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ACTIVE VERSUS PASSIVE MANAGEMENT: FRAMING THE DECISION

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Active versus Passive Management: Framing the Decision

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The debate over passive versus active management is more than a debate over whether markets are efficient or not. Standing on the downhill side of a financial bubble as we do today, it's difficult to argue that markets are efficient. To the contrary, financial bubbles suggest the occasional presence of gross inefficiencies.

This is even better support for active management than the mere presence of small, short-term arbitrage opportunities. If markets or large segments of markets can become hugely mispriced, the opportunities for active management to add value must be quite significant.

If we are to follow the debate to its next logical step, we must derive an affirmative answer to the question, "are markets inefficient?" We must be careful with our basis for answering this question, however. We must guard against the temptation to overreact to very recent successes or disappointments, for example.

In business, it is frequently sensible to reward successful enterprises and sanction those who do not succeed. In investments, this is typically a path to disaster. Buying an asset or a strategy after a few brilliant years may be tempting, but that choice is often made just before that asset or strategy falters severely (witness the funds that chased growth strategies 18 months ago). Buying an asset or strategy after a few disappointing years may be uncomfortably counter-intuitive, but it is often the best path to investment success. The markets do not reward comfort, nor do they generally reward investing in whatever has worked best in the past few years.

In other words, the best *investment* decisions are often contrary to human nature, and are rarely comfortable for seasoned business managers accustomed to rewarding success. If active management has gone through a phase of disappointing performance relative to passive alternatives, this might be, contrary to typical corporate thinking, precisely the time to invest in active management.

Passive management is the ultimate momentum strategy. Passive investing puts the most money into the largest stocks—not the largest companies, but the largest stocks. This implicitly means that a passive portfolio has a disproportionate investment in the stocks that have been most successful *in the past* and are most expensive compared to their fundamentals *in the present*. A move to passive investing will necessarily mean selling the stocks that we are most overexposed to and buying the stocks that we are most underexposed to, *relative to the index that we choose*. Active investing involves a systematic program of rebalancing, which can cut our exposure to the most expensive stocks in the index and give us more exposure to the out-of-favor and undiscovered gems of the future.

While the best strategies in investing may stand in opposition to some classic corporate behavior, we can nevertheless learn some important lessons from corporate behavior.

What do successful corporations do first, when a specific line of activity begins to fail? They will first turn a critical spotlight on themselves, and perhaps on their industry in general.

Success means standing out from the crowd. Success means performing where others have either failed or where others have done no better than everyone else. Southwest Airlines has outperformed its peers because it has seen what others have not, and has chosen to break with convention and do things differently. It is difficult to outperform your peers if you follow convention.

Some of the most successful university endowments may be good examples of this in the institutional investment world. One achieved a return of over 9% in the twelve months ended in June 2002, handsomely beating average investors' returns, as U.S. equities were down 15% and global equities down 24% over the same period. This positive performance would have been impossible with the peer group sensitivity that most institutions exhibit. Unconventional approaches to policy allocation, risk allocation, and risk management have played a key role in the university's outperformance of the market and its peers.

It's fascinating, as we look to the past decade of institutional investment management, that the most important evolutions may have produced handicaps as well. To the betterment of the institutional asset management industry, we've seen:

- A growing recognition of the central importance of benchmarks and policy management.
- A more disciplined approach to managing and overseeing risk applied.
- A greater willingness to apply objective measures of success or failure to active management.

Disciplined, systematic approaches to asset management are on the rise. A collective wisdom about how to manage active risk has been forming. It may just well be that there has never been a stronger consensus on how to manage assets in the institutional investment world. Therein lies the problem.

Imagine, for example, a world where all investors rely on the same "value at risk" calculation for managing risk. All investors might be responding simultaneously to the same information, exaggerating asset price adjustments, and driving valuations to significantly over or under equilibrium levels.

More frequent measurement of performance may contribute to a greater focus on short-term results. While it is unequivocally a good sign that plan sponsors are more frequently informed about short-term results, it is not necessarily good that they are more *reactive* to short-term results. As our collective infrastructure grows to support increasingly more frequent evaluations of performance, should we redirect our performance goals to increasingly shorter-term performance metrics?

The shortest-term sources of productivity in the active management business are found in arbitrage strategies. Should we all pursue short-term arbitrage strategies? The industry as a whole cannot succeed by doing so, as the arbitrage opportunities will vanish.

