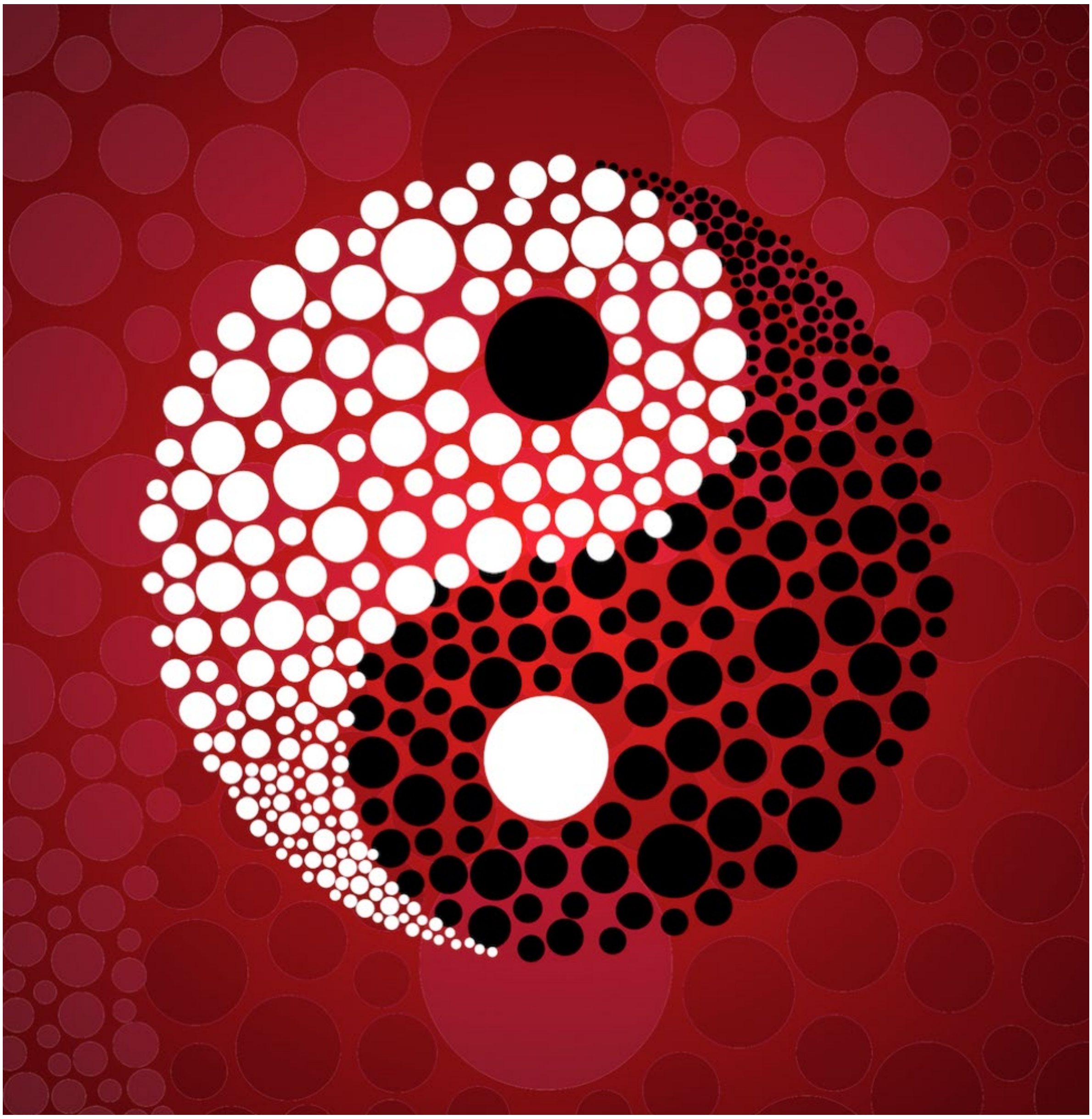
Active Investing:

Shaping its future in a disruptive environment



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Prepared by Amin Rajan for the London Active Investment Summit 2017

Author: Prof. Amin Rajan

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CREATE-Research
4 Mayfield Park
Wadhurst, TN5 6DH
United Kingdom

Telephone: +44 1892 784 846
Email: amin.rajan@create-research.co.uk

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The current debate on actives vs passives has been binary, treating the two styles as if each leads a separate existence. All manner of predictions have been made, many far removed from the way the world of investing actually works.

This paper aims to provide a balanced perspective by turning the spotlight on the complementary nature of these seemingly diverse styles based on historical experience.

It is clear that both styles share a good outlook, as some investors prefer beta exposure, some prefer alpha exposure and some prefer both.

My foremost thanks go to various business leaders participating in our latest interview programme. Their invaluable insights have enabled me to add colour and nuances to the ideas presented in this paper.

They are: Tom Caddick (Head of Global Multi Asset Solutions, Santander Asset Management), Mark Dampier (Research Director, Hargreaves Landsdown), Hans Georgeson (CEO, Architas), Martin Gilbert (CEO, Aberdeen Standard Investments), Bill McQuaker (Fund Manager, Fidelity International), Stephen Pearson (CIO, Jupiter Asset Management), Lane Prenevost (Head of Investments, Retail Banking and Wealth Management, HSBC), Maarten Slendebroek (CEO, Jupiter Asset Management) and Richard Wilson (CEO, BMO Global Asset Management).

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If, after all the help I have received, there are errors or omissions in this paper, I am solely responsible.

"The truth is rarely pure and never simple."

Oscar Wilde

Amin Rajan
Project Leader
CREATE-Research

Contents

1. Executive summary

"We shall see light at the end of the tunnel before long."

An interview quote

Introduction and aims

"Active managers having best year since bull market began" ran the headline in CNBC in July 2017.

Some 55% of large-cap active managers beat their benchmarks, according to the latest global survey from Bank of America Merrill Lynch. This is the first time that the majority achieved this feat since the 2008 crisis.

Before then, this statistic would have hardly merited more than a passing reference. However, active investing has experienced unexpected headwinds. Replicating a decade of out-performance pre-2008 has proved challenging.

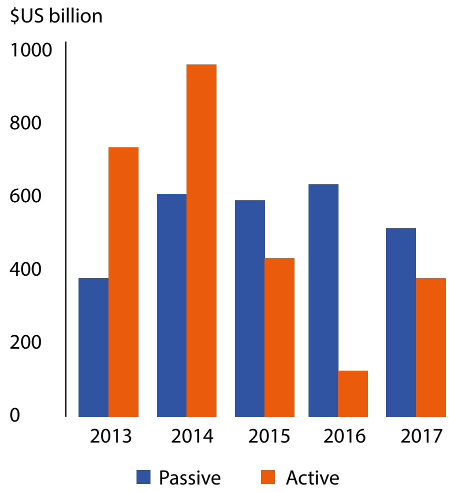
It is too soon to say whether the tide is finally turning in favour of active funds, despite improving investor sentiment indicated by rising net inflows in all markets so far this year (Figure 1). Equally, it is hard to ignore such favourable signs that argue against painting a bleak future for active investing, as has been expressed in the media over the past two years.

Commentators often over-simplify investing by implying that investors have a binary choice between what they perceive as two competing alternatives: actives and passives. They also appear to lionise a strategy just because it is riding high at a particular phase of the market cycle.

Their debate has generated more heat than light, while displaying 'recency bias' – uncritically projecting the here and now into the future. The reality, as ever, is more complex and nuanced.

Hence, in this report, CREATE-Research has probed how active and passive styles complement one another in today's investment portfolios; and how the unprecedented monetary stimulus, in the wake of the 2008 crisis, has disproportionately influenced their respective fortunes as an unintended consequence.

Figure 1: Money flowing into mutual funds



*2017 figures are year to date
Source: Morningstar

Accordingly, this paper has four aims:

- To assess the performance of active management historically and identify reasons why it has been challenged in this decade
- To examine investor concerns about passives investing as it continues to attract the new wall of money, often at the expense of actives
- To uncover the subtle chemistry between active and passive investing that underpins their interdependent cyclicality
- To suggest actions that can enhance the relevance of active investing in a landscape where passive investing is now becoming a default option for many investors.

