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EXPOSING THE MYTHS & REALITIES OF PASSIVE INVESTING

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Whatever else one might say about active managers, they typically don't lack self-confidence. For example, a recent article suggested that "Whether it is stocks, bonds or other assets, an active manager with a rigorous top-down and bottom-up investment process and an outlook that vets the potential for a variety of both short- and long-term developments should be able to outperform a benchmark over time, adding value for investors."[1] This claim echoes those cited (mockingly) 20 years ago by Sharpe,[2] and they weren't new then.

Of course no one would argue that successful active managers don't exist, in some cases famously so (Warren Buffett comes immediately to mind). The question is not whether successful active management is possible, but whether successful active management is prevalent. And here the advocates of active management argue two propositions:

- Active management "works" if it's done well.
- If it's not done well, the solution is to do it more aggressively.

We'll examine each of these propositions in turn.

DOES ACTIVE MANAGEMENT "WORK"?

Answering this question requires us to define what it means for active management to "work," and that can be complicated—especially when we consider, as we should, risk as well as return. For our purposes, we'll say that an active manager succeeds when he outperforms an appropriate passive benchmark. "Appropriate" is an important qualifier—among other things, it means that the benchmark should be consistent with the manager's "natural habitat." For example, if an active manager typically buys only small- and mid-cap stocks, his performance shouldn't be compared to that of the S&P 500® or the Dow Jones Industrial Average™.

We can consider the prevalence of successful active management in both theoretical and empirical contexts. The theoretical argument begins with a tautology: the sum of the values of all investors' portfolios must be exactly equal to the sum of the values of all stocks outstanding.[3] From day to day, therefore, the change in the values of all investors' portfolios must be exactly equal to the change in the values of all stocks outstanding. This means that the return of the average investor's portfolio must equal the return of the average stock.

In this simplified context, passive investors own a proportionate slice of every stock available, and will therefore earn the market's average return, less fees and expenses. But if passive investors are removing a proportionate slice of every stock, that means that active investors as a group must also own a proportionate slice of every stock. Therefore active investors, as a group, will also earn the market's average return, less fees and expenses. But fees and expenses are inherently higher for active investors than for their passive counterparts. This means that "properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs."[4]

"Properly measured," of course, is another important qualifier. It does not mean, for example, that the average active investor cannot outperform the S&P 500, or MSCI EAFE, or the Russell 2000, or any of many other well-known indices we could name. Each of these indices encompasses only a subset of the available investment universe,[5] and what the theory tells us is that the average investor (across all stocks) cannot outperform the average return of all stocks. If large-cap U.S. stocks do relatively badly, it's certainly possible for the average active investor to outperform the S&P 500. That's why it's important for the passive benchmark against which a manager is compared to be appropriate to his style of management. In practice this means that benchmarks should reflect, with admitted imperfection, the universe of stocks from which the manager draws his portfolio holdings—large-cap benchmarks for large-cap managers, small for small, value for value, growth for growth, etc. The same logic that applies to the market as a whole will also apply to sub-segments of the market. The average large-cap growth investor will earn the return of the average large-cap growth stock, and so on. So goes the inexorable arithmetic of active management.

These theoretical views are confirmed in empirical results. Since 2002, S&P Dow Jones Indices has compared the returns of active managers to style-appropriate benchmarks—large-cap funds against the S&P 500, mid-cap funds against the S&P MidCap 400®, etc. The message of this research is very clear: most active funds underperform their benchmarks most of the time.[6] The theoretical argument for passive management is borne out by real-world experience.

WHEN ACTIVE MANAGEMENT FAILS

We are sometimes told that the reason active managers fail is that they're insufficiently active. The argument here is that managers who know that their performance will be compared to a passive benchmark are reluctant to deviate too much from that standard. They therefore hold too many positions they don't find especially attractive, simply because these stocks provide diversification and reduced tracking error relative to their benchmark index. The proposed remedy is for active managers to use only their "best ideas," or to invest with a greater degree of conviction.[7]

The "best ideas" movement has some appeal because of the nature of portfolio diversification in a multi-manager context. Plan sponsors and consultants are well aware that combining active managers can often produce an aggregate portfolio in which the managers' style and stock selections are diversified away, leading to a large closet index fund for which the sponsor is paying active management fees. Obviously, if a sponsor's managers all hold 100 stocks now, and are limited to holding only their 10 "best ideas," the resulting aggregate portfolio will be less index-like and less diversified than its starting point.

