Considering the unconsidered

By Joao Frasco, Chief Investment Officer, STANLIB Multi-Manager

In this brief article, I'll take the middle ground in the battle raging between active and passive managers and commentators around which strategy is "best".

Unfortunately, this discussion is usually tainted by personal incentives of providers "talking to their books". As the second largest multi-manager (by assets under stewardship) in South Africa, we have chosen not to offer funds that are either fully active or fully passive, but rather focus on our investors' needs and combine active and passive as required to deliver on their objectives. We put clients first, not just a plethora of products to maximise the aggregation of assets.

I will briefly introduce the topic, point out the pitfalls when engaging in this debate and the flaws in some of the arguments. This should provide you with a fuller understanding of the difference, and the nuances worth appreciating when considering the alternatives available. I will also briefly touch on why we consider passive investing within some of our funds and the considerations which we find attractive.

Is active investing a zero sum game?

Let us be clear upfront that passive investing doesn't exist. I'm not making the weaker point that it doesn't exist in a vacuum, which by itself would be a controversial statement to some (and yet completely true), but rather that it doesn't exist at all.

Investing is an active process - always. Passive investing merely points to certain decisions in the investment process that are "outsourced" and somewhat passive i.e. someone is still making very active decisions around these. In Richo's article, he will explore this thread in more detail as it is critical to this discussion and understanding that "passive" investing is actually a misnomer at best and a unicorn at worst.

There is a theme that I will point to throughout this article which is very important and I will introduce it here. Active investing is not a zero sum game. Although it deserves repeating, I will save the reader the drama. It deserves repeating because an important person in finance (a Nobel Laureate) titled one of his papers "Active management is a zero sum game", and it has become the mantra of a legion of passive investors ever since, without an appreciation for the absurdity of the statement beyond a very narrow application, which is itself absurd.

I know that I should not be firing shots without backing them up, so follow my reasoning below.

I will begin the argument at the detailed level where it is typically used, and zoom out to the more general levels where it is never considered. The argument is typically made in the context that the average active manager cannot outperform the index, because the index is the average of all active managers. This seems innocent enough, but of course it is completely fallacious. There is no index without trading by active managers (and all other investors, lest we believe that the market only consists of active managers), so it is the index that represents the sum of what all investors are doing, not the other way around. Investors are somehow working to beat something that doesn't exist until some action is taken. If everyone stopped acting at once, what would the index do? Nothing!

It is actually worse than just that, so let's go back to my comment above in parenthesis and some of what followed, which I quickly glossed over. The index doesn't actually average anything. I would be very happy to supply formulae for index calculation methodologies, but most of them do not involve any averages at all. In addition, active managers are by no means the only investors in markets. You have day traders, banks, corporates and other institutional investors and of course one of the biggest groups of investors, index trackers (or passive investors). You could find (even though you do not) that it is the rest of the investors that are underperforming the index and not active managers (lest you believe that it can't be passive investors because they really do give you the index).

Let us take a quick detour to have a quick look at this. I've chosen the Satrix ALSI Index Fund (not to pick on Satrix, but because they are probably the biggest and most well-known passive provider in SA). If I look at their latest minimum disclosure document (to April 2016), the fund has returned 13.21% p.a. for the three years versus 14.38% p.a. for the benchmark which is the FTSE/JSE 203 (the All Share Index). That is significant underperformance for someone who may believe that you can simply buy the index, but it is actually worse than you may think.

The performance of the fund assumes (you will find this on the third page of their document under Additional Information) that income reinvestments are done on the ex-div date. But the fund does not reinvest income on the ex-div date. It cannot, because it does not get paid the dividends until a couple of weeks later. The first page of the document shows (under Fund Information) that income is actually paid out as income declarations twice per year, which means that investors need to wait until they receive the income before they can reinvest it. The actual performance for the investor could therefore be quite different to the performance of the fund. To be clear, this is not necessarily different for actively managed funds, but the point I am highlighting here is the comparison between a passive fund and the index it is tracking (not between active and passive investing). Specifically, the index assumes dividends are reinvested when declared and that everything happens magically at zero cost, but passive managers have certain constraints that differ to this assumption.

