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Passive vs. Active Investment Management Strategies

Comparisons, Perspectives and the Relevance to Financial Advisors

Passive vs. Active Management: An Introduction

Most investment managers advertise they possess superior investment skills and are poised to reap great results. Despite their persuasion, common sense argues against the possibility of everyone's being above average.

However, the fact that everyone cannot be above average does not prove being above average is impossible. It merely proves it is difficult.

Passive Investing -Defined

Passive investors believe it is not possible to accurately identify investments that will consistently top market averages, at a low enough cost to justify the effort. Passive investors attempt to simply duplicate their respective investable universes.

Active Investing - Defined

Active investors believe that they are able to consistently identify enough high-performing investments to ultimately achieve better than average results. Active investors seek out what they consider to be better than average opportunities.

Background

All investors as a group actually represent the market. Empirical evidence and common sense suggest that on the average, active managers fall behind their benchmark indices by the additional cost of running their business.

Advocates of passive investing believe the market behaves according to the efficient market hypothesis. The efficient market hypothesis states that prices are always fair and quickly reflect any new information that becomes available. In such a world, no investors could systematically exploit any miss-pricings, as they would be instantaneously corrected.

Advocates of active investing suggest that the market provides sufficient inefficiencies to be successfully exploited by the astute investor.

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Active vs. Passive in Perspective: Much Ado about Nothing?

How important is the active vs. passive investing decision to investors?

As academically interesting as the debate between active and passive management may be, it does not answer the most important questions an investor is faced with:

How much money do I need to retire? …To fund education? How many years do I need to keep working? How much should I save? Is my business protected if my partner dies? How much can I afford to spend based on my assets? How much can I afford to lose in a year without jeopardizing my goals? Is my family protected if I die or become disabled? Are my assets going to benefit my family and my favorite charity or the government?

Will there be enough???

The Holistic Approach

No amount of money management prowess or cost savings could ever make up for the failure to correctly answer the questions above. Comprehensive financial planning sets the very foundation for the financial future of investors.

The active vs. passive management debate should only be addressed after a solid investment foundation has been built. A solid planning foundation consists of goal identification, coordination of various financial planning aspects, development of an investment policy based on specific goals and risk tolerance.

Whether investors use the services of an advisor or attempt to "go it alone," arriving at a destination without a roadmap depends on blind luck alone. Investors that lack answers to the questions above have very limited odds of succeeding.

Staying the Course

Investors can potentially lose disproportionately more money by being whipsawed (repeatedly buying high and selling low) than from employing managers that under-performed an index.

Whipsawing is due to chasing "hot" trends and by a general lack of conviction and investment discipline. Even the most successfully implemented strategy can be rendered useless if abandoned at an inopportune time.

In the absence of a solid foundation, investors may lack the strength of conviction necessary to stay the course through a multitude of market cycles.

How Important is the Active vs. Passive Investing Decision to Advisors?

Responsibilities and Opportunities

Advisors have both the responsibility and the opportunity to guide their clients through the important financial decisions they are facing. When managing and monitoring clients' economic well being, advisors should steer their clients to concentrate on their total wealth and financial picture. The value of all investments—home, capitalized future pay, etc.—determines how much investors can afford to spend on goods and services today and in the future.

There is good news: investors' and advisory firms' priorities are finally aligned. The competitive landscape of the industry and its future trends highlight this fact.

Competitive Environment

In order to survive and compete in the emerging environment, independent advisory firms will have to clearly define and articulate the added value they provide.

The investment advisory industry will continue to be shaped by demographics, new technology and internal competitive forces. Advisory firms will need to provide unique services, as well as consolidate commodity-like tasks through outsourcing for quality control and cost savings.

The investment advisory industry faces a ripening environment for consolidation.The very fragmented nature of the industry, the potential future growth driven by the baby-boom generation approaching retirement, improving technology, more sophisticated intermediation and new entrants are all reshaping the competitive landscape of the business.

Holistic Approach

Successful advisory firms could help clients with estate planning, refinancing mortgages, tax planning, college funding, retirement-income projections, exercising stock options, analyzing insurance, etc. These services are client- centric and unique in nature. Unique services cannot be commoditized and can defend advisory firms against competition. Advisory firms that forego such services could feel significant competitive fee pressures.

Counting on investment selection alone will not be sufficient to differentiate an advisory firm from its competition.The problem of increased demand for ancillary services is compounded by the inherent difficulties of being a successful investment manager.

Put in perspective, the decision between actively managed or passively managed investments looks only marginally significant. Arguing about indexed investing vs. actively managed investing out of context puts the horse behind the cart.

Tactical Allocation – retain, delegate or ignore?

Understanding the main drivers of portfolio returns is a major step in properly implementing an investment strategy. In order of their influence on results, these drivers are:

1. Strategic asset allocation investment policy between growth and fixed- income investments. This allocation should be based on each client's unique objectives and risk tolerance. The policy allocation should be the foundation block of any long-term investment strategy.

