



ACTIVE INVESTING: REST IN PEACE OR RESURGENT FORCE?

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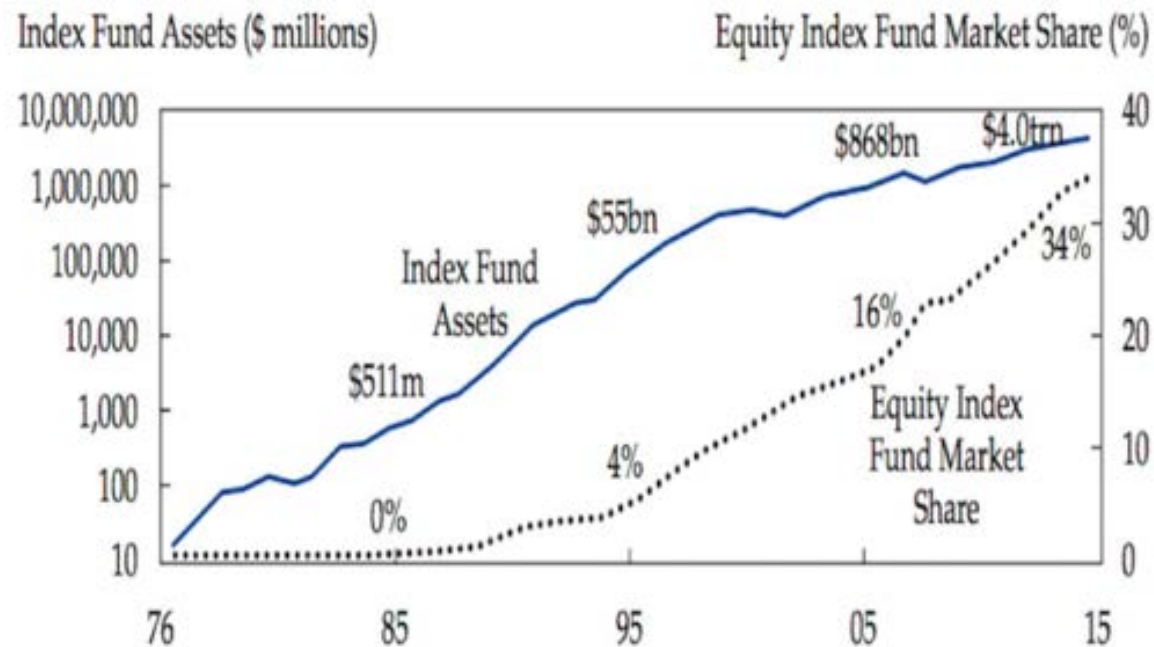
The Active/Passive Divide



Jack Bogle, the Greatest Disruptor?

