ACTIVE INVESTING: REST IN PEACE OR RESURGENT FORCE?

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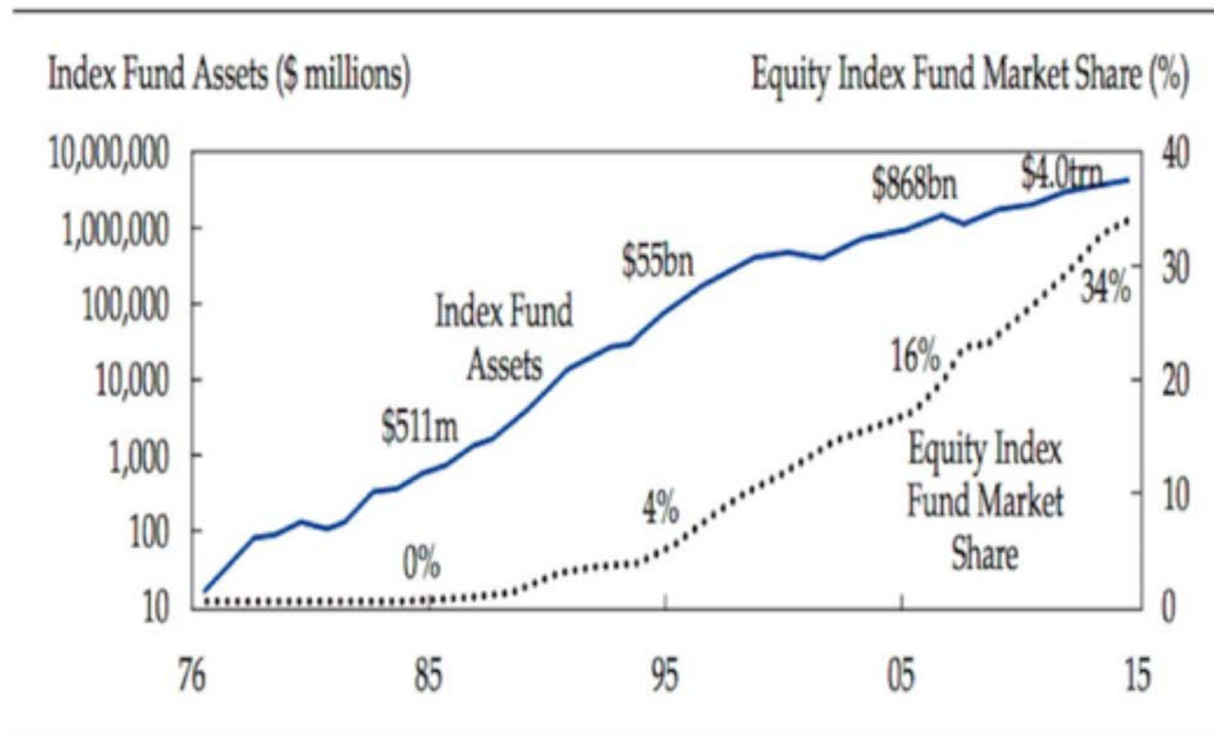
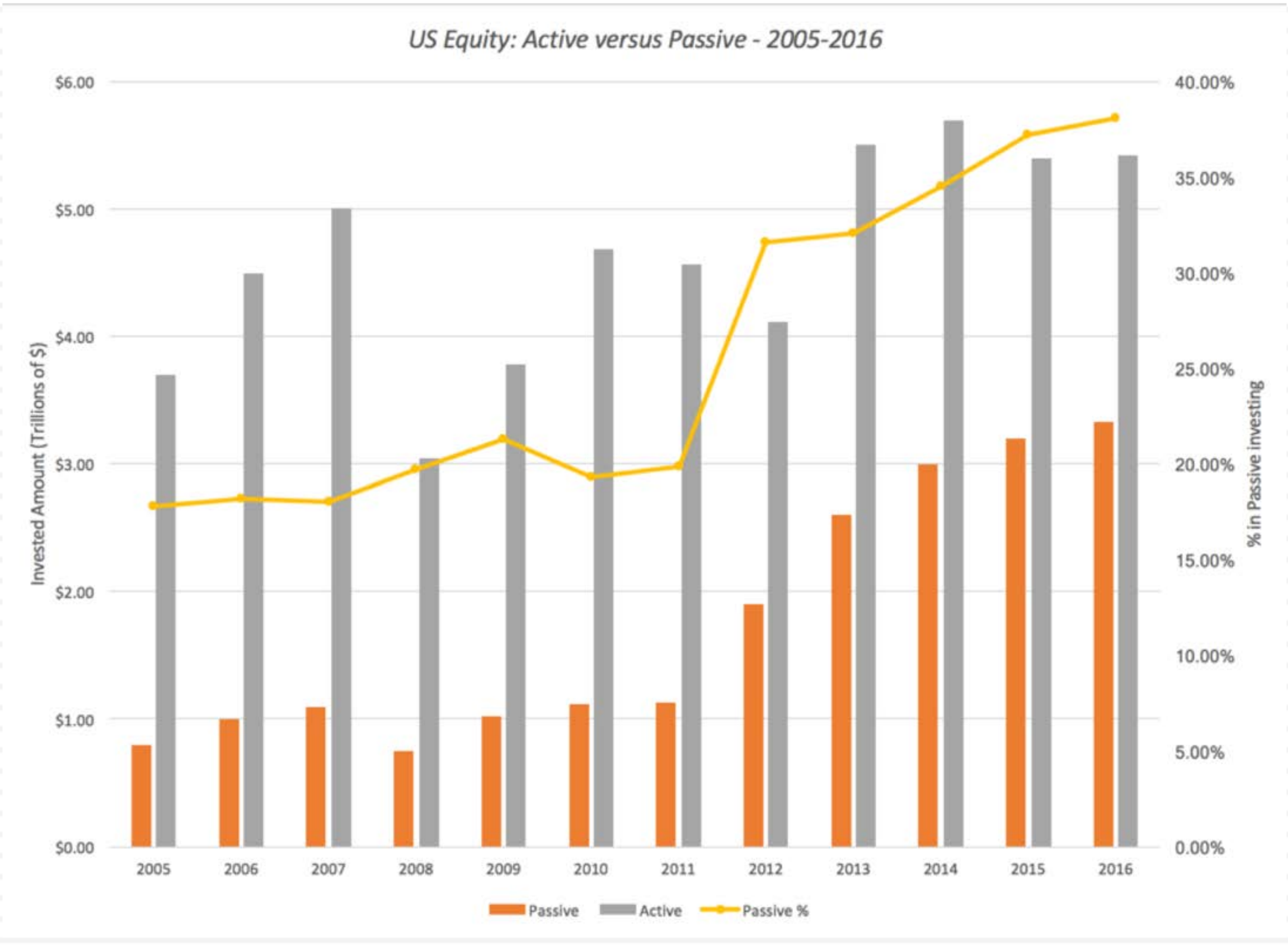
The Active/Passive Divide