This paper is based on an extensive literature survey of widely respected research studies, bolstered by interviews with business leaders in the investment industry: both from buy side (wealth managers and financial advisors) and sell side (asset managers). Their comments are quoted in the margins. References in square brackets appear at the end of the report.

Key findings

1. A variety of factors have undermined the performance of active managers

Since the 2008 crisis, the majority of active funds on both sides of the Atlantic have underperformed against their benchmarks after costs. And success, when it did occur, did not necessarily persist in the years that followed.

Five factors have undermined performance and the associated fund flows.

First, it is believed that there are too many asset managers fishing in a limited pool of market-beating opportunities. Everyone has to run faster just to stand still.

Second, and more importantly, the unprecedented monetary stimulus from central banks – designed to protect and boost economies in the West via quantitative easing – have also ended up artificially inflating equity valuations in this decade, often benefiting the good, the bad and the ugly indiscriminately. Value investing appears to have been unwittingly sidelined.

"Ultra loose monetary policies have caused a big disconnect between market prices of equities and their fundamentals."

An interview quote

Third, on both sides of the Atlantic, regulators and fund buyers have identified total expense as a major detractor to performance. This has been particularly acute with funds identified as closet trackers.

Fourth, regulators have not only banned the payments of commissions and rebates, but they have also helped to promote a savings environment that has favoured low-cost passive investing.

Finally, investors have been faced with a number of 'tail risk events', like falling oil and commodity prices, bank restructuring, the Brexit vote and the Trump election. Wrong calls have been inevitable, undermining the performance of active managers.

As a result, passive investments have experienced strong net inflows – part structural, part cyclical.

Structural, because passives have a number of desirable attributes from the investor perspective. For example, cap-weighted indices are cheap, transparent and require minimal governance, offering a set-and-forget autopilot option. ETFs, on their part, offer attractive features that include intra-day liquidity and the flexibility to slice and dice the investment universe allowing investors to pursue specific themes over a market cycle in a tax-efficient manner.

Cyclical, because passive investing has been a big beneficiary, as stocks have often moved in lockstep with market changes due to central bank action – inflating many asset prices well beyond their fair value.

The failure to distinguish between the structural and cyclical drivers have led pundits to project a challenging future for active investing, while ignoring some of the issues that go hand in hand with passive investing.

(Section 2 gives more details)

2. Passive investing has its own limitations

Passives will always remain attractive for those who want low-cost market beta. However, the new well of money flowing into passives has given rise to some concerns.

For example, in cap-weighted indices, companies are included because of their size, not their intrinsic merits. Exceptional companies are included in the same basket as mediocre ones, as part of bulk buying.

This creates 'index premium' where every dollar goes to the same place as the previous dollar.

By one account, the premium has risen from 12% in 2006 to 61.9% in 2016 in US stocks. Evidently, one third of all companies in the Russell 2000 index are not earning any money at all, the highest percentage of non-earners in the history of the index.

"The limitations of passives are becoming more obvious as they attract more money."

An interview quote

Last, but not least, cap-weighted indices could make booms and busts more likely and more extreme due to their inherent tendency to buy high and sell low, via strong price momentum in both directions.

ETFs, too, have also caused a different set of concerns. With their extraordinary level of trading, they are deemed as increasingly leading some markets rather than mirroring them. The largest ETF today evidently has an average holding period of just 9 days.

Thus, ETFs are believed to be out of sync with the two traditional functions of equity markets: price discovery and efficient allocation of capital.

The growing concerns on this score were duly highlighted by a recent headline in The Wall Street Journal (August 2017):

"World's Biggest Pension Fund Want to Stop Index Trackers Eating the Economy"

Lately, the spotlight has also been turned on the liquidity of fixed income ETFs, notably high yield. A number of these ETFs are more liquid than the underlying market and can be traded at significantly tighter spreads. How this would unwind when markets reverse or major defaults occur remains a cause for concern.

However, these limitations do not detract from the widely accepted merits of passive investing, which have yet to acquire a critical mass of assets to pose systematic risk.
The true test of passive investing will be best judged not by the inflows while markets remain buoyant but by their resilience when the monetary stimulus ends and volatility resumes its normal pattern.

(Section 3 gives more details)

3. Both actives and passives have swapped places as winners during different phases of market cycles

Time series data, spanning the past 30 years, reveal a number of points worthy of note.

First, the recent headlong rise of passives has been immediately preceded by nearly ten years of outperformance by actives in the last decade. Indeed, there is a cyclical pattern in the fortunes of both these styles, with one doing better when the other is not.

Second, passives have done well when markets are rising and actives have fared especially well during market corrections, as their mangers have been able to use a broader toolbox of strategies including broad diversification, tactical switch into cash and more astute stock selection.

Third, notwithstanding this cyclicality, there are many examples of active managers delivering outperformance, with strong performance persistency over multiple market cycles.

Fourth, actives involve much more

> *"The goalposts are changing as we go into low return environment: actives will have to compete on price as well as value."*
>
> An interview quote

than stock selection. They seek to add value also via asset allocation, portfolio construction, risk budgeting, tactical tilts and fiduciary management. Likewise, passives are not all that passive. Investors also have to construct a portfolio, allocate capital to chosen indices and conduct periodic rebalancing to achieve their goals.

Finally, like yin and yang in Chinese philosophy, the two styles are diametric opposites, yet inseparable – due to the changing level of market efficiency over a cycle.

As active managers seek to buy underpriced stocks and sell overpriced stocks, price anomalies are reduced and markets become more efficient, making passives more attractive. As more money flows into passives, valuations become distorted over time, thus opening the door for actives.

On this argument, actives are due to make a comeback before long, as large inflows into passives have created price distortions.

The timing is hard to predict. The timeless wisdom of John Maynard Keynes comes to mind: *"markets can remain irrational longer than investors can remain solvent"*.

Now that the central banks have started shifting into lower gear, the correlation between stocks is falling (Figure 2) and the dispersion in stock prices is getting bigger, creating a better environment for actives to deliver.

(Section 4 gives more details)

4. The burden of proof has shifted for actives

However, active managers now recognise that the rise of low-cost passives has been a structural game changer. The pendulum is unlikely to swing back all the way in the active direction.

Price competition will intensify, if the recent US trends are any guide. Margin compression will be the norm. In the active space, consolidation is inevitable.

There is no magic bullet, only hard graft.

Thus, actives face a choice: adapt and innovate and deliver value for money or become a victim of the new Darwinian forces.

Accordingly, active managers are responding. Indeed, many have delivered outperformance over multiple cycles due to seven guiding principles that have long driven their business models. These principles are now being emulated by other active managers.

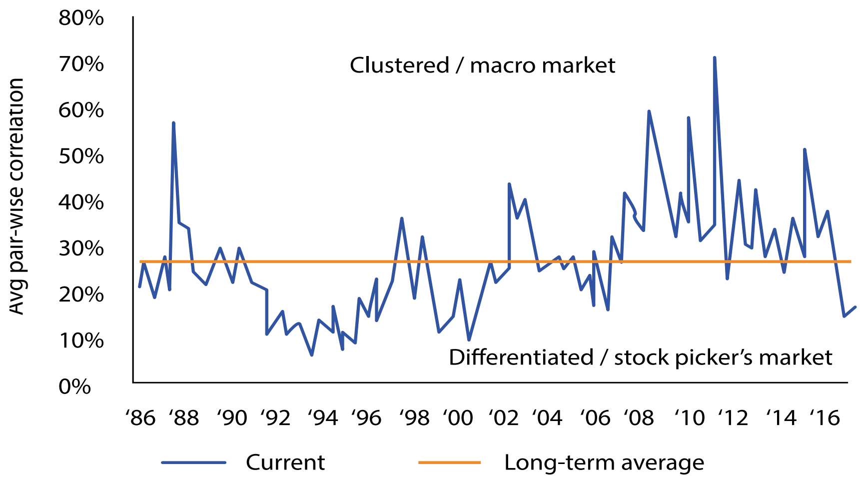
Winds of change are evident, as the focus of the debate shifts from whether passives are better than actives to how to grow the size of the overall pie, so that both strategies can benefit.