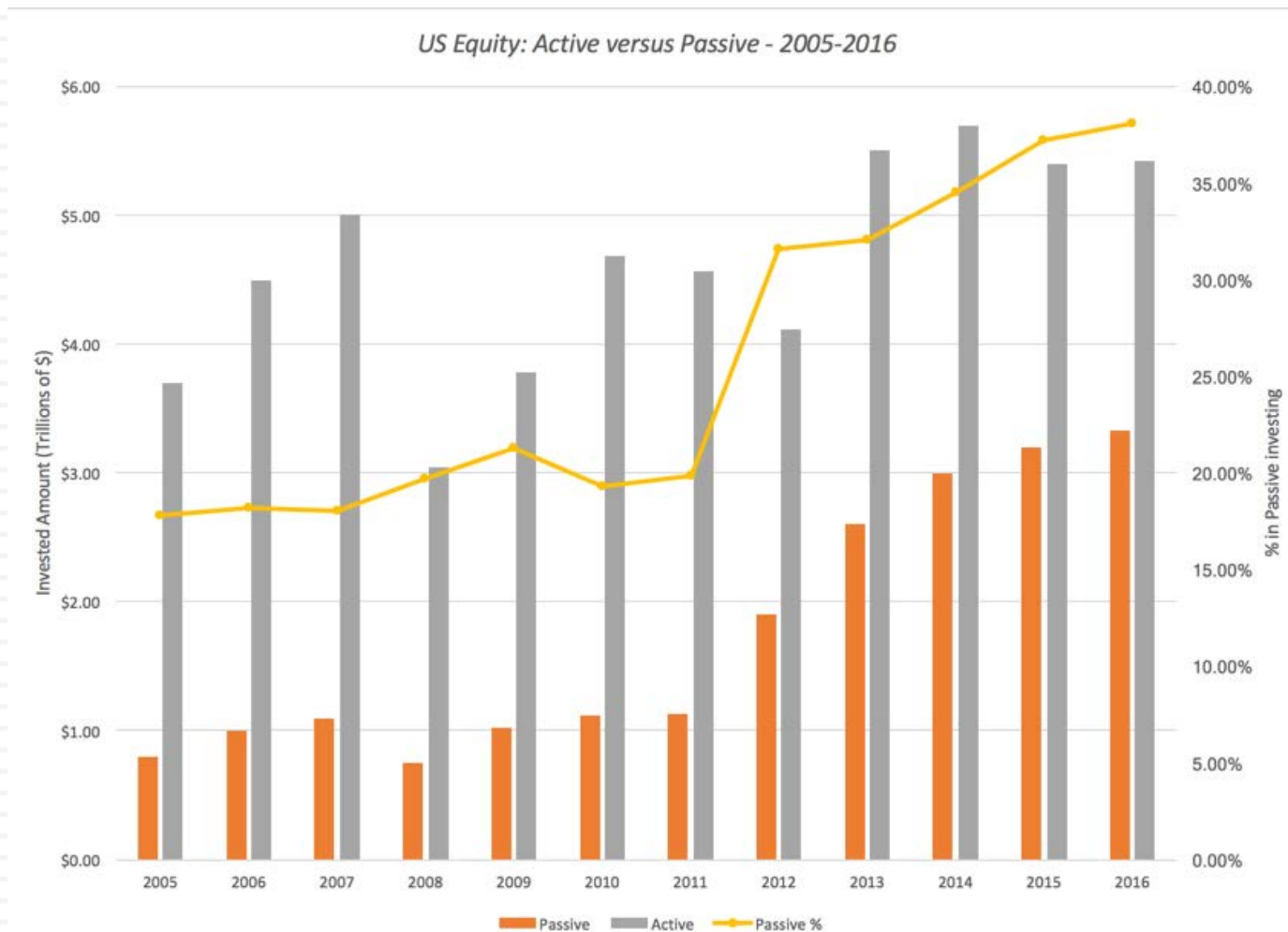
Markets  Chart of the Day

Figure 1. The Growth of the Index Fund



Sources: Morningstar; Strategic Insight Simfund.

