Active vs. passive

Who, what, why, when

January 2012

1. Introduction

With the growing interest in passive solutions and the burgeoning growth of assets in ETFs, we are often asked our thoughts on the suitability of these products and their appropriateness within multi-asset portfolios.

Indeed in a recent a survey, conducted on our behalf by Scorpio early in 2011 across forty wealth advisors, we saw that over 50% of the respondents had added a passive solution to their client portfolios. We see the same trend amongst our own clients and their investment requirements.

Sadly much of the information available to investors on this important topic is partial. When both active and passive fund managers state their views on this debate, they can hardly be blamed for a bias towards their own style of management. However, both sides tend to use arguments that do not necessarily stand up to close scrutiny.

Given this situation we have put together this guide to help investors assemble a better picture of the issues behind this debate. While every investor's situation is different this article summarises our general thoughts on the topic.

2. Defining active and passive

Active: definition

Active management (also called active investing) refers to investment strategies where the manager makes specific investments with the goal of outperforming an investment benchmark index.

Passive: definition

Passive management (also called passive investing) refers to investment strategies that do not aspire to create a return in excess of a benchmark index. Instead the focus is on replicating the benchmark's performance at a lower cost.

3. Key principles in the active vs. passive debate

In this section we highlight some key principles to consider when deciding on the construction of an investment portfolio and whether to use passive or active investments.

- Appropriate asset allocation is still required with both active and passive solutions.

  Whether asset allocation decisions are done implicitly through the choice of benchmarks or explicitly through active asset class positioning, such decisions will often dominate performance.

  As such investors, even in passive solutions, need to think carefully about constructing an appropriate asset allocation strategy. This also needs to reflect the state of the markets (valuation and economics) as well as the investor's requirements.

- In order to find asset classes that can yield sustainable outperformance for active management, investors should consider the efficiency of any particular asset class.

- Efficiency is the speed at which information is reflected in prices and the ability to consistently gain from thorough and detailed research.

- Active management tends to be more likely to deliver outperformance in less efficient asset classes such as the small cap equity space. By contrast sustainable outperformance is more difficult to achieve in more efficient asset classes such as government bonds.

- Passive solutions work better in mainstream asset classes. In more niche areas passive solutions can be expensive or come with hidden drawbacks.

  For example in mainstream asset classes such as government bonds the index can be replicated easily without structural issues. Passive investing is more problematic in areas like credit or commodities. In these areas investors need to do extensive due diligence before selecting a passive solution.

- Passive solutions vary widely, and investors should not be led into thinking they are all the same. On issues such as fees, tax, liquidity and risk, passive offers differ enormously.

4. Putting the active vs. passive decision into context

Whether to go active or passive is just one decision when managing a portfolio. This decision is an output of a much larger decision tree, and for us is very context dependent.

In the construction and management of our multi asset portfolios, we focus much of our attention on deciding which asset classes we want to be invested in. Do we see value in equities, credit, emerging markets or bonds?

This is the first stage of our decision tree. The next stage is to consider if there are particular areas within each asset class towards which it is worth tilting our portfolios.

For example, within equities, do we prefer small cap or large cap, value or growth? With credit, do we prefer high quality credit vs. distressed credit? If there are tilts like these worth taking, going passive is not impossible, but certainly trickier and sometimes more expensive. It really depends on the tilt – regional for example is straightforward, value vs. momentum, high quality vs. distressed are difficult. We need to consider if there are any benefits to using a suite of active managers to implement these tilts.

Essentially the active versus passive debate for us is partly an implementation question. We aim to find the most efficient way to get the exposure that we want. At times the most efficient way might be to use passive strategies, while in others the best route may be active management.

5. Getting the asset allocation mix right

The decision tree outlined earlier in this document starts with asset allocation. To state the obvious, going passive still requires investors to get this right.

A passive solution may not save you from market crashes. Whether you are in an active equity fund or a passive equity fund, if markets fall by 20% you are likely to suffer material and painful losses.

Investors can not use passive solutions to decide how much equity exposure they want. Ultimately, a decision needs to be made. This decision needs to take into account both the investor's requirements but also to reflect the state of the markets at that time. In addition to the economic outlook, we would strongly argue for making this decision based on the valuations and margin of safety that each asset class offers. Varying the asset allocation according to a valuation based assessment of the return opportunities and the level of risks is of great value and importance.

However, if investors do not like this valuation approach, even simple rules of thumb can help. For example, a basic rule is to undertake simple, regular rebalancing of a portfolio to take money out as markets rally, and put money in when markets fall. Investment discipline, both at market peaks and troughs, is needed to make this tactic work.

Either way, getting a process in place where investors are able to enter in the market when fear is abundant and sell when exuberance is commonplace remains critical to do anything other than float with the tide.

6. Cost and benefits

Passive investing is often considered based on a low cost argument. It is therefore very important to look at active and passive investing in terms of costs and benefits.

Headline fees

Cost wise, by and large passive is cheaper than active management. However, beware, as this is not always the case. In our experience, for mainstream equities and bonds, passive is cheaper. In the credit markets, such as high yield and loans, passive can often prove to be the more expensive option.

	Active (bps)	Passive (bps)
Developed Equities	40 – 100	10 – 40
Emerging Equities	50 – 150	25 – 65
Government Bonds	20 – 40	10 – 30
High Yield Credit	40 – 75	45
Loans	40 – 100	83

Source: Momentum Global Investment Management, November 2011

Other costs

Beyond the headline fees, there are other costs to consider in deciding between active and passive investments:

- **Vulnerability to index arbitrage**: hedge funds arbitraging the rebalancing and membership of an index like the FTSE is at the cost of the performance of passive strategies. By nature, a strict tracker is forced to buy stocks after they have appreciated and sell others after they have fallen.

