July 25, 2017

Active Management To Better Serve Clients

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The pace of growth of passive investment in recent years is striking. Drivers of that growth are not hard to find: near-zero interest rates and central bank asset purchases have helped drive asset price inflation and narrow market breadth, an ideal combination for passive strategies; investors and regulators focusing on fees; technology enabling new strategies and approaches. Reflecting further however, we can see that all of these have merely helped facilitate a shift driven more by changes in risk appetite as investors, burned by the volatility of the last two decades, have become more risk averse.

These individual decisions however will affect not just individual investor portfolios, but may have broader consequences for markets and the broader economy. Herein we explore some potential impacts and unintended consequences, to gain some perspective and ask some thought-provoking questions.

A Passive Future?

Imagine a future where virtually all public market investment is passive. Without active managers looking for management to justify their strategy and performance, the feedback loop has gone quiet. Companies turn inward since disinterested investors leave management to themselves. Only highly egregious acts elicit responses from the minimal staff passive managers can justify given near zero fees. Management ego and greed come to dominate corporate activity. Management focuses on financial engineering to crystallize value, and grow through acquisitions rather than strategic investments. Acquisitions are an easier way to grow and keep the market capitalization, and through it the index weight, rising.

Index construction rules drive the playbook, and not only among constituent companies. This predictability also breeds opportunity for others to siphon off gains. Activist investors look to realize and transfer value rather than create it. As shareholders become less engaged, minority activist influence increases. Differential ownership and control structures (for example, non-voting shares) are resurgent. As control dissociates from economic ownership we see investors' interests subordinated. Successful start-ups will stay private longer, private equity will be able to game the index for low-risk returns, and of course every arbitrageur will gladly front run the ever larger flows around index changes. Compounded by easy monetary conditions, we are already seeing value transfer from investors to those taking advantage.

Perhaps the most serious impact is the breakdown in price discovery. Unlike active investors who are value sensitive, buying only when the price is right, passive investors are time sensitive, buying when the index changes. Greater numbers of buyers and sellers with well-informed but differing ideas of fair value is what enables a well-functioning market. Passive drives large, infrequent volume aggravating volatility and impedes price discovery. Ironically, passive strategies both rely upon and undermine price discovery at the same time.

With incentives misaligned for management and investors indifferent between individual investments, capital allocation will also be disrupted. Adam Smith's invisible hand suggests that individual self-interest drives capital, in aggregate, to its highest uses. But passive investment abdicates decision-making to index construction rules. We know that poor capital allocation will depress economic growth[i], however will that effect be readily recognizable as it is happening?

Markets with less synchronous stock price movements not only provide opportunities for active managers, but also seem to exhibit better capital allocation over time[ii]. With passive representing an increasing proportion of stock holdings, it is hardly surprising to see correlations of individual stocks rising.

If state capitalism is believed to be unable to allocate capital efficiently, can we expect index construction rules to yield better results?

Origin of the Specious

The most often referenced case for passive investment was Sharpe's 1991 article, "The Arithmetic of Active Management"[iii]. He posited that the market is a zero-sum game where half the dollars invested outperform and half underperform. Passive investors buy and hold the entire market, and therein will achieve average returns with minimal costs. All remaining investors are therefore active, and in aggregate will also achieve average returns, but being active, will incur higher costs to do so. Sharpe's conclusions rely on two assumptions.

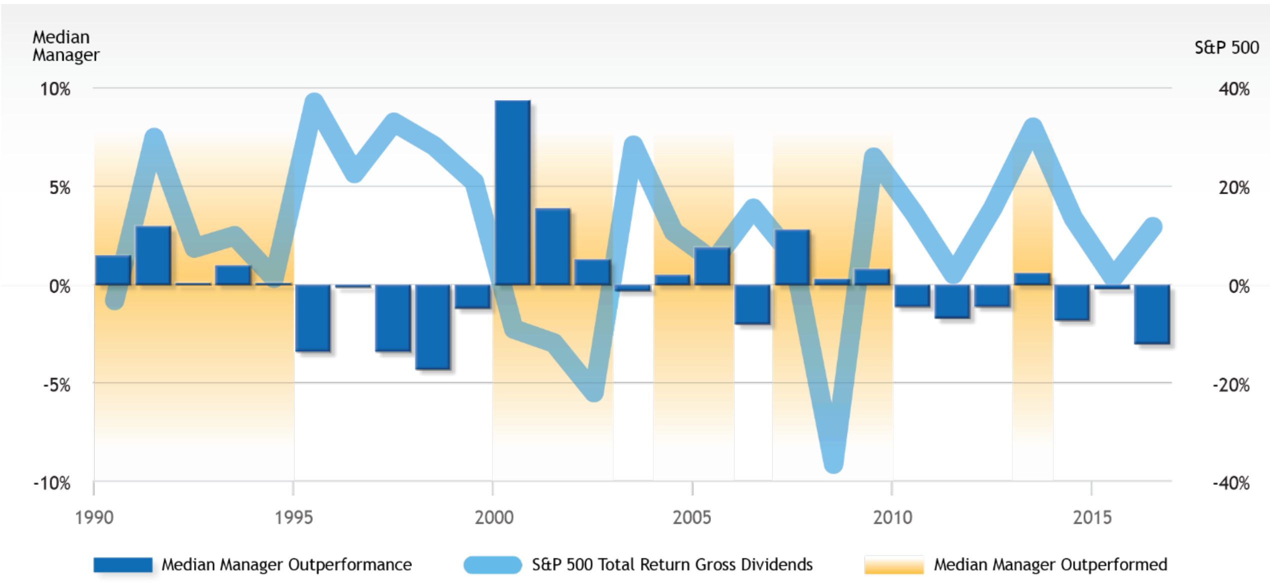
Firstly, Sharpe assumes that passive delivers average returns consistently. What we in fact see is that there are periods where the majority of active managers outperform the index and vice versa. While there are a number of reasonable explanations for this variation, it does indicate greater complexity than Sharpe allowed for. An additional consideration is that index strategies systematically lag their underlying index due specifically to those frictional costs, but active performance is generally considered relative to the index, not the actual performance achievable in passive.