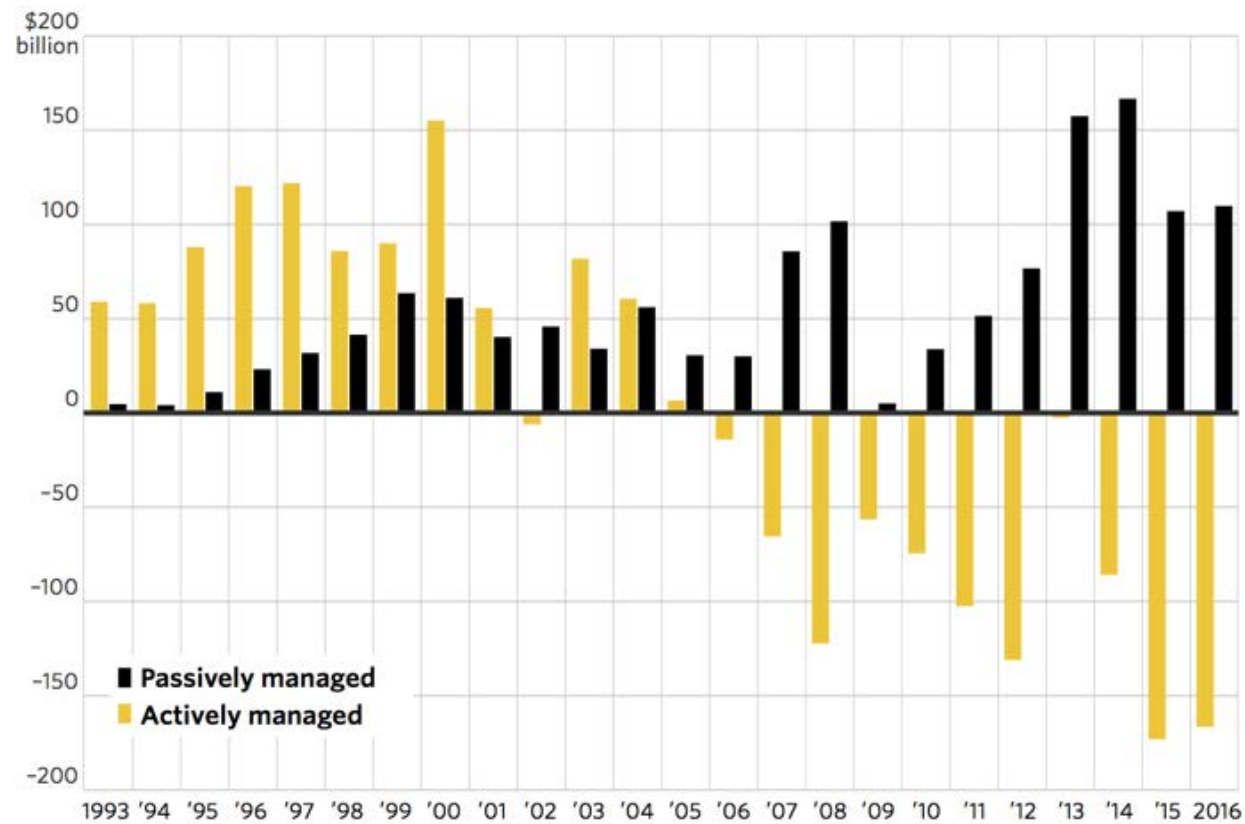
The Disruption Pace Quickens



And the fund flows back it up

Actively Departing

Net flows of U.S. stock mutual and exchange-traded funds

