INSIGHTS FROM CFA SOCIETY SINGAPORE

What most active versus passive debates miss

Outperformance is only one of the factors investors should consider – and it is not the most important

By Hansi Mehrotra

DO active funds outperform their passive counterparts? From the 1970s, when passive funds first launched, up until today, when their assets under management (AUM) have overtaken those of active funds, the active versus passive debate has centred on that question.

But this is only one of the issues that investors have to consider – and it is not the most important. The other considerations are more critical for two reasons: because they help us understand the first principles of the debate, and because they elevate that debate from the theoretical to the practical.

When it comes to the choice between active and passive, both the professional and retail investors among us have at least three questions to consider:

Can it be done?

Is it possible for any fund, or any investor, to outperform a market index? Of course. But why is it possible?

Let us imagine the market is composed of only two stocks of equal size and value, A and B. In a given year, Stock A's price increases by 20 per cent and Stock B's falls by 20 per cent. The total performance of the market index is the average of the two stocks: 0 per cent. As active investors, we could have picked Stock A and invested all or most of our money in it. And we could have added more value by shorting Stock B.

Of course, with only two stocks to choose from, we have a very limited number of potential decisions. But what if there were 5,000 stocks and they each yielded a return of roughly 15 per cent? Then, even if we did the research, the lack of dispersion of returns would mean we could not add value. So for active investors to have a chance to succeed, performance among securities has to vary widely.

Therefore, a rough gauge of whether active funds – or the active opportunity – can outperform is the number of securities available in a given market, the dispersion between the best- and worst-performing among them, and the proportion of retail versus professional investors. Big equities markets such as those in the US or India have more than 3,000 listed stocks with huge dispersions between them. So active investors do have plenty of opportunities to add value.

But the number of securities and the dispersion between the best- and worst-performing varies from market to market and from type of security to type of security, be it equities, fixed income, private equity, real estate, and so on. So not all markets are equal. Indeed, in some, the active opportunity may be close to zero.

The current fund assessment process, which is conducted through in-person meetings and email exchanges, is cumbersome, opaque, and costly. It is also accessible only to large research and advisory firms are influential enough. ILLUSTRATION: PIXABAY

Is it done?

This second question is what most active versus passive debates seek to answer. Adherents on each side quote the statistics on how many active funds have outperformed their respective market indices and how long they were able to maintain that outperformance.

But what do their analyses prove? Just because most funds do not outperform does not mean picking funds is an impossible or meritless endeavour. It just means it is hard. Otherwise, what would research houses and investment consultants offer as value propositions?

Fund pickers also know that active funds have to choose an investment style to express their investment philosophy. That style will necessarily underperform at times. If it did not, and if the market did not go against it every now and then, there would be few opportunities for stock selection within that style.

The purists compare funds of a particular style to a market index designed to match that style – for example, benchmarking value funds to value factor-based indices. This approach might help distinguish skill from style or factor returns, but it forces managers to define their philosophy based on the herd. And how does that help retail investors who tend not to have much knowledge about styles or opinions about which will outperform over the near or long term, whether they should invest in a combination of styles to dampen volatility, et cetera? What good does this approach do for them?

Can I do it?

This is the most relevant question for any investor. Active investors and active funds can outperform the market, but different investors have different abilities. Few of us can pick outperforming stocks and funds in advance. And for those that succeed, reversion to the mean eventually brings them back down to earth.

But while investors tend to be sceptical about stock-picking talent, we can be overconfident in our fund-picking abilities. The fund data flows suggest investors follow the performance of the past one, three, or five years.

Or perhaps the correlation is indirect: Maybe we follow star ratings that, in turn, are based on past performance. Or we follow the recommendations of financial advisers, which – guess what – are also based on past performance. Or we follow the regulators' suggestions and assess track records – another synonym for past performance.

What should we follow if not past performance and portfolio analytics?

Now that is a good question. The most influential research houses and consulting firms look at such qualitative factors as people, philosophy, process, the firm's commitment to and alignment of interests, and so on. They meet the investment, management, and even the operations teams. They then write ratings reports and sell them to financial advice intermediaries.

The current practice has a number of issues:

- The fund assessment process, which is conducted through in-person meetings and email exchanges, is cumbersome, opaque, and costly.
- Only large research and advisory firms are influential enough to meet with management teams. Smaller firms and individual advisers lack that access. Thus the ratings market may be dominated by a handful of players.
- Not all financial advisers agree with the value proposition and investment philosophy of the larger research firms or buy their research. They might conduct their own in-house analysis, but without comparable scale and access, they are at a considerable disadvantage. Then there are the incentives for financial advisers: the model is evolving around the world from commissions to fee-based advice, which is putting pressure on the industry.
- If investors want to assess and buy funds directly, as the Indian regulator encourages them to do, we cannot possibly have the scale and access unless we are multi-millionaires.

Why are fund ratings business models more reminiscent of those from the credit ratings industry than from stock research? Why are only a few ratings houses getting paid by the fund houses? Why are there not hundreds of opinions on funds, just like there are on stocks?

The answer, to my mind, is because of the information gap. Much of the necessary data – the performance and portfolio stats, the fund manager interviews about investment philosophy and process, about operational due diligence, et cetera – are available and accessible to only a few.

In the meantime, as investors – professional and otherwise – we should ask ourselves:

- Can I pick good funds with the time and information I have?
- Can I trust my financial adviser/myself to have the right expertise, access, and incentives to select good funds for me or my clients?
- Can I monitor the funds on an ongoing basis, changing the funds when necessary, such that any outperformance is not negated by the associated costs?

If the answer to any of these is no, then we should consider going passive.

At the very least, by contemplating these questions, we have taken a considered, deliberate, and intentional approach.

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