The principles in question fall into two groups, each with a distinct aim:

a. Delivering better net returns

- Investment performance must be the main avenue for building investor trust: today, a trusted brand means 'a promise kept'.
- Fees must reflect value added, with skin in the game: investors as well as regulators want a more equitable sharing of gains and pains.
- Investment processes must factor in the new reality of passive investing: new lenses are needed to look at markets from diverse perspectives.

Figure 2: Average pair-wise stock correlations based on 90 day periods, daily frequency



Source: BofA Merrill Lynch US Equity & Quantitative strategy (Based on S&P 500 universe)

"With passives here to stay, active managers need to craft a new narrative on what they stand for and what they can deliver."

An interview quote

- A superior talent pool and meritocratic incentives must be the key drivers of the investment engine: investment culture should promote diversity of thought, high active share, high conviction investing and should reward people on results.

b. Securing cost-effective growth

- Cost disciplines are essential: end-investors are increasingly fee-conscious as they become better informed.
- Diversity of innovative products and solutions will help to ride out market cycles: an active manager that can't outlive an out-of-favour asset class will struggle.
- New technology should be deployed to create new opportunity sets: improving alpha capability, enhancing client experience, penetrating the newly emerging client segments and containing costs should top the business agenda.

If there was an over-riding message coming out of our interview programme involving business leaders it was this:

As passives go mainstream, actives are as relevant today as ever, so long as they deliver their clients' performance goals at realistic prices.

(Section 5 gives more details)

2. The rise of passive funds in this decade:

What have been the challenges for actives?

"Growth in passive investing has been a profound development in this decade."

An interview quote

As many markets have been disconnected from their fundamentals to varying degrees by unconventional monetary policies since the 2008 crisis, stock picking has become harder in a number of asset classes – notably core. The policies have benefited the good, the bad and the ugly indiscriminately.

An overview

Since the 2008 crisis, passive investing has gained traction whilst the majority of active funds have underperformed against an appropriate market benchmark after costs. And success for active funds could not be guaranteed to repeat over extended periods.

On the other hand, pure cap-weighted passive funds have been deemed an increasingly easier and safer choice in a rising equity bull market.

They are cheap: investors are not required to research the securities that are in the index so as to beat it.

They are transparent: their stock and bond holdings of the index are on public display.

They are tax efficient in some countries: their buy-and-hold features do not trigger large capital gains.

They require minimal governance, offering a set-and-forget autopilot option.

Similarly, the key growth component of passive investing – ETFs – has also been in favour.

They are significantly less costly than active funds. They enable investors to increasingly slice and dice the investor universe to pursue specific themes over a market cycle.

They are an ideal wrapper because of attributes that include intra-day liquidity, transparency and tax efficiency.

That these advantages have influenced investor behaviours in recent years is not in doubt. That passive investing is becoming a durable phenomenon is not in doubt either.

However, what is open to debate is whether the issues with passive investing are widely understood; or, for that matter, the idea that active and passive investing are mutually supportive styles – with each relying on the other to survive to create a viable future. Increasingly, the active vs passive debate is not so relevant. We return to these points in Sections 3 and 4.

For now, it is essential to highlight certain trends that permit a deeper analysis of why the majority of active funds have had a challenging time until 2017 and what their future holds.

The data used here focuses on the US, where the trend towards index investing has been most pronounced and the relevant data sets are most reliable.

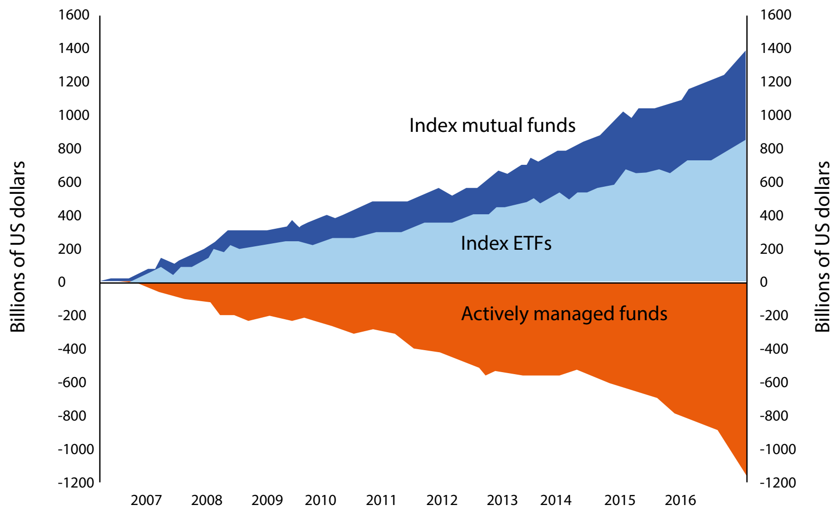
Recent trends towards index investing

a. Net inflows

The decline of active funds in the past ten years is summed up by a single data point.

Since the end of 2006, investors have withdrawn around $1.2 trillion from actively managed US equity mutual funds and have allocated nearly $1.4 trillion to US equity index funds and ETFs (Figure 3).

Figure 3: Flows from active to passive funds in US equities



Note: US domestic equity funds; figure as

Source: Investment Company Institute; Simfund; Credit Suisse

"Active managers who deliver excess returns net of fees have been relatively immune from pricing pressures. The rest are not."

An interview quote

The shift has benefited ETFs more than index mutual funds, although both have seen significant net inflows.

Either way, two sets of causes underpin the identified shifts against active funds: immediate, which are readily visible; and basic, which go to the heart of the problem.

b. Sub par investment performance

For the more immediate cause, one need look no further than the broad performance numbers (Figure 4).

In the US, passive funds have outperformed comparable active funds over 1-year, 3-year, 5-year and 10-year horizons for all the listed strategies.

Figure 4: SPIVA Year-end 2016 scorecard: percent of time indices outperformed active managers

Fund Category	1-yr	3-yr	5-yr	10-yr
All domestic U.S. Equity Funds	60.49%	92.91%	85.82%	82.87%
Global Equity Funds	79.71%	81.28%	85.29%	84.26%
Emerging Market Equity Funds	63.90%	83.56%	74.73%	85.71%
Investment Grade Long Funds	75.00%	98.04%	74.80%	96.30%
High Yield Funds	94.17%	90.91	88.04%	96.60%
Emerging Market Debt Funds	39.19%	82.54%	86.44%	76.19%

49% or less of Active Managers Underperformed the index	50-79% of Active Managers Underperformed the index	80%+ of Active Managers Underperformed the index

Source: S&P Dow Jones indices; Citi

Beyond the first year, the outperforming active funds lack persistency. Winners have not necessarily remained winners for long.

The persistency numbers are low for all funds in Figure 2: equity as well as bonds, developed as well as emerging markets, and investment grade as well as non-investment grade.

Overall, the US experience suggests an inverse relationship between the length of time horizon and the ability of top-performing funds to maintain their superiority.

"It is unwise to project the present into the future. Strategies go in and out of fashion."

An interview quote

c. The international experience is no different

The story is not too dissimilar in Europe either (Figure 5).

In countries as diverse as Denmark, France, the Netherlands, Spain and Switzerland, relatively better performance numbers in the first year appear to fade over 3-year, 5-year and 10-year horizons.