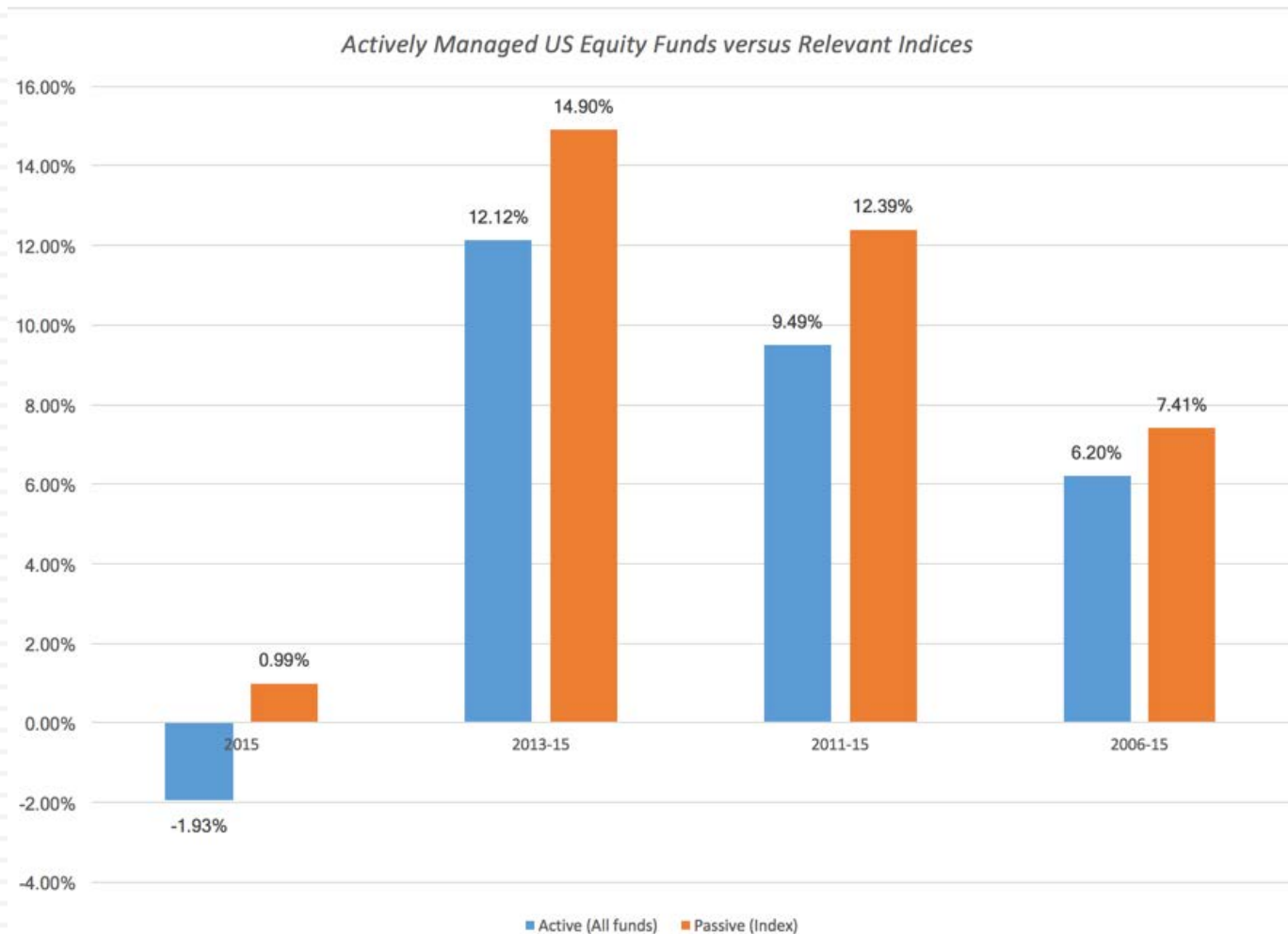


Source: Morningstar

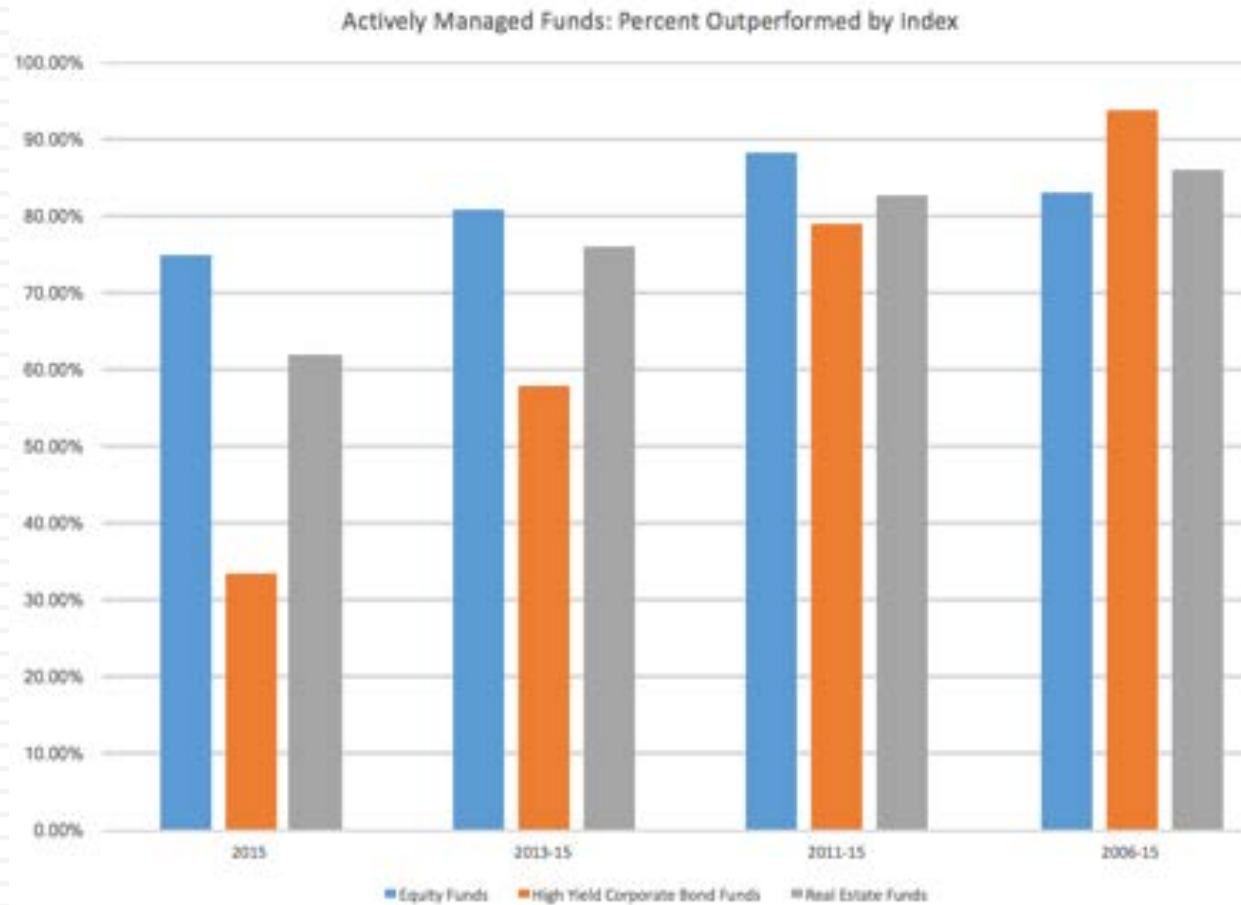
1. Active Investing cannot collectively beat the market... here's why..