2. Actively managed tactical allocation vs. a market neutral, static allocation. Significant value can be added (or detracted) by concentrating the portfolio in certain asset categories.

3. Selection of investments for each asset category may add (or detract) an additional layer of value.

A holistic approach based on the analysis of investors' unique circumstances should provide a strategic investment policy on what percentage of a portfolio should be in growth/equity oriented investments and what percentage in fixed income.

Tactical allocation among specific types of stocks (small or large, value or growth, foreign or domestic, etc.) and bonds (long or short, high-quality or low-quality, etc.) can be handled in one of two ways:

1. Investors retain the tactical asset allocation decision and actively manage the exposure to various categories. Most investors fall in this category whether they manage allocations in a disciplined, pre-determined fashion or simply let it fall where it may, as a residual of other decisions.

2. The investor ignores tactical allocation by selecting a neutrally weighted portfolio that reflects the entire available investment universe. Few investors select this truly passive asset allocation strategy. Given factors as homeland bias, investors tend to over-emphasize areas closer to home, consistently under-weighting foreign securities.

Only once both the strategic stock/bond allocation and the handling of the tactical allocation are decided upon, we can begin examining the merits and pitfalls of passive vs. active investment selection strategies.

Active vs. Passive Investing – Advantages and Disadvantages

Investment Selection - Passive Strategies

Passive investing presents some obvious advantages that are often publicized by indexing supporters.

Low cost - offers an incremental advantage that is both meaningful and certain. An active manager has to add enough value to overcome the cost disadvantage.

Reduced uncertainty of decision errors – investors are exposed to market risk simply by being invested. Reaching for returns in excess of those provided by the market brings about the additional risk of selecting the wrong investments.

Style consistency – If the appropriate indexes are selected, indexing, at least in theory, allows investors to control their overall allocation. Investors could only do this effectively through successful tactical allocation. There are no guarantees they will succeed.

Tax efficiency - Indexing is generally regarded as more tax efficient, though it is mostly the case for larger-cap indexes that are fairly stable and involve less trading. In smaller-cap indexes, where successful stocks grow in size and leave the index, tax liabilities resulting from more frequent rebalancings quickly accumulate.

Investment Selection - Active Strategies

The efficient market theory in its purest form strongly supports passive investing, as it dismisses the possibility for superior returns through investment selection. In reality, there are multiple market "anomalies" that do not support the efficient market theory, at least, not in its purest form.

Deeply rooted psychological biases negate the assumptions that all investors will act rationally. Passive strategies are also subject to certain natural biases, which may open the door to superior returns by active strategies.

Natural biases:

Large cap bias – Most indexes are market capitalization weighted. The largest holdings account for most of the return, causing indexes to out-perform active managers when large stocks do well, but under-perform when smaller companies are in favor. Historically, small companies have produced better returns than large ones.

Large market bias – The weighted nature of indexes also causes passive investors to maintain most investments in the largest markets. The largest markets are not necessarily the best performing.The over-emphasis on Japan in the EAFE index for instance, allowed most active international managers to out-perform that index for years.

Investment restrictions bias – Many large institutions are restricted by charter as to the types of securities they are allowed to purchase. Banks and insurance companies, for example, have many investment restrictions in building their bond portfolios. Such restrictions decrease market efficiency and leave openings to be exploited by opportunistic, skillful bond managers.

Psychological biases:

Cause and effect mismatches – Mistaking cause for effect could explain why investors tend to overbuy stocks with impressive earnings history, or with high past returns. Many investors assume past results are representative of future results. In reality, past results are representative of past events and will not necessarily repeat in the future. Excessive buying of stocks with high past returns leads to over-valuation. Active managers that are aware of this bias could benefit by avoiding many over-valued situations.

Conservatism bias – Once people have formed an opinion it is difficult to change it. The stocks of companies posting either positive or negative earning surprises tend to slowly reflect new information. Investors are initially unwilling to accept the new evidence of improved or diminished prospects. Active managers who recognize this fact could obtain superior returns by more quickly recognizing the new economic realities of the companies they research.

Narrow framing bias – Some long-term investors become obsessive about short-term price movements in a single stock or a narrowly-defined sector instead of focusing on changes in their total wealth. This phenomenon helps to explain excessive risk aversion. Narrowly-defined risk aversion leads to excessive under-valuation of certain stocks or sectors. The skilled, active managers who successfully recognize the narrow-framing bias could exploit excessive under-valuation.

Ambiguity aversion – People are excessively fearful of situations of ambiguity. Waiting for perfect information causes investors to miss superior returns. The lack of direct familiarity also explains the home bias most investors have. Over 90% of the equity allocation of U.S., UK or Japan investors is made in the home country. This is a much higher percentage than could be justified by the additional political or currency risk. Investors also tend to over- commit to their hometown companies, or even companies for which they work.

Ironically, the very success of indexing is based on the research work performed by active managers. The information disseminated through research by active managers leads to market efficiency. In a sense, passive investors are "free" riders, benefiting at no cost from the work of all active managers.