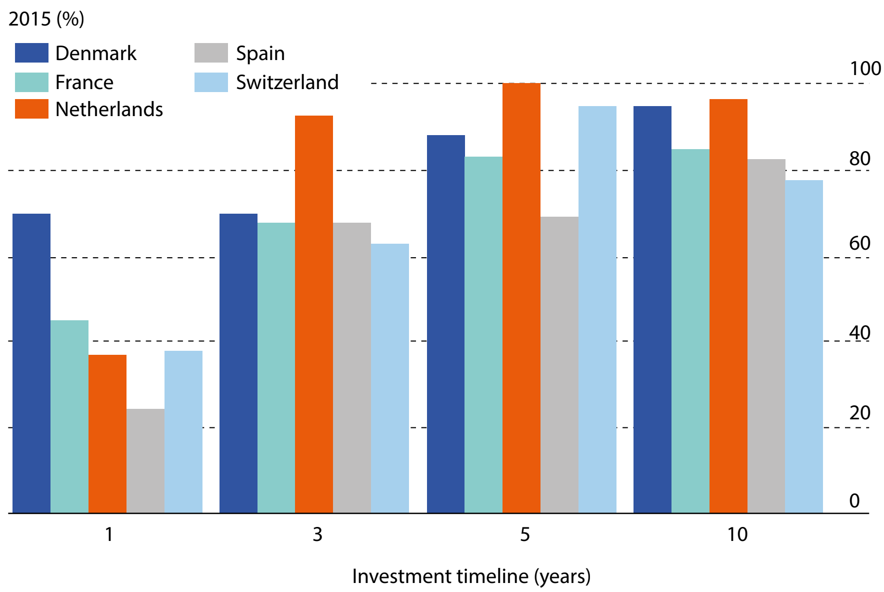
Cost has emerged as a key contributor. Equity passive funds charge their owners as little as 0.05 per cent of assets each year, compared with a weighted average of 0.82 per cent for active equity funds and below 0.50 per cent for fixed income funds.

In today's environment where central banks' ultra loose monetary policies have borrowed against future returns by artificially inflating asset values, fees have assumed added importance, as investors face a low nominal return environment.

Not surprisingly, some commentators have extrapolated current trends into the foreseeable future and drawn uncomfortable conclusions about business challenges faced by active investing.

For example, according to Moody's [1], passive investment accounts for $6 trillion of assets globally and 28.5% of assets in the US in 2016, a figure poised to exceed 50% in the next 4 to 7 years.

Figure 5: Percentage of active equity funds that did not beat their benchmark



Source: SPIVA

> *"In deep liquid markets of America and Europe, alpha is not easy to harvest."*
>
> An interview quote

This is duly corroborated by a well-known industry leader, Jim McCaughan [2]:

"The shift to passive strategies has been a game-changer of the asset management industry. A full-scale move to indexation and passive management is a long-term secular trend that may be only half complete. "I suspect that the move to indexation may have a long way to go."

But he hastens to add that every cloud has a silver lining: the rise of index investing also creates opportunities for active managers, as we shall see in Section 5.

Main reasons why active funds have been challenged

Many basic causes have been uncovered in a large body of literature to explain why the recent performance numbers of active funds are subpar. They boil down to the three main explanations that follow.

a. Too many asset managers are fishing in a limited pool

Charles Ellis, the veteran investment writer in his new book entitled *The Index Revolution* [3], takes a broad sweep of history and argues that, since 1960, the number of talented investment managers has grown faster than the number of investment opportunities.

In the period 1960-1980, active managers competed principally against individuals, conservative mutual funds and trust institutions.

While competing against these less-informed investors, it was not uncommon for active managers to notch up 200 or 300 basis points of superior performance each year. Over time, however, three principal developments created not only too many players, but also a more level playing field, according to Ellis.

First, the number of asset managers with highly qualified staff increased exponentially, creating an overcrowded field in which everyone has to run faster just to stand still. Whatever its size, alpha had to be shared between too many players.

Second, institutional investors became an important investor group, with better access to skills and advice. Retail direct investors, on the other hand, started migrating to index investing.

This view is also echoed in a recent study from Credit Suisse [4]:

"This is equivalent to weak players leaving the poker table. Since winners need losers, this can make the market even more efficient and hence less attractive for those who remain."

Third, the proliferation of technology caused a communications revolution and made it progressively harder to acquire an information edge. The internet has democratised investing.

Thus, markets have become more '*informationally*' efficient, according to Ellis. Stock prices trade at their fair value because all the available information about them is already factored in, as active managers have become ever more skilful over the years and in greater numbers.

Hence, consistently beating the market – active managers' core mission – is very challenging. Put simply, active managers are victims of their own success. This analysis does not allow for tail risks that have been normal in this decade (e.g. the Swiss currency crisis in 2014, or the Chinese equity crash on 17, August 2015).

> *"Loose monetary policies have lifted all boats and worked against value investing."*
>
> An interview quote

Even so, this back-handed compliment from Ellis appears to disregard a subtle interdependency created by:

- The way active managers assist price discovery and provide liquidity in times of stress that sustains index investing
- In return, the way index investing creates opportunities for active funds via price anomalies, as investors pour money into companies simply because they are in the index, not because of their intrinsic worth.

In other words, markets are efficient only because active managers buy underpriced assets and sell overpriced assets. Conversely, as the level of passive investing increases, markets become less efficient and active investing gains an edge.

This self-correcting mechanism appears to be largely absent in the active–passive debate.

Finally, Ellis's view on market efficiency has not gone unchallenged.

A paper from Vanguard argues that [5]:

"The fallacy of the 'efficient market' myth is that the underlying objective of indexing is to own the market (whatever that market may be) and to get a return of that market (minus costs).

The indexing concept makes no judgment as to market efficiency, size or style, nor does it need efficient markets to be effective."

Clearly, Ellis's views have not found ready support outside the US, not least because the investment pool worldwide has expanded massively, with varying degrees of liquidity and price anomalies for active managers to capitalise on.

In contrast, the next two causes appear to have widespread acceptance.

b. Returns have become a monetary phenomenon

Coming in the wake of the 2008 crisis, the QE programmes of central banks in America, Europe and Japan marked yet another milestone in a long process that has over time turned investment returns into a monetary phenomenon.

Especially since 2008, they have been influenced far more by monetary largesse from central banks than by the earnings boost from the real economy – contrary to all tenets of investing.

It all started with the so-called Greenspan '*put*'. During Alan Greenspan's chairmanship, with every market stress, the US Federal Reserve reduced its fund rates and added liquidity to encourage risk-taking to avert further deterioration.

The perception that the Fed would always intervene if markets tumbled is now deeply ingrained in investor psyche.

Of course, monetary stance has always been a factor in the cyclical movements of asset prices in the short term. However, the sheer scale of the recent central bank stimulus has been unprecedented in living memory, giving rise to moral hazard, as investing has become a one-way bet.

In the meantime, the rising monetary tide has lifted virtually all asset classes. The age-old principles of equity investing – long defined by fair value, time premium, risk premium, mean reversion and diversification – have been sidelined.

Unquestionably, QE has distorted asset prices, raised correlation within and between asset classes and borrowed against their future returns.

In this decade, investing has often been about second guessing the central banks' next move: a far cry from the fundamental investing of yore.

Accordingly, markets and individual stocks have been broadly moving in lock step. As the US example shows, the dispersion of stock market returns — showing how widely distributed returns of an index are — has been well below the norm for the past five years (Figure 6).

In a rising market, underperformance has been exacerbated by the usual *cash drag*: the need to hold a cash position that allows active managers to buy new securities and pay out for redemptions. This has harmed relative returns.

Active investing - which has long thrived on wider dispersion - has duly suffered, and passive investing has become a path of least resistance, giving rise to overcrowded convictionless trades and strong price momentum.

"Insurance companies don't need alpha because regulators judge them on beta."

An interview quote

Hence, the true test of passive investing will be best judged not by the inflows while markets remain buoyant but by their resilience when QE ends and '*normalised*' volatility returns.