- During 2015, for instance, about 40% of institutional money in equities was invested in index funds and ETFs and about 60% in active investing of all types.
- The money invested in index funds and ETFs will track the index, with a very small percentage (about 0.11%) going to cover the minimal transactions costs.
- Thus, active money managers have to start off with the acceptance that they collectively cannot beat the index and that their costs (transactions and management fees) will have to come out of the index returns

And they don't come close in delivering returns..



Or in beating their passive counterparts



2a. And the under performance cuts across style classes

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	Excess Return			% Outperformed by Index		
	<i>Small Cap</i>	<i>Mid Cap</i>	<i>Large Cap</i>	<i>Small Cap</i>	<i>Mid Cap</i>	<i>Large Cap</i>
Growth	-3.44%	-1.97%	-2.19%	91.89%	81.48%	86.54%
Core	-3.13%	-1.88%	-2.16%	91.44%	76.51%	88.26%
Value	-2.98%	-1.03%	-1.76%	92.31%	70.27%	82.17%
All	-3.02%	-1.59%	-2.19%	90.13%	76.69%	84.15%

2b. And across geographies..

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	Developed Markets		
<i>Country</i>	<i>One Year</i>	<i>Three Years</i>	<i>Five Years</i>
Australia	59.68%	65.69%	88.43%
Europe	31.94%	63.77%	80.63%
Japan	46.36%	58.20%	59.33%
US	74.81%	80.85%	88.43%
	Emerging Markets		
<i>Country</i>	<i>One Year</i>	<i>Three Years</i>	<i>Five Years</i>
Brazil	48.02%	70.63%	72.00%
Chile	88.37%	83.72%	93.33%
Mexico	67.35%	63.83%	76.19%
India	35.79%	46.79%	56.52%
Emerging	46.45%	59.54%	54.61%
South Africa	50.63%	63.36%	74.58%

3a. There is no consistency.. Winners don't stay winners for long

If there is consistency in performance, funds in a specific quartile should be more likely to stay in that quartile than move to another. The shaded numbers on the diagonal should all be much higher than 25%.