We're impressed by the discipline that the concept of risk budgeting has brought to the allocation and oversight of active risk allocation—but there are some shortcomings in this as well. Risk budgeting carries with it the presumption that opportunities for earning alpha come in a steady steam through time. Under the risk budgeting approach, if managers are allocated a certain amount of active risk, they are expected to spend that risk allocation every month. They are not supposed to vary from this risk budget as the extent of the perceived opportunity varies over time; the concept of risk budgeting rests on the assumption of a constant level of opportunity.

The logic follows then that one should be able to find and capture opportunities on a monthly basis, and the industry at large has become focused on those opportunities that occur on at least a monthly basis.

Warren Buffett looks only modestly better than average on this basis. The cumulative information ratio for Berkshire Hathaway over the past 33 years is a modest 0.7. This level is sufficient to make him the world's wealthiest investor (with his co-investors participating almost fully in these gains, contrary to many investment managers). But, it's insufficient to pass even the basic risk budgeting screens of many allocators of capital, such as funds of funds.

Buffett's extraordinary long-term success has come from decisions that don't pay off monthly, but rather from decisions that require more patience. A disciplined risk budgeting process would probably have to refuse allocations to the Warren Buffetts of the investment world.

Institutional investors have a comparative advantage. They can better bear short- to intermediate-term active risk. They need not add value every month, every quarter, or even every year. Their liabilities are far more diversified *across time* than the liabilities of most individual investors. They are therefore in a better position to profit from the short-term risks that the individual investor finds difficult to bear.

This competitive advantage in the financial markets, we believe, is increasingly overlooked—and conventional thinking about risk measurement and risk budgeting is partly to blame. Those who are willing to think less conventionally about risk budgeting may find an advantage, and that advantage may lie in the exploitation of the longer-term, less frequently occurring gross market inefficiencies.

While we mean to offer some provocative thoughts on this debate, we also want to deal with it in its more conventional terms. Let us come back to some of the more fundamental questions about the case for active management by specifying the first questions. Before even considering the case for active management, there are four preconditions to evaluate.

FOUR PRECONDITIONS BEFORE SWITCHING TO PASSIVE MANAGEMENT

The sensible time to even consider a switch to passive is when four preconditions are met:

1. Consider passive only when active managers have done consistently better than passive managers, lest we enter an up elevator just before it goes down.
2. Consider passive only when a switch to passive will not involve selling our most sensibly priced stocks in order to buy the market's most expensive stocks,
3. Consider passive only when a switch to passive will not involve selling companies with decent growth in order to buy companies with weaker growth prospects.
4. Consider passive only when the trading costs for a switch to passive will not be excessive. A good rule of thumb is that switching managers or strategies costs about 2% of assets, a daunting cost. If the active portfolios resemble the passive portfolios, this cost is assessed against a smaller share of the portfolio. And if markets are not overly volatile, this cost comes down.

We think that today's markets fail all four tests.

THREE QUESTIONS FOR PURSUING ACTIVE MANAGEMENT

When those four preconditions are met, as they will be from time to time, investors face three questions to consider in weighing the relative merits of active and passive managers. If we can answer these three questions in the affirmative, it still makes sense to stay the course with active management, *even if a switch to passive passes the four preconditions.*

In order to justify active management fees, active managers must outperform passive index funds on average over time. What does it take to do that, and what are the key issues in today's markets? In order to justify the quest for gains from active management, we must answer "yes" to three questions regarding asset pricing and manager identification.

Margin of Mispricing

Are some assets mispriced, above or below their appropriate fair value, by a large enough margin to justify trading costs? This is the easiest hurdle to overcome. When we see Palm, in an industry with low barriers to entry, low margins, and a fast-changing marketplace, valued at a higher price than General Motors (as was the case during its IPO in March 2000), in a capital-intensive industry with huge barriers to entry and high marginal per vehicle profits, we can confidently say that the market is inefficient. We cannot say how long it will take for the relative price to be corrected, but we can be patient.

The essence of this first question is: "Is it possible to add value?" The answer provided in countless academic journals, by countless investment managers (including those whose primary business is passive management), and by virtually all observers of the capital markets, is a resounding yes.

Inefficiencies abound. Academic literature has identified the P/E effect, the risk premium, the liquidity premium, the neglect effect, and dozens of other inefficiencies. The problem here is not whether inefficiencies exist, but rather that inefficiencies change over time. Because inefficiencies change over time, no static approach to managing active portfolios can hope to add persistent value in the very long run, without extended (and company-killing) dry spells.