Secondly, even if we accept that the index is average, Sharpe's theory also assumes that it is not possible to accurately pre-determine which active managers have a higher probability of outperforming. It is very difficult to outperform, however there are skilled managers who have outperformed over long investment horizons, and there are even some shared characteristics that can help differentiate these. Low turnover, high active share, low fees and expenses, and a close alignment of interests have all been linked to long-term outperformance[iv].

Passive addresses the risk of deviation from an index, but not the volatility of the index itself. Indices were developed to measure performance of, and relative to, the market. Indices are generally constructed without considering risk, but rather to represent the underlying market or market segment. For instance, capitalization weighted indices hold the largest stocks in that market in the largest allocations, giving them the character of momentum-oriented strategies — rising stocks are awarded higher index weights, falling ones lose weight. As one might expect, this performs well when there is persistence in individual stock performance. This can be seen in the .com bubble of the 1990's and in the narrow breadth of the last six years (Fig. 1). Also evident from this chart is its cyclicality, making even long-term performance comparisons sensitive to period and endpoint selection, and the tendency of even the median active manager to outperform in weaker markets.

Risk characteristics also change with index constituent weights over time. The FTSE TMX Canada Universe Bond Index is weighted by quantity of debt, not quality. This means that those issuers with the most debt will have the highest weight in the index. The same applies by credit rating – issuers who take on too much debt are awarded higher weights in the index, even if they get downgraded. The same can be seen in equities on slightly different terms. Take the Nortel example in Canada – as valuation soared, the index weight also rose to the point

Figure 1. U.S. Large Cap Fund Median vs. S&P 500



Sources: S&P, Goldman Sachs, Addenda Capital

where it was more than a third of the index before failing spectacularly.

Most of the popular indices are market capitalization weighted, meaning that "average" is in fact a weighted average that favours larger companies. As observed earlier, this ends up being a low-turnover momentum-driven strategy rather than a passive average.

Investments should be considered relative to the investors' objectives, time horizon, risk tolerance and other factors. Asset mix can try to reconcile these with the allocations to various indices; however the risk and reward characteristics of those indices will change over time with the indices' constituents.

Active Ownership Needs Active Management

Investors are not merely beneficiaries but owners of the companies they invest in. Investment managers have a fiduciary responsibility to protect and enhance the value of the investments they make. Proxy voting is part of this, but even here interpretations of the level of care required vary. Passive fees however do not support the research and analysis required to understand and evaluate management, and passive managers lack the context required to go beyond a rules-based approach, weighing in on select issues, but contributing little at the company-specific level. Effective proxy voting evaluates proxies in the context of the company, its operating environment, and developments in governance issues.

Going a step further to active engagement relies even more heavily on an understanding of the company. Passive efforts in this area may be well intentioned but will also lack real influence in the absence of a credible threat of action. Engagement with companies helps broaden the perspective of managers and understand their companies better. Mercer found a number of potential advantages for active managers integrating active ownership including: identifying issues; access to companies; engagement as a lever for change; and using active ownership to manage risk and enhance returns[v].

Conclusion

Passive management has served to disrupt traditional active management's high fees and unclear value creation. What may prove more interesting however is what sort of an evolution in active management this catalyzes. Disproportionate adoption of passive strategies may ultimately prove damaging for markets or the economy, but that does not diminish the requirement for active managers to satisfy investors that the value they get with active justifies the cost. Asset owners have become more sophisticated and are demanding more from their managers, consultants and portfolios. They are demanding more concentrated strategies, demonstrated efficacy, better risk controls and a more reasoned approach to stewardship. Better risk tools help evaluate managers, but also help managers better isolate core competencies and hone their focus on proven sources of added value. Executed effectively, active stewardship's complementary relationship with active management can also help enhance the combined value proposition. We believe the combination of active management with active stewardship helps us act more like owners, and in so doing, better serve our clients.

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