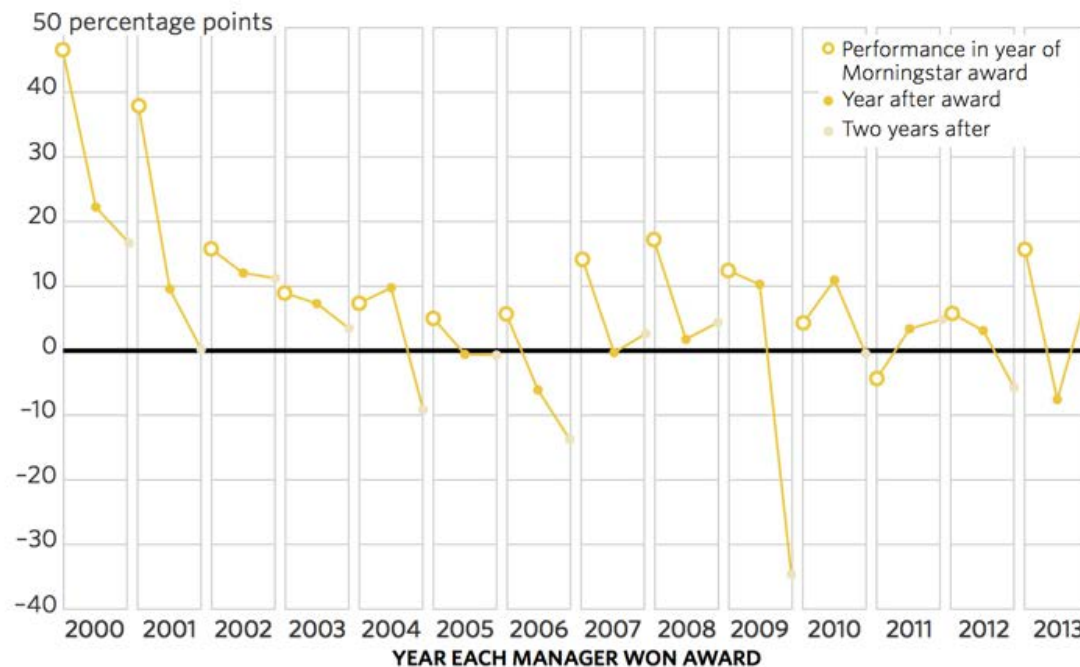
		<i>Following three year period</i>				
		<i>Quartile 1</i>	<i>Quartile 2</i>	<i>Quartile 3</i>	<i>Quartile 4</i>	<i>Merged/Liquidated</i>
<i>Last year</i>	Quartile 1	16.53%	21.42%	25.80%	29.51%	6.75%
	Quartile 2	27.10%	23.06%	21.89%	19.19%	8.75%
	Quartile 3	26.31%	21.92%	19.90%	16.02%	15.85%
	Quartile 4	15.18%	18.72%	17.37%	20.40%	28.33%

A top performing fund in the last year is more likely to become among the worst performing in the next few periods, than stay top performing.

A large percentage of the worst performing funds fail or are merged, creating a strong survivor bias. Consequently, any study that looks at the returns on only those funds that survived is likely to overstate the returns earned by actively managed funds.

3b. And super star managers fade quickly..

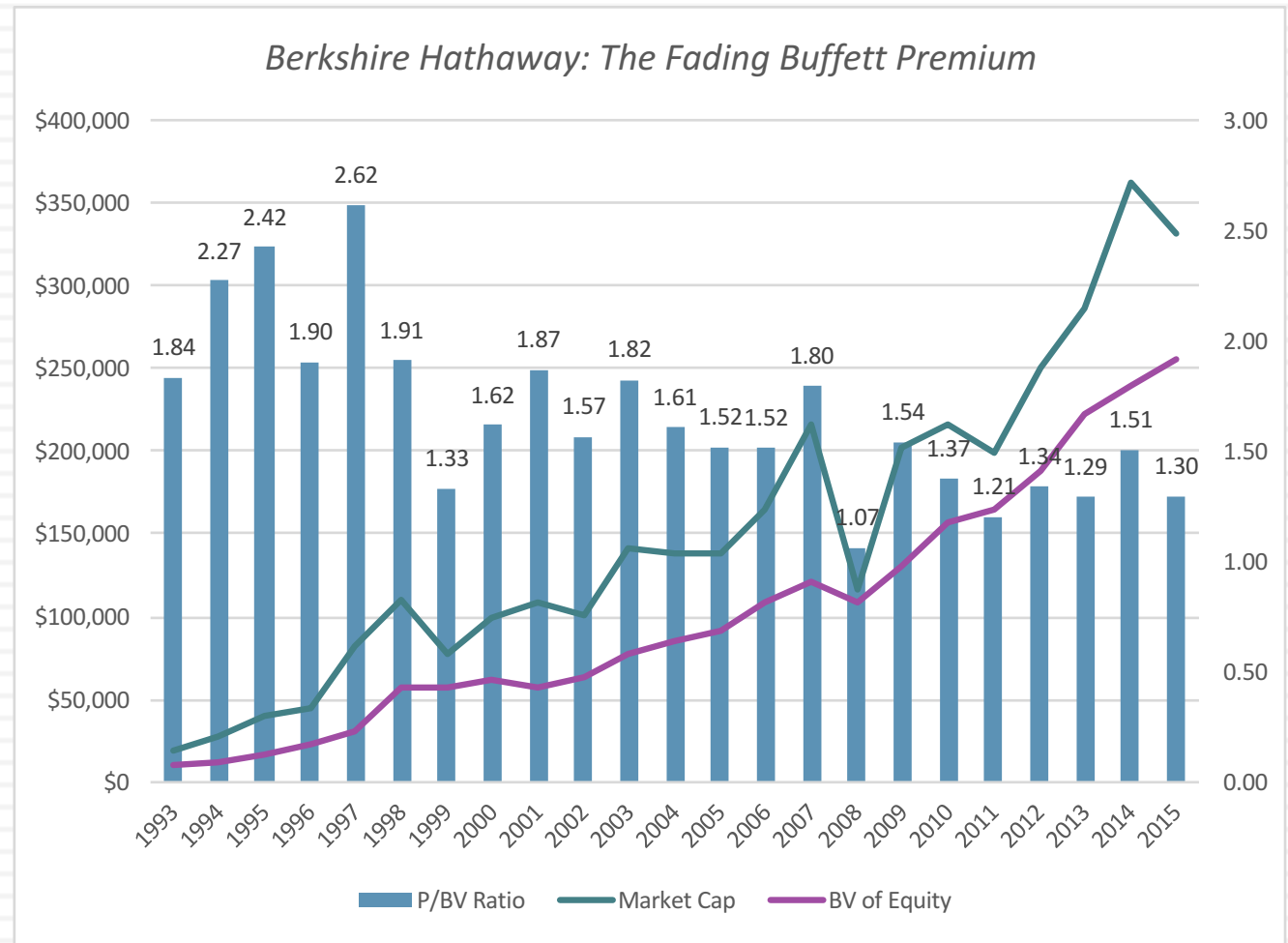
Managers named by Morningstar as top performers for a given year generally didn't perform as well relative to the S&P 500 in subsequent years.