Seeking to add value by exploiting market inefficiencies is, of course, a zero-sum game, less the applicable trading costs. The markets cannot outperform the markets. Accordingly, any assets that outperform must be offset by assets that underperform. The costs of implementing active management decisions are material, which means that the ideas must be worth more than the total implementation cost of pursuing a particular market inefficiency.

The second key problem with market inefficiencies is that they change. We could view each market inefficiency as an arbitrage opportunity; if enough money pursues an inefficiency, it will be arbitraged away. It will vanish. When one inefficiency disappears, often it is replaced with a new inefficiency. The consequence of this is direct and crucial to the exercise of active management. Static approaches are doomed to lose their edge.

Many investment managers proudly proclaim that they've been doing the same thing for the past 15 years and that they won't change over the next 15 years. To us, this would be an acknowledgment that we have not learned anything in the past 15 years. An effective investment process must be evolutionary, and must adapt to a changing world.

Identifying Mispricing

Can some managers identify mispriced assets in advance? This, again, is an easy hurdle. Warren Buffett is a case in point; his book value has outpaced the S&P 500's in 19 of the past 21 years. The problem is, you can't buy Berkshire Hathaway at book value. It trades at a substantial "Warren Buffett premium" over book value. Also, it's worth noting that *unsuccessful* managers are surprisingly consistent in their failures.

To state the (often-overlooked) obvious, the average manager will not beat the market, because managers collectively *are* the market. But, this does not mean that we can't find managers who persistently add value at the expense of those who are unsuccessful. The key challenge here is that opportunities in the markets are constantly changing. A manager who cannot adapt to changing markets cannot add consistent value.

The second question then relates to managers' ability to add value. Here, the key question is: "Are there some managers with an ability to add value?" The short answer is yes.

We find that competitive universes of active managers have a convergence of results over time. This would be expected in any random walk of returns. If returns are truly random over the course of several years, however, these results should converge with the square root of time. This means that the annualized ten-year returns for the best quartile of managers should outpace the worst quartile by less than one-third of the one-year spread. In fact, the convergence is more gradual than this. Ten-year results show a dispersion greater than half the average one-year dispersion. This is rather compelling evidence that manager skill does exist.

These statistics can demonstrate that, far from behaving like a random walk, manager results behave like a universe split between those who can add 2% per year, and those who forfeit 2% per year, each with their own random walk. The problem is that statistics can't tell us which of the winners were skillful, and which were just plain lucky. Furthermore, statistics can't tell us which of the skillful winners still has the ambition and energy to succeed in the future!

Here, yet again, we face a zero-sum game, less costs. The costs of active management, in the form of fees, are material. Even with performance-based fees, the fees are not symmetric. If the manager adds value, you will pay a fee; if the manager fails to add value, no manager will agree to pay you a negative fee.

In examining a manager's skill in identifying market inefficiencies, it is crucial to know what you've bought. Most active managers lagged the S&P 500 quite sharply in 1998. Yet, this was when the Russell 1000 index was up 24%, and the equal-weighted Russell 1000 was up 11%. Most active managers beat the S&P 500 in 2000, when the comparison worked the other way. Because most active managers invest in something closer to an equal-weighted approach, rather than a capitalization-weighted approach, most managers actually did fine relative to any benchmark that adjusts for this size bias.

Here, it is important to partition the risks that are the sponsors' responsibility from the risks that are the manager's responsibility. If a manager accepts a benchmark of the S&P 500, it's fine to assign responsibility for any shortfalls to the manager. If a large roster of managers all have the same bias, and all have the same resultant underperformance, though, it is important for the sponsor to recognize that this systematic bias across multiple managers is at least to some extent their own responsibility.

Identifying Managers

Can some plan sponsors identify skilled managers in advance? Here we get into some very sensitive territory. Can some sponsors add value with their selection of managers? The short answer is, "quite probably." Ambachtsheer clearly suggests that sponsors who engage in careful management selection, using as much discipline as they would demand of their managers, were able to handily outperform sponsors who are less disciplined, and with a strong correlation in the results. The message here is straightforward: Careful manager selection very likely adds value.