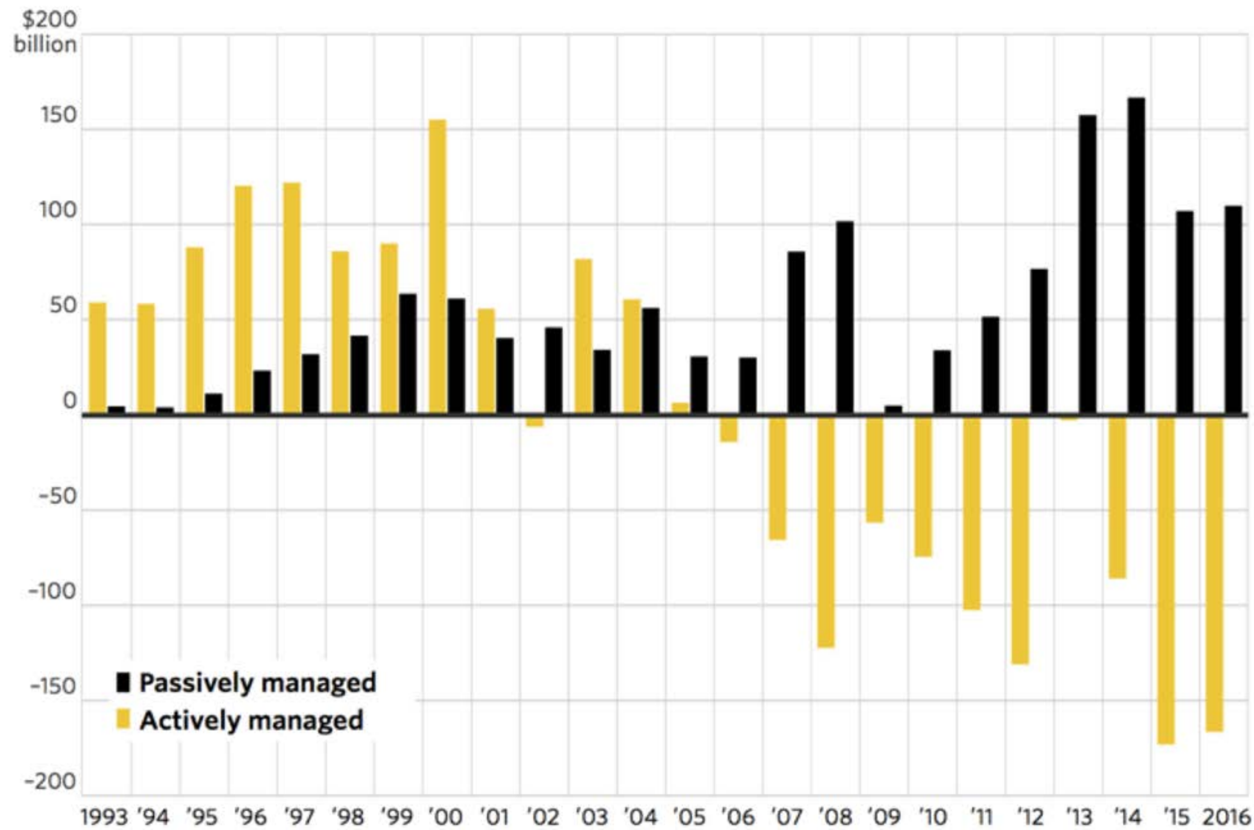
Jack Bogle, the Greatest Disruptor?



