

(Standing against) The pursuit of averageness

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There have been plenty of articles in recent times highlighting the rise of passive investing and predicting the demise of active managers ('active' meaning those who purport to take positions different to industry benchmarks with the aim of outperforming them).

There is a side to the investment industry that resembles the fashion industry. For a while now passive and semi-passive investing - in the form of ETFs, 'smart beta' and DIY low cost investing – has been prancing down the catwalk. And apparently it is really cool.

But there is another feature investing has in common with the world of fashion, and that is the tendency for investors to look back on earlier enthusiasm and wonder "what was I thinking?"

There are some perfectly sensible arguments for passive investing. It is just that these rarely feature in the discussion. More often than not it involves a flimsy critique of active management, or equally superficial advocacy of passive methods, usually with the aim of selling 'passive' products.

The usual narrative on this topic is uninformative to say the least. But in some cases, it goes further to create an inaccurate impression of risk and return, and dangerous overconfidence amongst investors. This is the motivation for adding some balance to the discussion here.

The case for passive investing

Whatever reasons are argued for taking a passive approach, the investor should know that they are, first and foremost, accepting the following position...

"As a passive investor I am content with achieving an average investment outcome"

In most cases this is because...

"I am happy to forgo the potential for a better than average outcome in return for removing the potential for a worse than average outcome"

It is important that these central truths are accepted *consciously*. If the passive investor is not fully aware of their decision to target mediocre outcomes, they may experience disappointment when they actually achieve them!

Additional rationale for passive investing may be legitimate, but they should always acknowledge the limitations. Too often these truths are masked by superficial arguments, and mediocrity is accepted *unconsciously*.

So, let's have a look at some of the common arguments for passive investing, and balance those arguments with their own limitations.

Low cost

The prospect of lower fees provides a reasonable argument for passive investment, but only if the above-mentioned limitations have been consciously considered and accepted.

All too often the passive argument equates low cost with superiority, without considering the broader implications. Passive investing should indeed be available at low cost. This is because it requires little human thought or analysis, can be largely automated, is easy to replicate, and therefore by definition produces average results.

But before nodding emphatically that low cost is a good thing, the prospective passive investor needs to make at least one active decision. They should first actively decide whether they wish to follow an approach that requires little human thought or analysis, is largely automated and easy to replicate, and which distinguishes itself by producing average results. Having thought about why passive investing is low cost, they can at least proceed with their eyes open.

Low cost solutions can appear tempting, and the investor's desire to reduce fees can dominate their thinking. Choosing a passive fund rather than an active fund almost certainly will reduce the headline fee level. But this does not account for the forgone potential for better than average compounding of wealth, and active risk management.

If an active manager over time compounds outperformance net of their "active fee", this would logically seem a better outcome. But the response of the committed passive investor is that the outperforming active manager is an elusive, even mythical creature. And thus there is no point in trying. Let's consider this next.

Most active managers underperform

Many active managers do indeed underperform, but this is a weak argument for passive investing. The same point is made every year, with studies across many markets citing that 70%+ of active managers fail to outperform the broad market after fees, as though this is some new revelation.

Why is this a weak argument? Because the fact that "*most active managers underperform*" is incorrectly used to assert that "*active managers have no skill and can only outperform by luck. It is not worth trying to select a good active manager*".

This is incredibly superficial. If we think about why most active managers underperform we can account, quite easily for a large component of this. A large proportion of the money under an "active" approach is managed with minimal divergence from market benchmarks (just look at the top ten holdings of the largest funds versus benchmark).

It is likely that fund manager 'business risk' and 'career risk' drive this behaviour, but that is not key to this discussion. Simply, if you hold similar positions to the benchmark, and charge

an active fee, it should be expected that you will underperform after fees. This is not a revelation, it is obvious.

Importantly, benchmark hugging behaviour is not difficult to identify. With a little effort, investors interested in a better than average outcome can avoid these approaches and narrow down their search considerably to more “active”, active managers. An important caveat here - even successful active managers will not outperform consistently every month, quarter or even year. For investors who hold this unrealistic expectation of an active manager, passive investing is undoubtedly the only viable route.

For those who can live with the fact that outperformance will not accrue in a nice linear fashion, let's move on to the next contention from the passive side. This one says that even if outperformance (or “alpha”) is possible, it has little bearing on investment outcomes.

Asset allocation is all that matters – alpha is not important

The origin of this argument is presumably the 1986 paper “[Determinants of Portfolio Performance](#),” by Brinson, Hood and Beebower. It is unclear whether most proponents of the argument have actually read the paper, because it is rarely referenced.

In any case, the argument is that asset allocation accounts for most of portfolio returns and therefore attempting to add active outperformance from other sources (e.g. stock selection) is a waste of time.

As with some of the other arguments covered here, this one is often dressed up as uncommon sense followed by the wise few, while fools waste their time with stock picking.

This is where many proponents of this view demonstrate they have not dedicated much thought to the matter. There is a very simple way to look at this. It is true that asset allocation matters a lot. But rather than uncommon wisdom, it is blatantly obvious, though still not a reason to shun active management.

To highlight this, over the last 114 years^[1] Australian equities (passive) have delivered an average annualised real return of 7.4%, while Australian government bonds have returned 1.5%. This means that after inflation, \$1 invested in Australian shares in 1900 is today worth \$3332, while the same investment into bonds would be worth only \$5.70. It doesn't take a genius to work out that asset allocation matters – a lot.

But now if we take the Australian equity figures and ask what would have happened if an active approach managed to average three percent annual outperformance over this time period, we find that the \$1 would have become \$77,000.