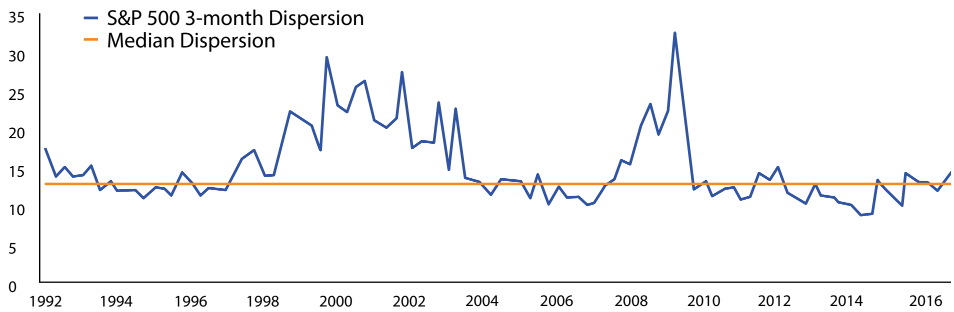
c. Regulators have turned the spotlight on fees

Since the 2008 crisis, regulatory scrutiny of the asset industry's various activities has been unprecedented. One area that has received special attention has been fees and charges.

The outward manifestation has been a scrutiny of closet tracking in many fund regimes: a practice of staying close to the benchmark index, while claiming to be an active manager and charging higher fees than passive investing.

In addition, on-going regulatory forays into fees have received widespread publicity and given the false impression that active funds *per se* do not deliver value for money, once all the costs are taken into account.

Figure 6: The dispersion of stock market returns has been well below normal lately



Source: S&P Dow Jones Indices

"There is no single investment style or rule that holds in every market environment."

An interview quote

On both sides of the Atlantic, the regulatory concerns have recently culminated into actions that have overtly favoured passive investing.

In the US, a new rule that came into effect in June 2017, enjoins investment advisors to assume a fiduciary role that requires them to act in the best interests of their clients and to put their clients' interests above their own.

All fees and commissions must be clearly disclosed in dollar form to clients, with full transparency around conflicts of interest.

The new rule stipulates that the client's best interests override all other considerations.

The debate leading up to the introduction of the new rule has reportedly led financial advisors to channel their clients' money into low-cost passive investing, largely as a pre-emptive measure to comply with the rule and deliver an acceptable total expense ratio for clients, when their advisory fees are added to the mix.

A similar trend is reportedly evident on this side of the Atlantic too, culminating in an unusually outspoken interim report from the UK's Financial Conduct Authority [6].

It revealed that there was no clear relationship between the fees of mutual funds in the UK and their performance. Furthermore, more expensive funds underperformed their cheaper peers. Finally, the majority of funds clustered within a narrow price range but often delivered very different levels of return.

The report went on to suggest that index investing was most appropriate for less informed investors. This recommendation was toned down somewhat in the FCA's final report published in June 2017 [7].

The UK's Department for Communities and Local Government has gone a step further. In 2014, it recommended that as much as £85 billion of defined benefit pension assets – from a total of £100 billion – managed for UK local authorities should be switched from active to passive management.

Similarly, the new mantra in the Netherlands lately has been "*passive unless…*" This is becoming the norm for the Dutch pension plans irrespective of their size or investment capability. Why? Because of the full cost transparency demanded by the regulator, the Dutch Central Bank.

With hindsight, this may hurt investors, if the tide is turning in favour of active investing, as the latest data in Section 1 seem to imply.

These are matters of detail. The substantive point is that growing regulatory scrutiny in America and Europe is widely believed to have been a significant factor in the rising popularity of passive investing, as this decade has progressed.

The three basic causes outlined above have led to concerns about the future of active management, while extolling the virtues of passive investing.

The concerns ignore the conventional wisdom: in the cyclical and self-correcting world of investing, there is no nirvana, only cycles. Index investing has its merits, but it also has its limits. The next section draws them out.

3. All that glitters is not gold:

What are the key issues with passive investing?

No single investment approach has ever thrived in all market conditions. Passive investing is no exception. It has its own challenges too. Some of them are being well flagged as a consequence of extraordinary inflows of late.

Cap-weighted indices

Since the first equity index fund was launched in 1976, the argument for passive investing has gone like this: equities will outperform other investments in the long run. But only few individuals are in a position to outsmart the market. Passive investing is the best low-cost option for tracking it.

"Passive investing is not all that passive. Investors still have to make certain decisions."

An interview quote

With its rapid rise in recent years, however, a number of potential shortcomings with passive investing have come to the fore, as narrated below.

a. Passive investing is not decision free

Investors have to choose among cap-weighted indices, or equally weighted indices or novel weighting schemes. They must also choose between passive funds and ETFs. There is no such thing as purely passive investing. It all depends upon how exposures are structured. Every exposure entails an active choice.

Investors also have to construct a portfolio, allocate capital to chosen indices and conduct periodic rebalancing to achieve their goals.

Semantics aside, there is a truly vast range of products today that do not neatly fit into two distinct camps of active and passive.

It is prudent therefore to consider a whole spectrum of investing types, with rules-based investing at one end and discretionary investing at the other; low-cost at one end and high-cost at the other. Cap weighted investing is just another rules-based, low-cost approach.

As Evan Grace puts it [8]

"Passives are better referred to as 'market exposures'. That takes us past the sterile debate (of active vs passive) and focuses on the types of exposures and risks involved. Market risk is what passive investing creates, and we should concentrate our analytical energy on how much market risk to hold and how it should be obtained."

He goes on to argue that how a portfolio is constructed is a blended, not a binary, decision. Returns are generated from both market risk faced by passives and idiosyncratic risk faced by actives. Investors have to choose the mix of these risks to suit their circumstances. And that's what they do.

Indeed, the two often complement each other in most of today's multi-asset portfolios that blend different asset classes and investment styles, as successfully exemplified by *Global Absolute Return Strategies from Standard Life Investments.*

b. Passive investing relies on yesterday's winners and inflates valuation gaps

By buying bulk, and without discriminating between its components, index investing blends the rise of the exceptional alongside the mediocre. And the index premium rises as markets scale fresh heights with new inflows, as has happened in this decade – further disconnecting valuations of individual stocks from their fundamentals.

In cap-weighted indices, companies are included because of their size, not necessarily their intrinsic merits. Past success is the defining criterion. Conventional value drivers such as earnings growth, currency trends, future prospects or macro economy do not feature in the selection criteria.

As a result, at some point, the index construction unavoidably ensures that the most valuable companies continue to remain so, irrespective of their future prospects.

It is possible that at least some of the component companies in the indices are included because of their future prospects. But there is evidence to suggest that the '*index premium*' resulting when every dollar goes to the same place as the previous dollar is now a significant factor, according to the New York Times analysis [9]:

"According to the calculations of S&P Capital IQ, non Russell 2000 index stocks carry a median price-to-book value ratio of just 1.34. But index stocks are accorded a 61.9 percent valuation premium at 2.16 price-to-book, as of June 2016. In 2006, for example, it was just 12 percent."

The analysis goes on to show two things. First, stocks owned heavily by index funds exhibit long-term pricing anomalies. Second, roughly one third of all the companies in the Russell 2000 index are not earning any money at all, the highest percentage of non-earners in the history of the index.

The combination of index investing and QE have benefited weaker companies often loaded with debt and dim earnings prospects.

Finally, from a fixed income perspective, index investing causes *adverse selection*: over-exposure to the most indebted companies or countries. The implied moral hazard is ever present when capital is directed to those who arguably deserve it least.

"As index constituents move in lock step, their diversification appeal is reduced."

An interview quote

To minimise it, however, smart beta strategies with new forms of weightings are now being devised.

c. Passive investing is cheap but not necessarily cheerful

The old cliché that diversification is a '*free lunch*' no longer holds when stocks inside an index move in lockstep with swings in the overall market.

This impairs investors' ability to diversify equity risk in their portfolios. In fact, the correlation within indices has quadrupled since the mid-1990s with the rise of index investing [10].

An earlier study by Rodney Sullivan and James Xiong [11] showed how rising inflows into indices and their associated high volume of trading have raised correlations across stocks, both in terms of price movements and trading volume.

Once conceived as a device for spreading the portfolio risks, indices no longer offer diversification opportunities due to the co-movements of their components.

There is another concern that is also frequently raised. Passive investing could also make booms and busts more likely and more extreme due to its inherent tendency to buy high and sell low.