The Disruption Pace Quickens



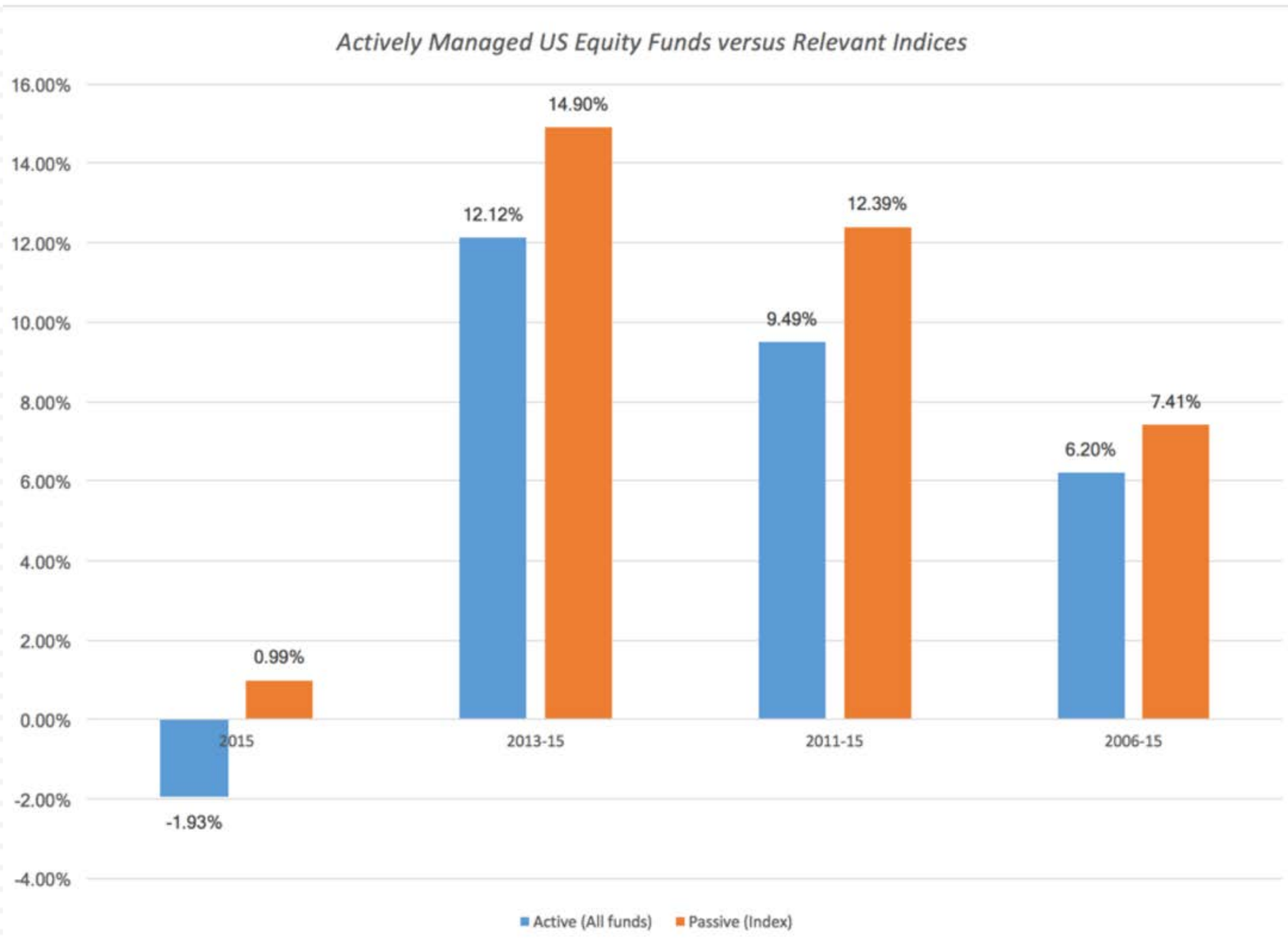
And the fund flows back it up



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

	Excess Return			% Outperformed by Index		
	Small Cap	*Mid Cap*	*Large Cap*	*Small Cap*	*Mid Cap*	*Large Cap*
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%
Alll	-3.02%	-1.59%	-2.19%	90.13%	76.69%	84.15%

2b. And across geographies..

	Developed Markets		
Country	One Year	Three Years	Five Years
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		
Country	One Year	Three Years	Five Years
