
# How Passive Is Passive?

Over the past few weeks, we have been looking at the changing relationship between active and passive investing. In Who's Driving?, we argued that low cost investment vehicles do not remove the need for judgement. More recently, in Active or Passive? We Think That's the Wrong Question, we looked at where active management can still earn its place and why the answer can differ considerably between markets.

There is one final question worth exploring: **how passive is passive investing, really?**

At first glance, the answer seems obvious. Buy an index fund, leave security selection to the benchmark and keep intervention to a minimum. But even that apparently simple decision raises another question: which index? The S&P 500, an equal weighted version, a global index, perhaps one tilted towards quality or value?

Once you start asking those questions, "passive" becomes rather less straightforward.

## An index is a set of decisions

A traditional index fund does something remarkably simple and useful. It follows a predetermined benchmark, usually at relatively low cost. Yet the benchmark itself reflects a series of choices: which securities qualify for inclusion, how they are weighted, how frequently the index is rebalanced and what happens when a company no longer meets its criteria.

Take weighting as an example. A conventional market capitalisation index gives larger companies larger allocations. An equal weighted index deliberately does not. A quality index might favour profitable companies with stronger balance sheets, while other approaches can tilt towards value, momentum or lower volatility.

They can all be implemented passively, but they clearly aren't making the same investment decisions.

This is where the traditional distinction between active and passive starts to become more interesting. Smart beta strategies follow predetermined rules but deliberately seek a particular type of exposure. Systematic strategies go further, using quantitative models to screen large numbers of securities according to factors such as valuation, profitability, financial strength, momentum and risk.

There may be no portfolio manager deciding that Company A looks more attractive than Company B. The investment decisions have not disappeared, however. They have simply been embedded in the rules.

**Passive describes how an investment follows its rules. It doesn't tell you who chose the rules in the first place.**

## And then there is the portfolio

Even a portfolio could be constructed entirely from conventional passive funds and still be actively managed. Someone has to decide how much to hold in equities and fixed income, which markets to favour, how much duration or credit risk to take, whether alternatives have a role and when those allocations should change.

Choosing a low cost S&P 500 tracker might therefore be a passive implementation decision. Deciding whether US equities should represent 20%, 30% or 40% of a portfolio certainly isn't.

The reverse is also true. Our Active portfolios primarily invest with carefully selected active managers, but we also use passive funds where we believe they offer the most appropriate or efficient exposure to a particular market. We have never seen a compelling reason to pay an active management fee simply for the sake of being active.

For us, the distinction has always been less important than choosing the right tool for the job.

## Two decades of active management still matter

It might initially appear slightly contradictory that more than two decades of experience managing active portfolios should be relevant to managing passive ones. We think it is, because much of our work with active managers has involved looking beneath headline performance to understand what is really driving returns, where the risks are, how a strategy might behave when market conditions change and, importantly, whether we are genuinely paying for skill or receiving an exposure that could be obtained more efficiently elsewhere.

We ask many of the same questions when looking at passive and systematic investments. An ETF still needs to be understood. A smart beta strategy embeds investment choices within its methodology. A systematic fund reflects assumptions about which characteristics may be rewarded and how they should be measured. Two funds that appear to offer much the same exposure can behave quite differently because of the rules sitting underneath them.

After two decades assessing investment managers, one lesson has been particularly useful: **the label tells you surprisingly little. You need to understand what is actually going on underneath.**

That applies just as much to passive investing as it does to active management.

> **Why we call it Enhanced Passive**
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> At TAM, our portfolios broadly follow two approaches to portfolio management. Our **Active portfolios** primarily use carefully selected active fund managers, although we also use passive funds where we believe they are the most appropriate or efficient way to access a market. Our **Enhanced Passive** portfolios turn that emphasis around, using predominantly index funds, ETFs and systematic strategies to implement our investment views efficiently.
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> Importantly, Enhanced Passive does not mean that the portfolio itself is passively managed. Both ranges share our strategic asset allocation, house investment views and overall approach to risk. We still decide how much to allocate to different asset classes and markets, how those risks should be balanced and when allocations should change.
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> That is why we chose the name Enhanced Passive rather than simply Passive. The underlying investments may predominantly be passive or systematic, but the portfolio management is not.

## Perhaps passive is a spectrum

The investment industry has traditionally put active and passive into two separate boxes. At the extremes, that still makes sense. A manager researching and selecting individual companies is clearly doing something very different from a fund designed simply to replicate the S&P 500.

Between those two extremes, however, there is now a lot of territory.

A smart beta fund can express a deliberate investment philosophy while following its rules mechanically. A systematic strategy can make thousands of investment decisions without a portfolio manager choosing a single security by hand. An Active portfolio can contain passive funds, while an Enhanced Passive portfolio can involve very active decisions about asset allocation and risk.

Perhaps, then, the labels are less important than understanding what sits behind them. The more useful questions are where the investment decisions are being made, what they are trying to achieve and whether they are adding value. Sometimes the answer will favour an active manager. Sometimes it will favour a simple index fund. Increasingly, it may sit somewhere between the two.

Passive investing has given investors an extraordinarily efficient set of tools, and systematic investing has made that toolkit more sophisticated still. Our job is not to favour one tool because of the label attached to it, but to understand what each does and use it where we believe it can contribute most effectively to a portfolio.

After more than two decades managing portfolios, perhaps that is the least surprising conclusion of all.

**The tools may be passive. Portfolio management never is.**