The problem here is that, as with the other decisions, we are looking at a zero-sum game. In order for some sponsors to add value with active manager selection, other investors must underperform. The cost of changing managers is material. These costs are added over and above manager fees, trading costs, and other ordinary operating expenses of active management programs. It is our view that, much as holds true with investment managers, a steady hand at the tiller wins in the longer races.

If a switch to passive does make sense, then it probably should occur in a measured fashion over time, to keep the cost of the transition down to a minimum. Most active managers have perhaps 5% to 10% turnover per month. A measured move into passive, which taps each active manager for 2% of assets per month, can help to avoid the terrible trading costs associated with an abrupt transition, by taking advantage of the active manager's turnover already.

But, today, even a measured move toward passive management probably does not make sense; we need only look at the stocks that we would be selling and the stocks that we would be buying to see the wisdom of staying the course with active management in the quarters ahead.

LARGE-CAP U.S. EQUITY

Are large-cap equities different from the rest of the equity market? Is the case for active management weaker for large-cap stocks? These questions are often asked because large-cap equities receive more investor attention than other segments of the market, and might be assumed therefore to be more efficiently priced. Furthermore, some would argue there is better liquidity and trading costs are lower in the large-cap universe, which would make inefficiencies in this market easier for investors to exploit, further reducing any inefficiencies that remain. The implications are not as obvious as they seem, however, and there are factors that strongly support the case for active management in the large-cap arena.

First of all, thanks to indexing and to fear of benchmark risk, many owners of the largest names hold them because they are a large component of the benchmark, not out of conviction of superior returns. When demand for these issues is driven by a quest for risk management rather than profit, we can expect inefficiencies to persist. As tangible evidence of this fact, our own core equity strategy has performed better than our small/mid-cap strategy, but most of that gain has come from our decisions within the top 100 universe, where we have had our very best results.

These results don't support the common view that it's easier to add value in the small-cap universe. While it may be true that inefficiencies are better among smaller stocks, the more likely implication is that the capturable inefficiencies (given the lower trading costs) are greater in the larger, more liquid end of the universe. Regardless of the reason, we do earn our best profits in our active trading of these largest stocks.

Higher transaction costs handicap an investor in the attempt to capture profits from existing inefficiencies in two ways. Fewer of the inefficiencies that exist among smaller stocks can be profitable because any gain is outweighed by the transaction cost. The sensible investment manager will exploit a smaller set of these inefficiencies, simply because many of them are not large enough to be profitable after paying higher transaction costs. In short, even when inefficiencies are greater than the transaction costs, the profits are reduced by these same costs.

Our own research suggests that the largest stocks in the market are surprisingly inefficient, providing ample opportunity to add value. The judgment regarding the merits of active management, we think, should be based upon whether or not active managers add value in the universe or not. There are more large-cap managers than mid- and small-cap managers, so there is more competition that can make these markets more efficient, *but there will also be more managers who fail to add value in the large-cap area*. If there is evidence that some managers have added similar value in the large-cap universe on a risk-adjusted basis, when compared to the successful managers in the small-cap arena and in other markets, then the case for active management in the large-cap area is made.

A possible parallel might be drawn between currency and large-cap equities. Watson Wyatt, Strange, Frank Russell have demonstrated that active currency managers have on average proven themselves capable of adding value, and the consultants have begun recommending active currency management to their clients. The surprising thing about this is that the currency market is clearly the largest, most liquid market in the world, with trading volume of over a trillion dollars each day. One might assume that such a market couldn't possibly be inefficient.

Like large-cap equities, however, risk management motives (the hedging of currency risk) and other non-profit related motives (central bank efforts to manage volatility) are present and important in the currency markets. Furthermore, the low transaction costs associated with currency forwards can mean that inefficiencies are more profitable, net of these low costs. This has certainly been our experience.

CONCLUSION

There are important questions to ask to evaluate the relative merits of active and passive asset management, and decisions may be made on these evaluations alone. We are reminded of what makes for a successful corporate culture, however, and wonder why businesspeople would assume that the principles of corporate culture don't apply to the investment world. A willingness to take risks and to apply an approach that differs from what everyone else is doing breeds the greatest corporate successes. Why should we assume that, in an industry where common wisdom and conventionality has taken an ever firmer hold, there can be no gains to taking an alternative approach?

Any doubts about the potential for active management to add value must first therefore lead to questions about the approach. Cultures, businesses, and economies move forward by seeking to overcome disappointment. Creative solutions are sought, and new ways of doing things are rewarded.

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