- **Roll costs**: in certain commodity markets like oil and gas, futures strategies are forced to roll their holdings month to month to avoid taking delivery of the physical good. In a similar way to index arbitrage of equity indices, this can present a headwind for passive strategies.

- **Trading costs and bid offer spreads**: trading fees and bid offer spreads vary both for passive and active funds. This is an opaque area and does not always favour passive strategies.

Benefits

On the other side of the debate there are certain advantages that differ between active and passive solutions:

Benefits of passive management

- **Ease of execution**: a quick and simple solution.

- **Relative certainty of performance**: usually get the index performance less fees and other costs.

Benefits of active

- **Possibility of outperformance**: more likely in some areas than others such as style specific (e.g. value or momentum) or the more inefficient areas of the market (e.g. small cap).

In summary, passive solutions tend to be best for temporary / tactical holdings in very mainstream / efficient markets such as large highly liquid equity markets, government bond markets and gold. With longer holding periods or other markets, it pays to undertake further research to ascertain whether active management is appropriate and can offer better opportunities.

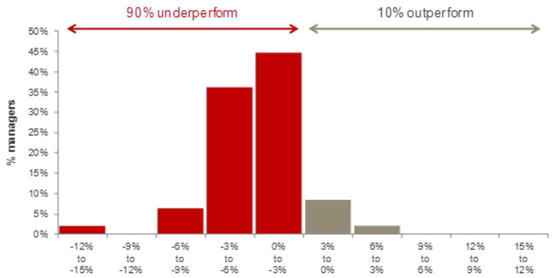
7. Can active managers outperform?

From our point of view, it only makes sense to use active management where the odds of outperformance are in your favour. There is little point in spending time researching managers and allocating risk budgets to areas where the chance of outperformance is slim.

Our research has highlighted that active management can yield benefits in less efficient markets. Efficiency is the speed at which information is reflected in prices and the ability to consistently gain from thorough and detailed research. Efficiency is a key determinant as to whether active management is likely to deliver results.

Active management is tough in efficient markets
Example: Distribution of alpha for US government bond funds, 1993-2011

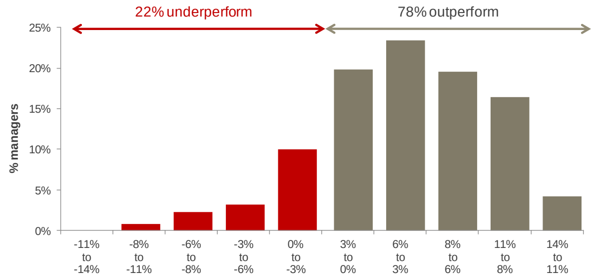
Chart I



Source: Bloomberg, December 2011

Active management is more likely to succeed in less efficient markets
Example: Distribution of alpha for US Small cap equity funds, 1993-2011

Chart II



Source: Bloomberg, December 2011

By contrast to the bond market (chart I), the chart above (chart II) suggests that in less efficient markets active management is far more worthwhile. The US small cap equity space has thousands of companies with relatively few investors scrutinising them. In this area, if we are only as good as the average investor at selecting funds the odds are in our favour at picking one who will outperform. This is an area worth spending time trying to find good managers.

Clearly, outperformance is not guaranteed. Even in the data sample illustrated above, nearly one in four funds underperform. So our response to this is not to pick one fund, but to assemble our fund selections into a portfolio of managers in this area, giving us the best chance of reliably outperforming.

8. Not all passive solutions are made equal

A final point on passive investing:

There are a multitude of passive options and strategies. Trackers, ETFs and futures are the most common. It is important for investors to properly understand each solution to evaluate if they are worthwhile.

Considerations for passive investing:
Fees: the various different passive solutions differ in the fees they typically charge. This does somewhat depend on how much you are investing and your negotiating skills. For the retail investor, equity ETFs can be an expensive solution in comparison to other options such as tracker funds. But comparing cost needs to be done on a like for like basis i.e. for ETFs and passive funds remember to take into account bid offer spreads as well as the annual management cost and TER.

Tax implications: a very complicated area. To take one example - does your ETF suffer withholdings tax? What is the impact? For a fixed interest asset class, this can be a substantial part of the overall return.

Liquidity: how liquid is the structure? Do you need and does the passive solution offer greater than daily liquidity. Passive funds general trade daily, but futures and ETFs trade continuously while markets are open.

Concentration risk: another important consideration – particularly in the credit space. In order to maintain daily liquidity (and potentially sizable inflows and outflows), the ETF will tend to hold the most liquid of instruments. The first US high yield ETFs only held 20 securities. That opens you up to far more 'stock specific' risk.

Security: a key point for commodity ETF's such as gold. Does the ETF physically actually own the underlying asset? Or does it just have an IOU from a bank (a so called synthetic ETF) which is worthless if the bank goes bust?

9. Conclusion

Whether investors go active or passive they still need to take a number of key investment decisions and these decisions are hugely important.

In terms of the potential for outperformance, contrary to popular belief, it is possible to find asset classes where active management has proven to provide a sustainable advantage to investors. Yet investors are far more likely to benefit from these rewards if they focus their efforts on areas which are less efficient and where managers stand a better chance of outperformance.

In the right circumstances passive solutions can be a very useful tool. They offer a low cost and easy alternative for many investment decisions. However, too many investors are lulled into a false sense of security. While for the most mainstream markets investors can sometimes get away with this approach if passive investing is to be a core part of a portfolio investors need to fully understand what they are buying.

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