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Elston Insights

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The active/passive debate revisited

- The active/passive debate is a hot topic again
- Whilst active asset allocation is key to driving portfolio returns…
- …active implementation using retail-long-only-single-asset-class-equity-funds (the focus of the debate) requires a more considered approach

The active/passive debate is a hot topic again

In recent weeks there have been a number of articles published in the financial media revisiting a familiar theme: the active vs passive debate. Here are some of the articles we have seen:

The smart way to invest in active mutual funds and make money – Bloomberg

The investing tide is shifting back towards active strategies - FT

How to get the best of both active and passive with an MPS – FT Adviser

In defence of active funds – FT Adviser

Passive Zealots really wind me up - Citywire

One article cites the comment of a "passive zealot" in a national newspaper:

> *"Investing in any market is a zero-sum game, before costs… This is due to the fact that the aggregate of all investors in a market equates to the index. In less efficient markets, there will be greater variance of managers' active returns, but they will still fall short, in aggregate, after management and trading costs."*

Anyone who participated in our CPD Webinar: Is Active Management a Zero Sum Game and agrees with some of Nobel laureate Professor William Sharpe's findings, might recognise that quote. But we agree being a "zealot" on anything is not helpful: a more nuanced approach makes sense.

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Defining terms

Most people launch into this debate without defining terms. If active management means active allocation across asset classes, then we agree it is essential. However if active management refers to security selection for a particular equity market, then we maintain that it is indeed a zero-sum game for long-only investors. Most retail single-asset-equity retail funds available to advisers and managers are "long-only" (no leverage, no shorting).

Is it really a zero-sum game?

As regards long-only retail equity funds, the statement in the comment bears true. Active fund managers in aggregate deliver index performance (for a given asset class) less active fees. For more on this see [Bill Sharpe's (yes, he invented the Sharpe ratio too) paper on "The Arithmetic of Active Management"].

Can active managers persistently outperform their index?

It depends. S&P conducts analysis of active funds and their performance against indices under the SPIVA banner (**S**&P **I**ndices **V**ersus **A**ctive). The SPIVA study evidence gives the following answers regarding active outperforming passive:

- NO for efficient markets (Global, US); and
- MAYBE for inefficient markets (UK Mid-cap/UK small-cap, Emerging Markets)

To check out the evidence, take a look at [our analysis of the SPIVA data] which specifically aims to evaluate this for UK-domiciled funds.

Where can advisers find out more on this?

You can spend an hour earning some CISI-endorsed CPD by going to ['Is Active Management a Zero-Sum Game?'] where I am in conversation with Dr. Tim Edwards of S&P Dow Jones Indices.

Does Elston believe in active management?

The question is too vague. It needs to be refined into three very different questions as follows:

1. **Does Elston believe in active management with respect to asset allocation?** Yes, absolutely! It's the main driver of portfolio outcomes. This is why the primary focus of the support we provide to our clients is on asset allocation research and recommendations. Asset allocation is not the *only* thing: it's (nearly) *everything*!
2. **Does Elston believe unconstrained active managers (e.g. hedge fund managers) can outperform the market persistently over time?** Yes but it's rare. Hedge funds can pretty much do anything - go long, go short, borrow to invest, have a concentrated portfolio, have huge single position sizes. It is *"true active"* management and we 100% believe in it. It's just rarely accessible to retail investors unfortunately, and true genius managers are (funnily enough) very rare to find.
3. **Does Elston believe that [single-asset-class retail-long-only equity] active fund managers can persistently beat the market over time, or during a given market regime?** As

above, *no* for efficient markets and *maybe* for inefficient markets. Partially because long-only active managers' hands are tied, for reasons as follows:

a) They cannot run high cash positions (so are always nearly fully invested in their asset class);
b) Many have to be benchmark-aware for compliance reasons (and indeed many are in fact closet trackers)
c) They *shouldn't* have a high proportion of obscure, illiquid holdings to juice-up (or destroy) returns
d) What they can have is high conviction/concentration, which can go very right or very wrong, which in aggregate again remains a zero-sum game.

Given that most adviser and manager portfolios are constructed with this type of fund, the bar is pretty high for active single asset funds to be worth the additional fees, in our view.

Some think we are passionate about index/passive funds only. Index funds/ETFs do a great job for delivering target asset allocations, keeping diversification high, liquidity ample and costs down. But incorporating index fund exposures doesn't mean we don't believe in active. We just believe in **true** active. And that's hard to find.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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