Finally, have a quick look at the fees for investing in this fund. The total expense ratio (again on the first page under Fees) is 0.72% p.a. for the retail fee class. So unless the fund can outperform the index by 0.72% (which would be weird for an index/passive fund), you should begin with an expectation of underperforming by 0.72% p.a. if they delivered the index's performance which they have clearly not done, having underperformed by 1.17% p.a. for the last three years using the reinvestment assumption.

South African listed equity probably represents the most liquid and efficient part of our market. Turn quickly to the bond market to see how much worse this can get. The Satrix Bond Index Fund aims to track the FTSE/JSE All Bond Index and although it was launched in December 2008, their minimum disclosure document does not show returns for three and five years. So we will look at one year return numbers. The fund has delivered 1.04% versus the index's 1.75%, underperforming by 0.71% and a total expense ratio of 0.60%. The since inception numbers are actually even worse at 11.80% versus 13.48%, underperforming by a massive 1.68%. Again, my point here is around index trackers versus the index, not active versus passive, but in this case it is instructive to look at how active bond managers have performed over one year. Most active managers actually outperformed the same index over the same time period, after fees.

This is important because active investors are investing very differently to the index, even if some control their duration (interest rate sensitivity) positions relative to the index. Their outperformance is clearly attributable (at least in part) to credit risk. That said, this is what you want from active management, not just idiosyncratic risk (which I described in our last issue), but systematic risk if that is not available cheaply through passive investing.

Active investing as a positive sum game

Apologies for the long digression, but details are important and seldom considered. It is generally much easier to be intellectually lazy and regurgitate everyone else's flawed arguments, than reasoning through problems carefully and doing the necessary research. Let us zoom out a little further and consider the broader benefits that all active participants bring to markets, adding further evidence against the "zero sum game" statement.

Markets represent one of man's greatest innovations, going back to the dawn of man and the barter system. As these markets have become increasingly competitive, so too have they become increasingly efficient, but this hardly applies to all markets all of the time. It should go without saying, but it doesn't so I will say it here; you can't have passive investing without a very active market (look at any alternative asset market if you are struggling to see this self-evident truth).

Markets provide many benefits including the transfer of goods, services and risk. Active investors represent the creators of markets. Insurance (or risk transfer) actually represents one of the most important features of capital markets (transferring risk from one person or organisation to another and from one point in time to another). Passive investors mainly take from markets, and provide very little in return. In economics, this is known as the "free-rider" problem. They "benefit" from the efficiency that sometimes exists in markets, while criticising that efficiency and not recognising the irony.

Although passive investing can provide some liquidity, this is generally very limited because by its very definition, the underlying shares should not be traded, except at the points of index rebalancing, when the liquidity provided is actually very concentrated. The liquidity at other periods merely represents money either flowing into, or out of, passive investing. It does not represent active trading opportunities. This brings us to the most important point around what passive investing does not provide (and which most active investors provide in boat loads – although not all do so), which is "price discovery".

Passive investments are required (by definition) to get and remain fully invested, without concern for price. They need to perform in line with the index they are tracking. They therefore don't provide price discovery in the markets, they are price takers and those prices are set by active investors. Active managers love passive investors, because they can trade against them. Passive investors actually make markets less efficient, providing savvy active investors with great trading opportunities.

This is why you will eventually find an equilibrium between active and passive investing (although this equilibrium could change over time), and why you will find a higher proportion of active investing in less efficient markets. For example, it should not be a surprise to find the highest level of passive investing in the US large cap space, and the lowest in emerging markets. Just look at how little is invested passively in African equity and how none is invested passively in private equity – which actually also talks to the point that you can't have passive investing without active investors.

Why passive?