Upward price momentum draws in new buyers. Its reversal turns them into sellers. When too much money is riding on stocks that move in lockstep, unexpected events can hugely amplify the impacts.

History shows that markets work best under two conditions: when people think and act not in unison, but independently of one another; and when price discovery is guided by people's expectations of future earnings, market position and the pricing power of individual companies.

Financial markets suffer extreme stress in their downward phase when too many people, acting in unison, stage a crowded exit and liquidity becomes scarce. In this context and, on past experience, there are three concerns as articulated by numerous investors today.

First, the times when passive investing reaches its peak popularity are typically in ageing bull markets or near market peaks, a situation perhaps where markets are currently.

Second, this will ensure that index investors will experience full market losses when the tide turns - possibly in greater magnitude than those held by active funds who can proactively defend portfolios by switching into cash.

Third, thus, passive investing avoids idiosyncratic risk only to replace it with a potentially even bigger systemic risk.

Thus, passive's strengths can turn into weaknesses, as the market environment changes. Passive investing is no different from other forms of long-only investing. None are fully resistant to market cycles.

Indeed, this form of reasoning underpins the available forecasts of the relative shares of active and passive investing (Figure 7).

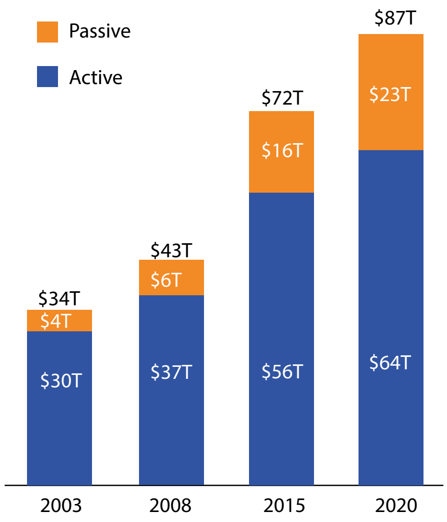
They show that the shares of active investing worldwide will fall from 78 per cent in 2015 to 74 per cent in 2020. In absolute terms, however, they will still attract a further $8 trillion, according to a recent study from Greenwich Associates [12]. It went on to argue that:

"Active management will remain a viable attractive business for the foreseeable future".

"The advantages of ETFs are hard to dispute. But their potential disadvantages are hard to ignore."

An interview quote

Figure 7: Global AuM: active versus passive



Source: Greenwich Associates 2016; BCG Global Asset Management 2016

Exchange traded funds

Back in 1976, the first index mutual fund was referred to as "Bogle's Folly" – after its founder. Yet, over time, it succeeded beyond expectations, paving the way for ETFs in 1992.

Currently, some $3.5 trillion is invested in ETFs worldwide, with every likelihood of notching up a compound annual growth rate of over 20 per cent by 2019 (Figure 8).

ETFs are cheaper to run, since they track indices rather than attempt to outperform them.

This is a far cry from the original aim of the indices. The Dow Jones Industrial Average was first created in the late nineteenth century as a summary measure of daily market changes. Now, indices are used as benchmarks for judging a manager's performance or as an investment strategy in its own right.

ETFs are an easy route into an asset class without having to pick individual funds or securities. They are also seen as a cash equitisation vehicle that parks excess money that would otherwise languish in a low interest rate environment. They are often used to short the market or to hedge and trade in an opaque manner.

However, like cap-weighted indices, ETFs have come under the spotlight as their rapid growth is exposing inherent challenges that pose three questions, as shown below. Only time will tell how real the implied concerns are.

"The average holding period of ETFs is much lower."

An interview quote

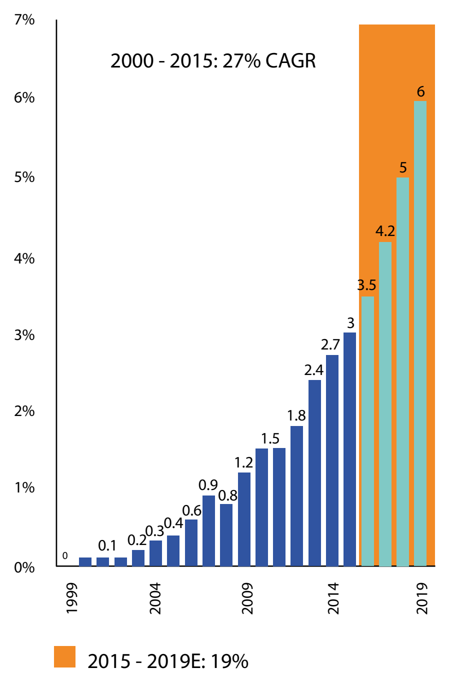
a. Are ETFs leading the markets rather than mirroring them?

Because of their sheer size and exponential growth, trading in ETFs has sky-rocketed, as described graphically by Jack Bogle last year in the Financial Times [13]:

"ETFs' impact on stock trading has reached mammoth proportions. They account for nearly one-half of all trading in US stocks. So far in 2016, the dollar volume of trading in the 100 largest ETFs has totaled $13.0tn. Trading in the stocks of the 100 largest US corporations totaled $13.9tn, only slightly larger. But the $1.6tn market capitalisation of those ETFs is but a small fraction of the $12.8tn for those corporate stocks. As a result, the annualised turnover rates are different in magnitude: stock turnover, 120 per cent; ETF turnover, 880 per cent. The implications of this rapid trading – call it speculation – have yet to be fully examined."

Historically, the primary role of equity markets has been to channel capital from investors to enterprises that want to grow their businesses. Investors were thus issued shares that were meant to provide a claim on the future profits of the borrowers.

Figure 8: Global ETF/ETP Assets under Management ($trillions) as of 7/12/16



Source: Morgan Stanley Wealth Management GIC [25]

Over time, however, trading in such claims itself has become more profitable than the rewards for holding them, giving rise to two other outcomes: vast growth in financial activity via derivatives trading; and a weakening link between equity markets and the real economy. ETFs are an outward symptom of this implied '*over-financialisation*' of markets.

Notions of time premium and risk premium are temporarily sidelined; as are the concepts of mean reversion and broad diversification that have long supported active investing.

b. Are ETFs reducing the benefits of diversification?

The high level of ETF trading is ensuring that the gap between the prices of individual stocks and their economic worth has been getting bigger. Stocks are more correlated with each other than they used to be, as we saw earlier. Their valuations are increasingly influenced by whether a stock is in widely traded indices or not.

This potentially reduces the benefits of diversification. It also promotes shorter time horizons and dilutes the tax benefits of ETFs in the US, according to Steven Bleiberg, William Priest and David Pearl [14].

The authors support their argument by highlighting the daily trading volume of the largest ETF in the marketplace today – the SPDR S&P 500 ETF (ticker symbol SPY) which had $225bn in assets at the end of 2016. With an average of 11.5% of the outstanding shares changing hands every day, the average holding period was around nine days (Figure 9).

While this degree of turnover may suit certain investors, it is unlikely to meet the needs of mainstream retail investors. It certainly raises the bigger question: are ETFs an investment strategy or a crowded trade driven purely by momentum? Only time will tell.

"ETFs are associated with over-trading that undermines price discovery."

An interview quote

c. Are ETFs undermining price discovery?

