Active or Passive? We Think That's the Wrong Question

A few weeks ago, in Who's Driving?, we looked at the extraordinary rise of passive investing and argued that low cost implementation does not remove the need for investment judgement.

The note prompted some interesting conversations with advisers and investors, particularly around a question that sits at the heart of the active versus passive debate:

If passive investing is so effective, where does active management still earn its place?

Morningstar recently published the latest edition of its Active/Passive Barometer and, at first glance, the conclusion does not make particularly comfortable reading for active managers. Over the 12 months to June, just over 40% of active funds outperformed their average passive peer. Look over longer periods and the challenge becomes clearer still. An investor selecting an active fund at random has historically been more likely to pick an underperformer than an outperformer.

So, is that the end of the active management debate? We don't think so. In fact, we think it may be the wrong debate altogether.

Not all markets are the same

One of the most interesting aspects of the Morningstar research is not simply that active managers struggle overall. It is how dramatically their success varies between different parts of the market.

Active managers have found it particularly difficult to add value in areas such as US large cap equities. That should perhaps not surprise us. The world's largest companies are followed by thousands of analysts and investors, information travels almost instantaneously and finding something the rest of the market has missed is increasingly difficult.

Elsewhere, the picture can be quite different. Morningstar found better results from active management in a number of areas, including parts of fixed income, real estate and the small and mid cap equity markets. It also found that cost matters considerably. In 16 of the 20 categories studied, selecting from the lowest cost group of active funds improved the chances of outperforming.

The evidence does not simply tell us to choose passive. **It tells us to be much more selective about where we pay for active management.**

Passive doesn't remove the investment decision

As we argued in Who's Driving?, choosing passive investments does not make the portfolio itself passive. Someone still has to decide how much to allocate to equities and bonds, which regions to favour, how much duration and credit risk to accept, whether alternatives have a role and when to rebalance.

Those broader portfolio decisions can ultimately matter considerably more to an investor's outcome than whether a particular US equity fund beats its benchmark by 1%. Passive investing is therefore not the absence of investment decisions. It is simply a different way of implementing them.

The concentration question

There is also an interesting consequence of passive investing's extraordinary success. Most major equity indices are weighted according to market capitalisation. Put simply, the bigger a company becomes, the more of it the index owns.

Following the exceptional performance of US mega cap technology companies, some of the world's most widely held indices have become increasingly concentrated in a relatively small number of businesses. That has been enormously beneficial while those companies have continued to perform strongly.

But an index does not ask whether a company has become too expensive, whether its prospects have changed or whether owning more of it represents an increasingly large portfolio risk. If its market capitalisation rises, its weight in the index generally rises with it.

None of this means that market capitalisation weighting is inherently wrong. It simply reinforces the importance of understanding what you own.

This is also where systematic and enhanced passive strategies become interesting. Rather than simply accepting every characteristic of a traditional market capitalisation weighted index, rules based approaches can seek to retain the efficiency, transparency and cost advantages of passive investing while addressing issues such as concentration or unintended factor exposure.

It is a subject we will return to in a future Investment Note.

So where does active management fit?

For us, active management should have to earn its place. If an active manager is effectively replicating an index while charging considerably more to do so, the case for paying the additional fee is difficult to make.

Instead, we believe active management should be concentrated where there is a credible opportunity for judgement to add value. That might come through selecting skilled managers in less efficient markets. It could involve changing duration or credit exposure within fixed income, reducing exposure to an asset class where valuations have become difficult to justify, increasing exposure where opportunities have improved, or introducing investments that behave differently from traditional equities and bonds.

Importantly, none of this means we believe we can predict every market movement correctly. Active decisions can be wrong, and Morningstar's latest research provides a useful example. Some active bond managers positioned themselves for risks that ultimately did not materialise as expected, while passive strategies simply remained invested and benefited from doing nothing.

> **Sometimes the best active decision is knowing when not to be active.**

The ability to make a decision is not the same as always making the right decision. For us, the case for active management rests instead on having a disciplined process for deciding when intervention is justified and, equally importantly, when it isn't.

Active and passive, not active versus passive

This thinking is reflected in the way we construct portfolios at TAM. We offer both Active and Enhanced Passive portfolios, but we do not regard them as competing philosophies.

Our Enhanced Passive portfolios make greater use of ETFs, index funds and systematic strategies, providing broad and efficient market exposure while allowing us to address some of the limitations of traditional index construction.

Our Active portfolios give the investment team greater flexibility over implementation and manager selection. They invest primarily with carefully selected active managers, **but we also use passive funds where we believe they provide the most efficient or appropriate exposure to a particular market.**

Both approaches start from the same place, sharing our strategic asset allocation, our house investment views and the same fundamental objective: constructing diversified portfolios around an investor's agreed level of risk. The difference is primarily in how those views are implemented and how much discretion we use in getting there.

The question we think investors should ask

Perhaps investors should stop asking:

"Is active better than passive?"

And ask instead:

"Where am I actually getting value from active management?"

In highly efficient markets, the answer may be that a low cost passive or systematic strategy is extremely difficult to beat. Elsewhere, particularly where markets are less efficient, securities are more complex or risks require greater judgement, there can still be a meaningful role for active management.

For us, portfolio construction is therefore not a choice between active and passive. It is about combining passive efficiency, systematic discipline and active judgement, using each where we believe it has the greatest potential to contribute. That is increasingly how we think about portfolio construction at TAM.

Sometimes the best active decision is knowing when not to be active.

TAM ASSET MANAGEMENT INTERNATIONAL LIMITED
Nexteracom Tower 1, Ebene, 72201, Mauritius

+230 454 6400

www.tamint.com