insync fund managers

September, 2023

Is the 'Passive versus Active' Argument Flawed?

By Grant Pearson, Head of Strategy and Distribution

This managed fund comparison is often accepted on face value but is it valid?

In the world of investing, the 'Passive versus Active' debate has raged for years. The prevailing notion, often accepted at face value, is that passive investment funds consistently outperform their active counterparts. But is this argument truly as solid as it seems? In this article, I will critically assess the notion that passive investing is the undisputed champion and explore the flaws that often go unnoticed.

Let's begin asking why the active managers in comparisons are not also represented as 'capital weighted aggregates' of the collective returns of the managers involved (e.g. global large cap equity fund index versus MSCI index Fund)? This, of course, supports a fair 'apples to apples' comparison. But first, how did the view that index returns are superior come about?

Three factors have certainly helped drive the belief in the assertion:

a) The dominance of a handful of index fund managers have excelled at marketing their offerings. They also enjoy a position of relative ease in tracking and publishing results. But should performance accountability be a requisite for any investment including the indexers? Moreover, index managers have benefited from associated lower labour costs. However, the advent of artificial intelligence threatens to disrupt this, by challenging the need for analysts and portfolio managers in active approaches. Nevertheless, today, when an index product posts subpar returns, it can conveniently attribute its underperformance to that nebulous entity known as 'the market.'

b) Active managers number in the thousands. They don't have a concentrated and organised marketing capability to push back against the assertion. By nature, active managers are self-involved as they heavily compete with one another. They haven't allocated resources to analytical proofs for a holistic contrary argument. This has not been for their collective greater good, so perhaps they now should.

c) There is a clever inference made by passive promoters that because passive allegedly outperforms, say 85% of active managers in a given 'point to point time period, it must obviously be a futile and difficult process to select the 15% that out-do the index fund.

In this contest, the Index promoters are winning the perception stakes, and not just with retail advisers and investors but many institutional investors, researchers, trustees and asset consultants. Yet, examine key factors more deeply and the outcome is not as one-sided as often implied.

7 realities require consideration in portfolio construction: Today, active managers are treated as 'islands' in comparisons. Often, their individual result is pitted against an index, yet this is not the investor's reality. This is important as it alters the basis of performance evaluation.

1. **2-3 active funds blended often do better** than an index fund if devised properly by trained professionals. Across 34 years in the industry I've witnessed countless examples at an investor portfolio result level. The reality is that most investors using active managed funds tend to use a composite of them with various weightings that also shift over time. Intermediated inputs of some form are present in a very large portion of all active funds under management (FUM), be it model portfolios or forms of advised recommendations. This is a valuable layer of skill that impacts the reality for end investors. Excluding this fact infers that such inputs and professionals offer zero value to the outcome. There is, however, a vast amount of fragmented evidence that proves that this overlay of active combinations, do produce better returns. The industry has not yet collated this at a systemic level for publishing but perhaps it should. Index managers are benefiting for the lack of appropriate realistic analysis.

2. **Applying meaningful time-based measurements:** 'Rolling Returns' instead of commonly used 'point-to-point' returns provide investors with far more useful assessments of historical returns, as they better account for the average result across all start/end months of the year, thus aligning an investor's likely return experience. Index promoters and researchers have avoided using this superior measure of returns.

3. **Challenging the over-simplification of index comparisons**: Using almost any month of 'point-to-point' returns, a cohort of 10-20% of active funds usually outperforms the relevant index fund. This is especially so outside extreme frothy markets. Thus, it's inferred that professional advice can't identify these points and the successful active funds often enough to make a resounding impact.

4. **Measure active returns, risk adjusted and in the hip-pocket**: Active management is only accurately calculated at the investor's dollar account level, not at the fund level because **risk and volatility management** are provided with active management, and this alters the $-based account balance. Two funds can post the same return 'point-to-point' yet have very different account balances simply due to the volatility in each. How often, how far and for how long a fund drawdown is, impacts account balances. For retirees siphoning off income and capital this is essential knowledge. It's all in the dollar-based arithmetic, but this can't be captured at the fund level where marketing is focused. Index funds have no risk or volatility management . Thus, along with the all-important hip-pocket is the cost/benefit of risk management in active investments. Both are crucial considerations.