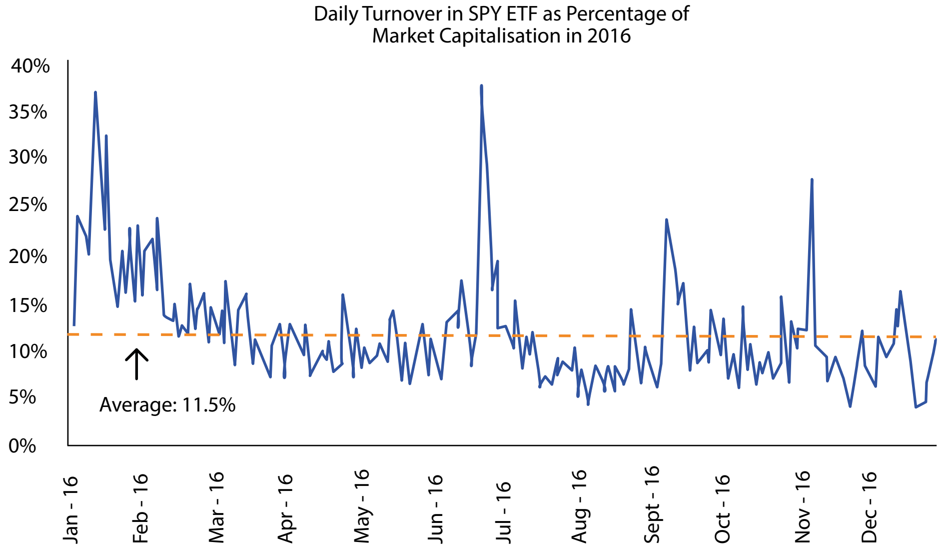
ETFs are perceived to be out of sync with the two traditional functions of markets: price discovery and efficient allocation of capital. In the process, they are becoming a new stock market phenomenon in their own right – where stock performance can be influenced to varying degrees by inclusion in a major index.

As ETFs have attracted more money, they have the potential to create a divergence between the price-earnings ratios of its constituents and non-constituents.

A US study by Eric Belasco, Michael Finke and David Nanigian [15] found that over the period 1993-2007, flows into S&P 500 created a divergence of 1.8% between the index constituents and non-constituents.

If this is true, the divergence can create arbitrage opportunities for active managers. However, these are hard to realise, according to the authors:

Figure 9: ETF investors have shorter holding periods than might be expected



Source: Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, "Exchange Traded Funds (ETFs)". Annual review of financial economics vol 9, 2017

"Indices have a strong price momentum in both directions. That can be good and bad."

An interview quote

"Informed investors may recognise the oversupply of capital to stocks in indices and then place arbitrage trades which counteract the effect. However, the speed of adjustment back to equilibrium valuations will be slow in the presence of inattentive investors... By their nature index fund investors are inattentive to valuations and ... arbitragers ... are rather impatient."

This view echoes John Maynard Keynes' timeless wisdom: "*markets can remain irrational longer than investors can remain solvent*". Capitalising on price anomalies requires both a buyer and a seller with diverse views on valuations.

Without them, it is hard for active managers to find someone who would want to initiate a trade.
While most equity valuations remain inflated by central bank action, and the rise of index investing continues unabated, pricing anomalies are not so prominent on investors' radar screen currently: quite the reverse.

Or as Michael Mauboussin of Credit Suisse [4] puts it:

"Markets tend to be informationally efficient when investors use heterogeneous decision rules. This is the wisdom of crowds. The loss of diversity as the result of converging decision rules creates fragility in the market and the possibility of prices departing substantially from value. This is the madness of crowds."

Unsurprisingly, Luis Aguilar, commissioner for Securities and Exchange Commission, confronted fellow regulators during a speech in Washington last year: "should we consider curtailing the growth of ETFs?" [16]. The SEC has since initiated a review of the ETF industry. Only time will tell how real the above cited concerns are.

However, on current reckoning, compared with active funds, passive equity funds may be hurt more in a deeper downturn, owing to their extra strong price momentum.

Some consequent reversal in the fortunes of active funds is likely, as we shall see in the next section.

4. Balancing the yin and yang of investing:

How have passive and active investing fared over different cycles?

Although conceptually opposites, passive and active investing are now increasingly regarded as complementary and interdependent. Both have had real results and both have swapped places as winners during different phases of market cycles.

Active investing has had its share of successes in the past. The pendulum will likely swing back in its favour, when valuations reconnect with their fundamentals as QE shifts into a lower gear and mean reversion reasserts itself.

"Active equities have a varying performance over a market cycle."

An interview quote

A historical perspective

a. Active equities have had regular ups and downs in the past

Starting in the depths of the recession in 2009, the current bull market in equities is now the second longest since WWII (100 months) next to the dot.com bull market (113 months), according to data compiled by Fortune [17].

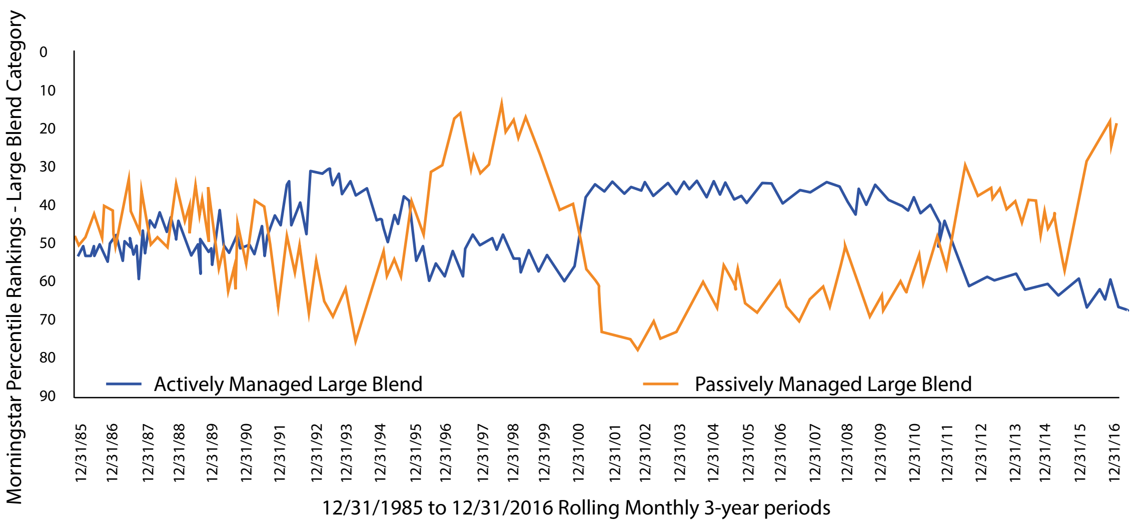
In both these bull markets, the rise of index investing has been noteworthy. However, in both cases it has been part of a cyclical process that has witnessed changing fortunes, according to historical figures compiled by Hartford Funds [18].

The figures focused on Morningstar Large Blend equity funds which is the largest Morningstar category with $1.98 trillion in net asset size, accounting for around 15% of the US mutual fund market. The choice of this category rested on the widely held view that it was the most efficient - the one in which active investing makes little sense.

The active component of the category was then compared to the appropriate Morningstar S&P 500 Tracking category. The results are given in Figure 10.

They show a clear cyclical pattern in the fortunes of both time-series. They also show that there is a clear inverse relationship, with no clear winner over the past thirty years. Most of all, they show a sharp reversal in the fortunes of passively managed funds once the dot.com bubble burst. The recent headlong rise of passives

Figure 10: Active and passive outperformance trends are cyclical



Source: Morningstar 2017

is preceded by nearly ten years of outperformance by actives.

That's only part of the story. There is also a more nuanced view when outperformance data for individual years are considered, according to the authors:

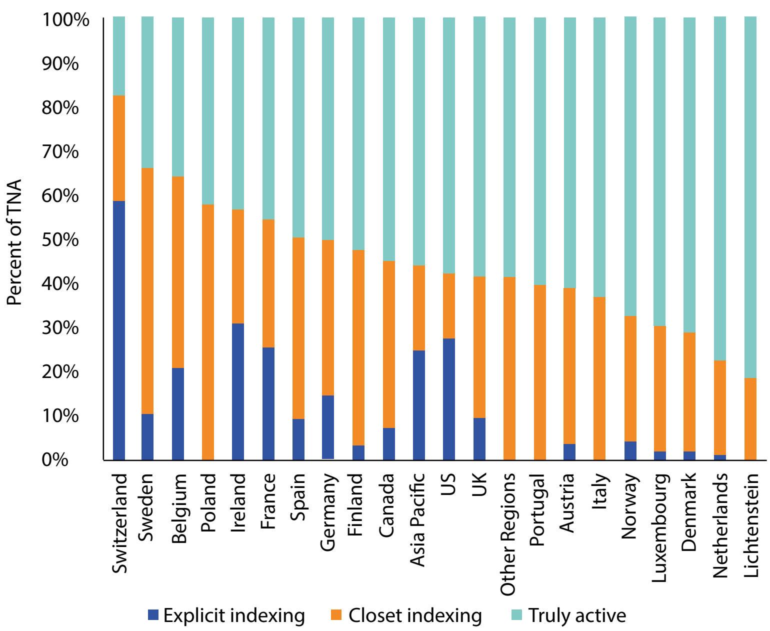
"A wider look at the chart reveals that active and passive have traded the lead in performance over time like two evenly matched racehorses. From 2000 to 2009, active outperformed passive nine out of 10 times. During the decade before that, passive outperformed active seven out of 10 times. And over the past 32 years, active outperformed 15 times, while passive outperformed 17 times... Like the ocean tides, active and passive management's performance ebbs and flows."