Note: Performance of Morningstar Domestic Stock Fund Manager of the Year, relative to annual total return of the S&P 500. Analysis uses largest fund if manager helmed multiple funds.

Source: Morningstar

Active Investing's last gasp defense..



The Future of Active Investing

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- The active investing business will shrink: Fees will continue to drop but market share will also continue to decline. It will be less profitable and hire fewer people as analysts, portfolio managers and support staff.
- More disruption is coming: The businesses that are most ripe for disruption are ones where the business is big (in terms of dollars spent), the value added is small relative to the costs of running the business and where everyone involved (businesses and their customers) are all unhappy with the status quo. That fits the active money management perfectly and it should come as no surprise that the next wave of disruption is coming from fintech companies

The Dark Side of Passive Investing?

- Corporate Governance: The critics of passive investors point to the fact that Vanguard and Blackrock vote with management more than 90% of the time.
- Information Efficiency: Active investors collect and process information, trying to find market mistakes, they play a role in keeping prices informative. This is the point that was being made, perhaps inartfully, by the Bernstein piece on how passive investing was worse than Marxism and leading to serfdom.
- Product Markets: There are some who argue that the growth of passive investing is reducing product market competition, increasing prices for customers, and they give two reasons.
 - The first is that passive investors steer their money to the largest market cap companies and as a consequence, these companies can only get bigger.
 - The second is that when two or more large companies in a sector are owned mostly by the same passive investors (say Blackrock and Vanguard), it is suggested that they are more likely to collude to maximize the collective profits to the owners.

Your Choices

- Should be an active or passive investor? There is no one answer that will fit all and each of us has to make the judgment that best reflects us (both in terms of financial standing and personal characteristics).
- As I see it, you have three choices:
 - Go passive: Decide on how much risk you want to take, diversify broadly and hold index funds/ETFs to match your risk profile and cash flow needs.
 - Go active: This can range the spectrum from market timing to stock picking, short time to long time horizons and different investment philosophies.
 - A Hybrid: You can mix active and passive shifting from one to the other over time or using one for one part of your portfolio (pension fund) and another for a different part of your portfolio (savings).

Here are mine..

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- **I am an active investor** on the portions of my investment portfolio that I can control. My justification is not that I have better information, can process that information more efficiently (in valuation models) or that I have special insights on markets.
- I have two factors working in my favor:
 - ▣ I understand and get along with **my client**. I invest for myself.
 - ▣ I have **faith** in value and that market prices converge on value.
- That said, I will be at peace with myself, if at the end of my investing life, I look back at the returns that I have made and conclude that I could have done as well or better, investing in index funds. **I enjoy investing.**