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

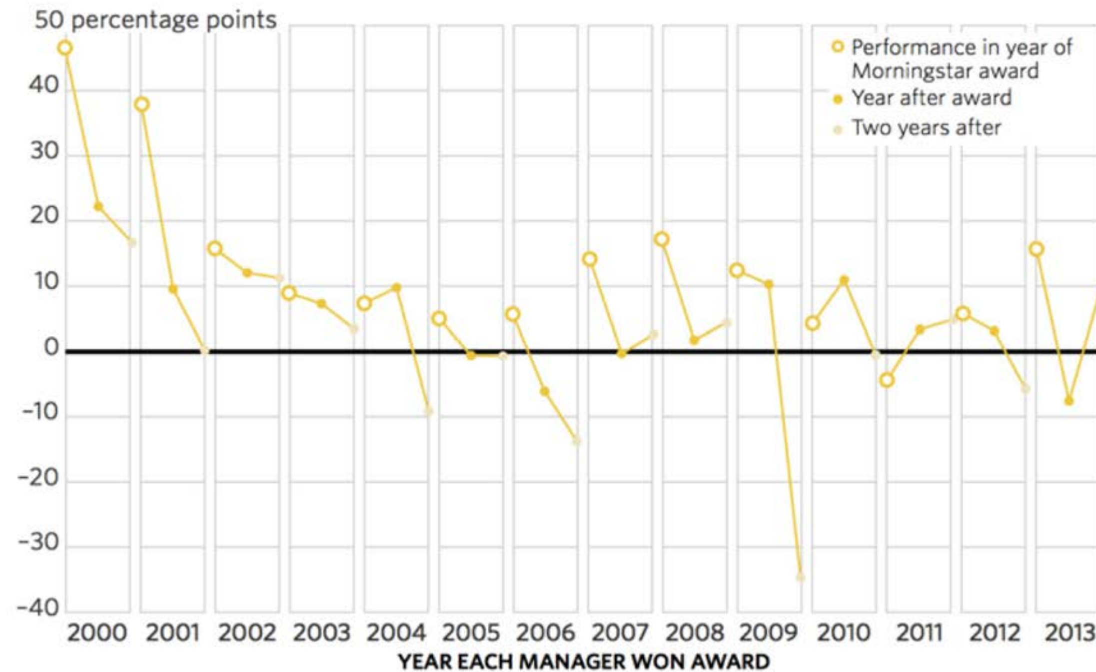
If there is consistency in performance, funds in a specific quartile should be more likely to stay in that quartile than move to another. The shaded numbers on the diagonal should all be much higher than 25%.

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

		Following three year period				
		Quartile 1	*Quartile 2*	*Quartile 3*	*Quartile 4*	*Merged/Liquidated*
Last year	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 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..