To make this more tangible to an investor today, suppose you have \$100,000 to invest for the next 25 years, and assume the same average annualised real returns. In bonds this grows to \$146,500, in passive equities \$592,270 and, assuming three percent outperformance, in active equities it becomes \$1,180,000.

So while it would be wrong to say outperformance is easy, it is certainly also wrong to say that it does not matter. And there are impressive long term track records out there that prove it exists.

But even active managers with a successful track record are not safe. Another line of criticism claims that outperformance does not reflect skill. Instead, the theory goes, any outperformance is simply coming from common market ‘factors’ – which can be easily extracted via systematic passive investing. This misguided perception that active managers are all alike, and entirely devoid of skill, has contributed to the rise of new, ‘innovative’ passive approaches. This is what we turn to now.

“Smart beta” is the new passive, or active, or something...

This particular line of thinking has given rise to a new range of investment products, and conveniently ripened them for promotion. It concedes that the traditional passive approach may not be ideal, but still disputes the existence of active skill.

So called “smart beta” strategies attempt to systematically identify features of stocks that will lead to better portfolio weightings and outcomes than traditional market capitalisation weighted benchmarks.

The first thing to highlight is that market capitalisation weighting is the purest form of passive investing. To make the point, if you had enough money to buy all the listed stocks in Australia without making active decisions, you would end up with a market cap weighted portfolio. Given passive investing centres around the belief that markets are efficient, the passive investor wouldn’t question whether the prices (market caps) of companies were fair.

This fact may put the smart beta crew at risk of experiencing an identity crisis in later life. If you say active management is a waste of time, but claim your approach is better than pure passive investing, then what are you? Once you adjust the pure passive approach, it involves some active shift from the market portfolio.

Maybe you can call it passive – because it is available at a low fee, involves little thought and is easy to replicate! But “smart beta” is a misnomer – it is really “dumb quant”, “no-frills active” or maybe “no-skills active”. In any case, it does involve active positions. So if it performs better than average over the long term, you will have got a good deal. If it does average or worse, then perhaps you get what you paid for!

So investors should be aware that smart beta can certainly do worse than average. But it does at least provide access to “no-skills active” mediocrity at a cheaper price - for those that really want it.

Whether you consider a pure passive approach, or an “active approach in passive clothing”, the question of risk is all important, and one where perception may deviate from reality.

Passive investments are less risky

The perception that passive investments involve less risk than their active cousins flows from a number of sources. These can be broadly categorised as relating to either relative risk, or absolute risk.

We can deal with relative risk pretty quickly. Passive investments have less relative risk. For investors whose definition of intolerable risk is *any period of underperformance compared to the broad market*, they should take a passive approach.

The “*compared to the broad market*” part of the above definition is all important. Pure passive strategies can certainly eliminate risk of underperforming the index they are replicating. On the other hand they are entirely capable of underperforming active managers, both in up markets and in down markets. If watching this happen would cause a passive investor great discomfort, and the risk of capitulating at the worst possible time, they need to revisit their definition of risk.

Regarding smart beta, as noted above, this is really “no-skills active”, and so it does have relative risk – depending on which benchmark you compare it against. For those that wish to view it as passive, simply compare it against itself and the relative risk goes away - problem solved!

Absolute risk is a more complex matter because there are so many definitions and it is highly subjective. A general perception is that passive investing is less speculative in nature, because it is broadly diversified, and because it doesn’t attempt to pick (consciously select) individual companies.

It is true that diversification is sensible and reduces risk. But that can be achieved with active management. With regard to stock specific risk, the passive index may have similar or even more risk. An ASX 200 ETF for example would concentrate 46% of an investor’s exposure into the top ten stocks, and 26% into the four big banks. Passive approaches still pick individual companies – they just apply a different rationale. The key advantage enjoyed by a passive manager is that when something goes wrong, they can claim “it wasn’t me – the market made me do it!”

Whilst on the speculative nature of active versus passive, it is interesting to consider the most basic definition of speculation – “The forming of conjecture without firm evidence”. The passive investor is, whether consciously or unconsciously, saying it is a good idea to buy all of these companies, without firm evidence.

In contrast, some active investors focus on fundamental valuation discipline in deciding how to invest. They believe that if you do not have a strong view of the value of a company, based on available facts, then you have no idea whether you are overpaying and should not invest. In terms of absolute risk, overpaying is the surest path to permanent loss of capital. In this regard, the passive investor could be said to be more speculative than valuation based active investing. This is a key part of risk management in active investing, but is less obvious to the casual observer.

Another point on risk is the perception that passive strategies are more objective, more transparent, and therefore less prone to slick salesmanship than actively managed offerings.

A recent presentation making the case for investing in a US equity ETF provided a reminder that passive products have no waiver on this front. The argument was that US market valuations are elevated for a reason and have further to go. It also added that US corporate profits are at record highs, providing another reason to invest.

To balance this argument, we refer to a comment from Jeremy Grantham:

“Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism.”

Investors should of course make up their own minds, consciously. But it is important to note that some active managers provide transparency equal to or greater than passive managers. Moreover, investors should remember that providers of passive products (and smart beta), are no better, nor worse, than active managers when it comes to self-interest and the desire to raise assets.

Summing this all up, investors should think carefully and consciously about their investment beliefs before wading into the latest high fashion. Across all classes of investment, history is littered with examples where popular investment ideas looked most enticing on the eve of being exposed as the latest emperor’s new clothing.

[1] Credit Suisse Global Returns Yearbook 2014