So why would anyone invest passively if so many negatives can be associated with it. Well, there are actually a couple of very good reasons, but none of them relate to the usual comments espoused by passive providers hoping to get you to invest passively. They represent the very reasons why we as STANLIB Multi-Manager do not have a passive range, but rather utilise passives within our portfolios and funds for our investors. We'll unpack the reasons to invest a portion of your funds passively below:

→ **To reduce the total cost of investing**
Most investors should only be concerned with net returns, without worrying about the absolute cost of achieving those returns as they are already factored into the net returns. Many investors do however have an aversion to high costs, especially when it is difficult to know whether future net returns will be higher or lower than passive alternatives. Going back to the Satrix passive example, would you rather have paid Satrix 0.72% p.a. for a 13.2% p.a. return achieved over the past three years, or Allan Gray 2.40% p.a. (more than three times more) for a 15.1% p.a. return achieved over the same period? Some investors will hate paying so much more, while others will be very happy to have made 1.9% p.a. more after fees i.e. they will have approximately 5% more in their bank or investment account.

Sometimes, there is a fee arbitrage opportunity within a specific market, where you invest a core portion of your portfolio passively at low cost, and the rest very actively at a much higher cost. This is a cost effective combination and provides the same expected return than the alternative of investing the entire amount with more benchmark cognisant managers at a higher average cost. We don't think this opportunity exists in South Africa, so don't follow this approach locally.

Lack of knowledge of the best active managers in the market

Individual investors in South Africa who do not know how to choose from over 165 equity unit trusts (including "passives", may rather just choose to invest passively with one of the names they recognise). Institutional investors, could do this in foreign markets that they do not cover but would like to get exposure to. I.e. we don't have the skill or capacity to ascertain who the best active managers are in Japan or China, so perhaps they would decide to invest passively there. Although this may appear to be sub-optimal (especially in less efficient markets where the biggest opportunities to invest actively lie), it is actually more consistent than drawing an active manager name out of a hat or worse, picking one based on past performance.

→ **To create more "balanced" portfolios**

There may be other opportunities on the continuum between passive and active (e.g. Smart Beta or risk factor investing) that allows us to create more balanced portfolios. By balance we mean portfolios free of unwanted systematic biases. For example, most South African active managers are underweight Naspers, partly because it is such a big weight in the index. Passive weighting to Naspers introduces substantial single stock risk to a portfolio. Smart Beta or risk factor alternatives may provide something in between. For example, up weight your exposure relative to active managers while still not giving you the full exposure that passive brings.

Another area where this has been particularly useful, is in our property portfolio which must be 100% invested locally (as it is used as an asset class building block for many of our other portfolios that may be getting their offshore exposure elsewhere). We've moved all of our passive exposure (about 15% of the total fund) completely away from the SAPY (South African Property Index) and towards the PCAP which places a greater weight towards inward listed property shares. This allows us to participate more fully in rand hedges in a portfolio that cannot invest offshore.

There are many other reasons to invest passively, but not once have I mentioned the usual rhetoric regurgitated around active managers underperforming some fictional index on average and ex-post (after the fact). Let us rather focus on doing the hard work of finding the opportunities for our clients and executing these cost effectively to deliver on their financial security.

Conclusion

Investors reading commentaries from professional money managers on either side of the aisle, are probably already sceptical about who is "right" and which arguments are valid. They probably remain confused however because of the amount of misinformation provided.

We prefer to understand markets and the opportunities provided by all market participants, and turn squarely to face our clients and investors to understand what they are trying to achieve. It is then easy to know how to build portfolios to meet investment objectives, instead of building strategies around what will attract the most assets and make us the most money.

We then do not need to pick sides, or provide a plethora of solutions to ensure we maximise the share of their wallets, but can rather focus on utilising all available options to maximise the chances of our clients meeting their goals/objectives. It also allows us to focus on the longer-term nature of these objectives, instead of the short-term nature of the latest rankings tables.

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