Active Investing’s last gasp defense..

Berkshire Hathaway: The Fading Buffett Premium

$400,000
$350,000
$300,000
$250,000
$200,000
$150,000
$100,000
$50,000
$0

3.00
2.50
2.00
1.50
1.00
0.50
0.00

Year	P/BV Ratio
1993	1.84
1994	2.27
1995	2.42
1996	1.90
1997	2.62
1998	1.91
1999	1.33
2000	1.62
2001	1.87
2002	1.57
2003	1.82
2004	1.61
2005	1.52
2006	1.52
2007	1.80
2008	1.07
2009	1.54
2010	1.37
2011	1.21
2012	1.34
2013	1.29
2014	1.51
2015	1.30

P/BV Ratio — Market Cap — BV of Equity

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.

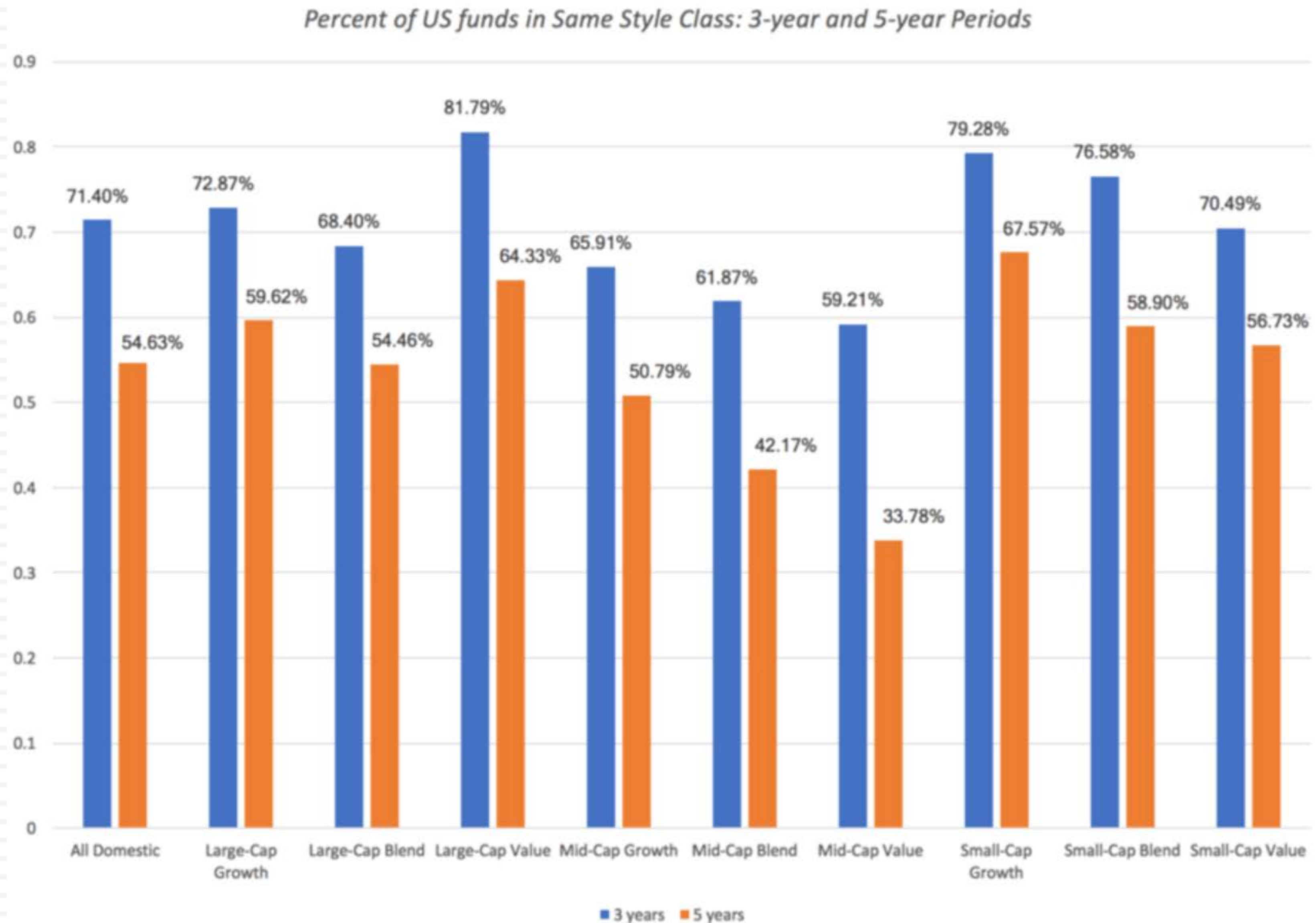
The Roots of the Active Investing Malaise