Is that a good thing? Its success, both in the aggregate and at the individual manager level, depends on two assumptions:

- The manager must have positive stock selection abilities. (If he doesn't, making his portfolio more aggressive won't make his performance better.)
- The manager's a priori identification of his "best ideas" must be accurate.

Neither of these assumptions is certain to be true (we've already seen that the first one typically is not), and the success of the "best ideas" concept requires that both hold true simultaneously.

In part, the "best ideas" movement may be a reaction to developments in the index industry. Consider: 30 years ago, if an investor wanted a tilt toward small-cap growth stocks, he had to hire an active manager who specialized in small-cap growth. The investor's results would then reflect a combination of exposure to small-cap and growth factors (not necessarily consistent exposure, mind you, but exposure nonetheless), as well as the manager's stock selection ability (potentially either positive or negative). The manager could be paid both for providing access to the factor exposures and for stock selection.[8]

Today, of course, an investor who wants small-cap growth can buy a small-cap growth index; he can expect to have consistent and cheap exposure to the factors he cares about. With factor exposure available passively, a manager can't expect to be paid active fees for providing it. Our small-cap growth manager now has to outperform a small-cap growth index—not the general market index to which an earlier generation might have compared him. In this evolving paradigm, he may find it advantageous to run a concentrated portfolio in order to assure that most of his tracking error comes not from factor bets, but from individual stock bets. But the arithmetic of active management operates just as relentlessly in a constrained space as it does more generally; there's still no a priori reason to believe that a manager's stock selection ability is positive.

A related argument holds that asset owners should index large-cap, well-researched stocks, and use active management only in the less well-researched small- and mid-cap arenas. At first blush this is plausible, and it's certainly true that research coverage is tilted toward larger companies.[9] But the absence of research coverage implies only that the likelihood of misvaluation is higher among smaller companies. There's no reason to assume that the likelihood of undervaluation is higher, and it's the assumption of undervaluation that makes the argument for active management of small-cap stocks. The empirical data, on the other hand, demonstrate that active management is just as difficult for small-cap managers as it is for large.

THE THINGS WE KNOW

Years ago, Mark Twain observed that "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." One of the things many investors think they know for sure is that active management offers improved performance over passive indexing. Sometimes they're correct. More often, they're not. Successful active management is possible, but not prevalent. Investors who try it should consider the odds.

[1] Douglas Hodge, "Straightjacket investing: Passive has its limitations," Pensions & Investments, February 5, 2013, http://www.pionline.com/article/20130205/REG/130209945/straitjacket-investing-passive-has-its-limitations.
[2] William F. Sharpe, "The Arithmetic of Active Management," Financial Analysts Journal, January/February 1991, pp. 7-9. Available at http://www.stanford.edu/~wfsharpe/art/active/active.htm.
[3] This example assumes that we're concerned with equity portfolios. The same argument could be made for other asset classes.
[4] Sharpe, op. cit.
[5] For example, the S&P 500 concentrates on the largest-capitalization segment of the U.S. equity market.
[6] Aye Soe, "S&P Indices versus Active Funds (SPIVA) Scorecard," Year-End 2012, http://us.spindices.com/documents/spiva/spiva-us-yearend2011.pdf.
[7] Tracking error measures the degree to which one portfolio tracks another. See Mike Sebastian, "Conviction in Equity Investing," Hewitt EnnisKnupp, November 2012, http://ssrn.com/abstract=2176862.
[8] Of course, factor exposures can subtract as well as add return, but no active manager ever featured a factor that he didn't think would be positive in the long run.
[9] See, e.g., DWS Investments, "The case for global small- and mid-cap investing," June 2012, https://www.dws-investments.com/EN/docs/resources/sales-ideas/DGSCGF-WHITE.pdf.

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