5. **Index comparisons rarely exclude companies with poor stewardship**. Most active funds including non-ESG offers do have standards on this to various degrees. If you care about good stewardship and basic common values, then this needs to be accounted for in comparisons. Investors *do care* by and large, but that doesn't mean they necessarily want ESG focused funds. Governance matters but indexing is devoid of this.

6. **Poor index benchmark selection**. Whole sectors of an index's return are often pitted against a manager whose fund deliberately doesn't invest in most of it (e.g. emerging markets and resources). An active mega cap global equity manager is often compared to an entire index (usually the MSCI-AWI) that's mostly comprised of non-large cap stocks and also in countries they wouldn't ever invest in. One has to ask if this is appropriate?

7. **The downsides of 'dominated concentration'**: The risk of concentrated investments, particularly in specific sectors or narrow asset classes, may not be adequately addressed by passive strategies. When a few large-cap stocks dominate an index, the overall index performance becomes highly sensitive to the performance of those stocks. If one or more of these stocks experience significant price declines, the entire index's performance can be adversely affected. Diversification is key in managing risk. Concentrated indices lack the benefits of diversification, which can help cushion the impact of poor performance from a few individual stocks. Diversified portfolios tend to exhibit lower volatility and more consistent returns.

When indices prove useful: There is however a stage of a cycle when it's a probable advantage to invest in an index, assuming one wants to take on the timing risks. When a market reaches euphoric heights, then most active managers tend to underperform the index, in part because they apply various risk-weighted inputs into their decision-making. This is about managing the downside risk and index funds do not do this. Thus, the cheapest way to participate at these junctures, in simple return terms, often sees index funds excelling for a time.

Index funds may ironically also provide a less risky investment in a handful of narrow investment sectors offering limited stocks. Take listed property assets for instance. In Australia/New Zealand, to 'outperform' the index requires concentrated high exposure bets (risk) by active managers and with likely increased volatility. This may not suit the profile of the end investor, but active managers will struggle to beat the index if they don't do so.

The emotive arguments: They are rarely debated. For instance, does one want to contribute 'dumb' capital for others to gain, often at the expense of *mum and dad* investors? It is the human condition that stands at the very core of capitalism and hence markets. Human endeavour to do better than average is how the world works and for markets to function long term. If most capital became 'dumb' it primarily supports the badly-run and mediocre companies and debt issuers that should be allowed to fall. Our prosperity and economy requires failure as much as reward.

Structurally a second issue emerges. The growing concentration of retirement assets in many developed nations is continually reducing the number of trades and views taking place across markets. Pooled capital fund decisions once numbering in the thousands are drifting towards a massively reduced number, resulting in a narrowing spread of returns and risk for investors. It's driven, of course, by both the merging of managed pools (e.g. retirement funds), and them bringing asset management in-house or indexing it. It's primarily based on scale arguments of cost (not risk-adjusted outcomes). These factors remove a benefit of choreographed combinations of approaches where sensible management of duration, style and risk is being collapsed to just a few – and often just an index.

This drives an 'averaging down result' where it's marketed as an excuse to fund beneficiaries as 'acceptable because it's the market'. This phenomenon is closing the spread between offerings by reducing alternative views and processes. Mediocrity is the likely outcome, as the concentrated owners have neither a group nor personal incentive to take on risk beyond an index, and in reality aren't held accountable by their members. In Australia, government has inadvertently created a reward in the system for this trend. How can this be good for individuals, businesses, and governments responsible for their citizens, let alone for effective capital markets long term?

One last thought is why should an index be assumed as the automatic benchmark of returns at all? A large unexploited benefit in comparing things less simplistically is there for not just active managers but also advisers. At the very least it makes for a great debate.

In conclusion, the prevailing 'Passive versus Active' debate is far from settled

We advocate for a more nuanced and informed approach to portfolio construction. Trustees, financial professionals, and policymakers should reconsider the almost automatic use of indices as benchmarks and as investment solutions and engage in a deeper analysis. As the industry evolves and investors seek more tailored solutions, it's time to move beyond false over-simplifications and engage in meaningful dialogue about the future of investment management. By doing so, we can ensure that investors are equipped with the best tools to navigate the ever-changing financial landscape.

Ends.