1. A Flatter Investment World: The advantages that professional money managers have over retail investors have shrunk considerably.
2. No Core Philosophy: Most professional money managers seem to have no core philosophy, careening from one to another, based upon last year's winners.
3. Bloated Cost Structures: The costs of professional money managers reflect an older, more forgiving investment world.
4. Career Protection: To survive as an active money manager, you may have to settle for either consistent mediocrity or one-shot success.
5. Macro Factors: The shift to local from global, across the world, and to a lower-interest rate, higher risk premium world has made stock picking a less lucrative game.

1. A Flatter Investment World

- From information to processing models to trading platforms, professionals at the active investing game (including mutual funds and hedge funds) and individual investors are on a much more even playing field than ever before.
- Regulatory authorities, especially in developed markets, have cut down on inside sources.
- Even when institutions find an edge to exploit, say with flash trading, it is worth noting that the returns, while lucrative at first, fade quickly as imitators step in.

2. No Core Philosophy



3. Bloated Cost Structure

4. Career Protection

1. Scaling up pressure: To the extent that their income is a function of assets under management (AUM), it is very difficult, if not impossible, to fight the urge to scale up a strategy to accommodate new inflows, even if it is not scalable
2. Quasi Indexing: If you are a money manager running an established fund, it is far less risky (from a career perspective) to adopt a strategy of sustained, low-level mediocrity than one that tries to beat the market by substantial amounts. This has led some of the largest funds to quasi-index.
3. Lottery Investing: At the other end of the spectrum, if you are a small, active money manager trying to make a name for yourself, you will naturally be drawn to high-risk, high-payoff strategies, even if they are bad bets on an expected value basis

5. Macro Factors

- Structural Shift: The old order (with a clear line of demarcation between developed & emerging markets) is being replaced with a new one (with new power centers and shifting risks), upending historical relationships and patterns.
- No more mean reversion: Given how much of active money management is built on mean reversion and lessons learned by poring over US market data from the last century, it should come as no surprise that the payoff to screening stocks or following rigid investing rules has declined.

And clients bear some of the blame..

- Don’t ask, don’t know: Knowing past returns are too good to be true, they refuse to ask questions, perhaps because they don’t want to hear the answers.
- Long term in principle, short term in results: They claim to be long term, while demanding to see positive performance every three months.
- Make me a lot of money, but don’t ever lose a lot: They complain about quasi indexing (while using tracking error to make sure that deviations from the index get punished)
- Not my fault: They refuse to take responsibility for their own financial affairs (blaming their financial advisors for all that goes bad).

In effect, clients get the active money managers they deserve.

The Future of Active Investing

- 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.
- Quant investing is not the answer. Anything that can be quantified can be imitated and anything that can be imitated will./

A Pathway to Active Investing Success

1. Have an investment philosophy that fits you: The best investment philosophy for you is the one that best fits you as an investor, in sync not only with your views about markets but with your personal makeup (in terms of patience, liquidity needs and skill sets).
2. Balance faith with feedback: Investing requires balancing faith with feedback, faith in your core market beliefs with enough of an acceptance that you can be wrong on the details, to allow for feedback that can modify your investing decisions.
3. Find your investing edge: Drawing on the language of competitive advantages and moats, what sets you apart does not have to be unique but it does have to be scarce and not easily replicable.

Potential Edges in Investing

1. In sync with client(s): If you are managing other people's money, your most consequential decision will be the screening your clients, turning money away from those who are not suited to your investment philosophy
2. Sell Liquidity: To be able to sell liquidity to investors seeking it, especially in the midst of a crisis, is perhaps one of investing's few remaining solid bets.
3. Tax Play: Investor price assets to generate after-tax returns and if you are an investor with a different tax profile, paying either no or low taxes, you will be able to capture some of the return differential.
4. Big Picture Perspective: As we become a world of specialists, there is an opening for "big picture" investors, those who can see the forest for the trees and retain perspective by looking across markets and across time.

Individual Investor Choices

- Should you 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..

- **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**.

A Picture to hold on to…