry powder')

whilst looking for opportunities. Excess cash can be a drag on performance during strong bull markets if alpha is not being added through their portfolio but during negative market conditions they also have the ability to easily increase cash reserves. This both adds to downside protection and provides readily available cash that can be quickly deployed as opportunities arise.

A Futile Debate

The SPIVA® Australia Scorecard, by and large, confirms what we should already know i.e. that the average actively managed portfolio should underperform the market by an amount equal to the fees charged. But this simple analysis of a group's average performance says nothing about the distribution of skill, the extent of over and underperformance and potential for individual highly skilled active managers to outperform in the future. So in this important context the SPIVA® Australia Scorecard's headline numbers are somewhat misleading as a guide; the report makes no attempt to separate active managers with key attributes for potential outperformance from those that are almost destined to underperform.

Ultimately the debate is futile because you don't have to pick a side! The question over whether or not to actively or passively invest within a single asset class is far less important than asset allocation itself. In our view, the choice between active and passive investments really depends on the allocation or investment exposure you are seeking and we advocate the use of both types of investments. We take the view that passive index investments (ETFs) are best used for long term allocations to more developed/efficient markets, strategic beta and for shorter term tactical plays or dynamic asset allocation. We would use active managers for absolute return allocations and

relative return allocations in larger and less efficient markets where a manager can demonstrate an edge and produce alpha from having a high active share score; within a single country emerging market for example. Ultimately it depends on the risk & return objectives you have set for your portfolio and if you can achieve those objectives without running the risk of being exposed to active

managers who might underperform then passive investments would make sense.

The active versus passive debate is one worth having, but it's focused in the wrong direction. Active asset allocation versus passive (or strategic) asset allocation is a far more important debate and one that we don't hear nearly enough about.

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