However, the more investors select indexing, the less efficient the markets become due to decreased research coverage.

Opportunistic, active managers could exploit increased inefficiencies and deliver market-beating returns. As a result, more investors would migrate to active styles in search of better returns. Research coverage, in turn, would increase, also increasing the efficiency of markets, therefore the relative attractiveness of passive management.

Passive management could not exist without active managers keeping the markets efficient.This apparent paradox serves as a natural "check and balance" system in the markets.

Unbiased investor advisors that correctly identify the advantages and disadvantages of both passive and active strategies can help their clients create investment portfolios that allow for the benefits of both worlds.

The Proper Way to Use Passive Strategies - What Makes a Good Index?

Requirements:

An index should accurately represent the universe of investment choices as well as the performance of the asset category it represents.

Growth indexes must accurately track the investment results of growth stocks and maximize separation from value index results. The separation of results is desirable and necessary in order to gain maximum diversification benefits from non-correlating asset categories.

An index should be investable.

A theoretical collection of stocks or bonds that an investor cannot feasibly purchase is not useful. Investors must have the option of investing in the benchmark index through an appropriate proxy (Vanguard S&P 500 Index Fund, iShares Russell 1000 Growth Index, etc.).

Index tracking errors by investable indexes are a fact of life. On occasion, index funds have significantly under-performed, the theoretical index they were designed to track.

Index should be truly passive and objective.

Subjective and qualitative screens are, by definition, not truly passive. Forcing the world into predefined categories results in indices that don't truly represent their intended target.

Considering the above requirements, an examination of the major index providers leads to certain practical conclusions. No index provider provides the best of all worlds.

Wilshire indexes offer the most market capitalization and style fine-tuning.They also offer the highest degree of return separation. However, they offer no investable alternatives.

Russell indexes come second in market capitalization and style fine-tuning as well as in return separation. Russell indexes can be purchased though iShares and are consistent with the investment universe many managers invest in across asset categories.

While good broad market benchmarks, the S&P Barra and Dow Jones indexes are the worst style-specific benchmarks. They are too simplistic and tend to overlap more. S&P Barra divides the world in value and growth only by looking at book value.

The proper way of using Active Strategies - How to select an active investment manager?

Investment Selection – Active Strategies

Most investment industry advertising includes the disclaimer: *"Past performance is not a guarantee of future results."* While this is a legal requirement, it is also very true.

In selecting investments, many investors and advisors alike, erroneously rely on past performance data. Numbers are widely available and, at least apparently, are easy to interpret. Last but not least, good past performance is also easy to sell.

In reality, one can expect consistently poor-performing managers to continue to perform poorly. The same cannot be said about managers who have demonstrated superior returns. These managers may not necessarily continue to do well, no matter how much most investors want to believe it.

Identifying active investment managers that are capable of beating passive, indexed strategies should go well beyond the numbers.

In many cases managers can become victims of their own success. Let's examine some of the reasons why previously successful managers may not repeat their index-topping performance in the future:

- Success leads to asset growth, lower flexibility and reduced investment alternatives.
- Success may lead to lack of focus (marketable star managers may be used to launch new products or simply in other non-investing capacities).
- Star managers may be lured away with higher pay by other firms.
- Star managers may quit to start their own firms, or simply lose interest and motivation.
- Success could lead to overconfidence, sloppiness and downplaying risks.
- Buyout of successful firms - could lead to a multitude of integration problems.

To overcome the inherent advantages of indexing, advisors recommending active strategies should be reasonably careful to avoid the above-mentioned pitfalls.

While there are no guarantees, there are certain attributes that most successful active managers have in common:

- Disciplined and research-oriented, providing a clearly articulated process.
- Low expenses - show commitment to higher returns to investors.
- A true passion for investing rather than a passion for empire building - shareholder interests should come ahead of the management company's interest.
- Close-knit investment teams - people who like each other tend to achieve better results as a team and are less likely to split.
- Consistency between the advertised investment process and the reality of operations.
- Interest of the managers are aligned with the interest of the shareholders through incentive systems.
- Unique investment edge: a successful proprietary valuation model, specific knowledge in any one area, quicker access to information, etc.

An in-depth qualitative research process could uncover active managers with a long-term sustainable edge. Such managers may indeed add an additional layer of value to the bottom–line of investors' portfolios.

Conclusion

While we found no overall right or wrong answer to the active vs. passive management debate, there are a myriad of valuable observations that can be professionally considered.

While there are advantages and disadvantages to using both active and passive strategies, we now understand that this debate should not be taken out of the context of investors' goals and objectives.

It is also important to keep in mind that the tactical allocation decision ultimately influences the decision between active and passive management. Finally, we have learned that, although passive strategies may have an edge in very efficient areas of the market, active strategies may have an edge in less efficient areas. Both strategies will continue to co-exist in the industry because their relationship is symbiotic.