The authors go on to show that active has fared better during market corrections. There have been 22 such corrections over the past thirty years: active outperformed passive 16 out of 22 times.

"Closet tracking has reframed the active-passive debate. Its really about low-cost passives vs high-cost passives."

An interview quote

Figure 11: Explicit and closet indexing by country of domicile



Source: M Cremers et al, Journal of Financial Economics 120, 2016

Overall, the data make one telling point: both active and passive have had extended periods of under-performance only to rebound notably thereafter when the cycle turned. We return to this point towards the end of this section.

b. Closet indexing has distorted the performance data

For now, it is worth highlighting one factor that has artificially depressed the performance of active investing in different fund jurisdictions: closet indexing (Figure 11).

These are copycats with portfolios that mimic a benchmark with little chance of beating it after fees; while still charging active management fees. In the process, they depress the overall performance numbers for true active investing.

Their scale varies between countries. A recent Morningstar study found that 20.2% of large cap funds in Europe over the period 2005 to 2015 were closet trackers [19].

Their existence was first articulated in an earlier widely quoted study by Martijn Cremers and Anti Petajisto [20].

In it, the authors advanced the novel concept of *'active share'* - the proportion of stock holdings in an active portfolio that differs from its benchmark index. The higher the active share, the higher the chances of outperforming its benchmark. Indeed, active share can even predict fund performance, the authors argued.

Subsequent studies, however, showed that even with survivorship bias in the data, higher levels of active shares do not predict outperformance.

If anything, the higher the active share, the larger the dispersion of excess returns and the higher the fund costs. Active share is just as likely to correlate positively with performance as it is to correlate negatively.

Intuitively, a portfolio should be different from its benchmark in order to beat it. A high active shares will be of real benefit to investors if it is allied to the skills of a good stock picker.

"Many active funds have done well in this decade, despite the market distortions."

An interview quote

But the two key merits of the paper are still valid. First, it shows how to gauge funds that are genuinely active from those derided as closet trackers.

Second, the widely reported shift from active to passive has not been framed properly. Much of it may be simply switching from expensive passive to inexpensive passive.

Some positive stories

a. Examples of funds that have a long history of beating the markets

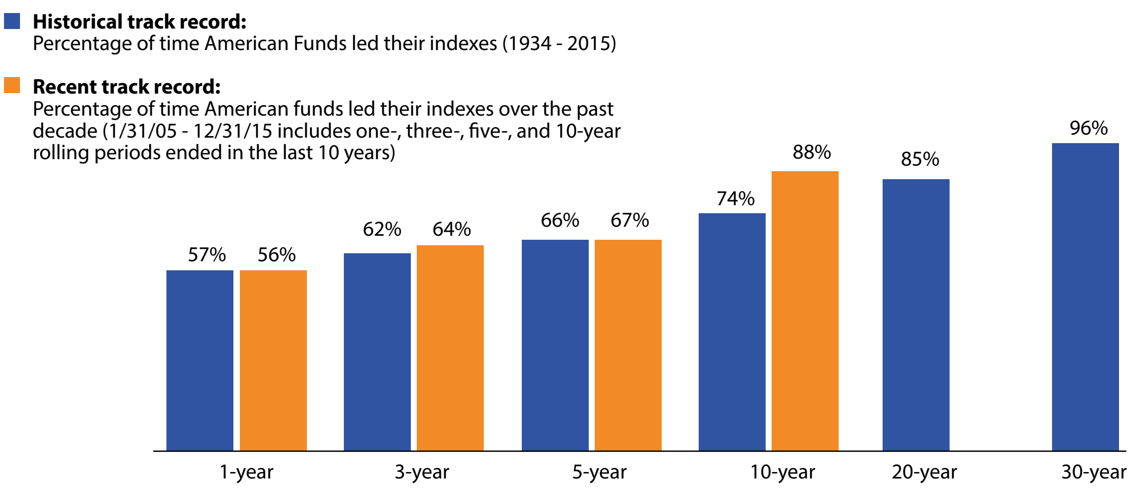
To add more colour to the foregoing analysis, we now present some case examples of successes.

The first one applies to *The American Funds* started by Capital Group some 85 years ago [21].

The first point to note is that they have outperformed their benchmarks most of the time throughout their long history. Their excess return has been larger, the longer the time period (Figure 12).

Second, the funds have also delivered downside protection and minimised losses during volatile markets – that is, minimising negative absolute returns relative to the market's decline. Over cohorts of 10-year periods, American Funds have avoided market losses by anywhere between 10% and 25%.

Figure 12: The equity-focused American Funds have a long history of outperformance



	1-year		3-year		5-year		10-year		20-year	30-year
Outpaced indexes	4,245	1,083	4,352	1,195	4,332	1,227	4,185	1,550	3,312	2,301
Total no. of rolling monthly periods	7,427	1,933	7,008	1,874	6,601	1,827	5,674	1,759	3,915	2,390

Source: Capital Group, 2016

"It is unwise to say passives are good and actives are not. Each has its merits and each has its limits."

An interview quote

Third, their fees have been competitive, compared with the industry average for active funds. Expressed as the percentage of industry average, the ratio for different fund subcategories has been as follows:

- growth funds 55%
- growth-and-income funds 54%
- international/global equity funds 66%
- equity-income funds 50%
- balanced funds 60%

Finally, performance persistency has been high overall and in each of the subperiods: strong periods of performance have been followed by equally strong performance (Figure 13).

Indeed, the American Funds are not an outlier. Vanguard's active equity funds too, have outperformed their benchmarks (Figure 14) [22].

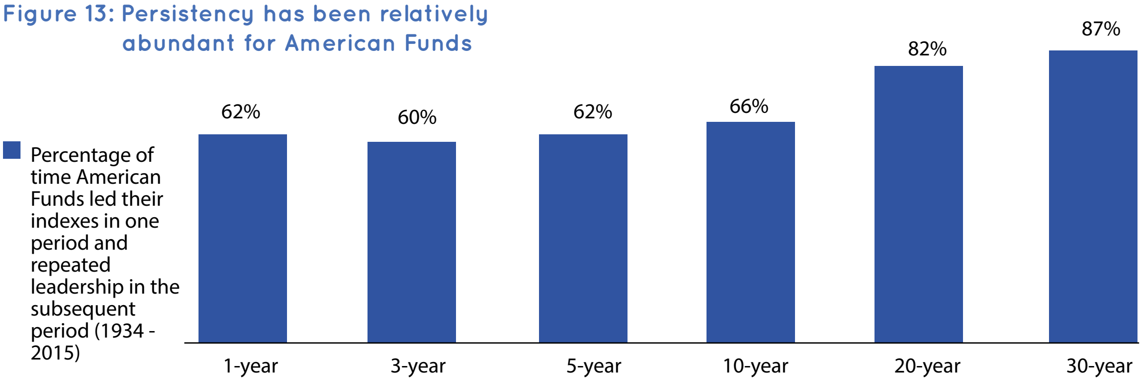
On this side of the Atlantic, there are examples of impressive excess returns too, first highlighted by Chris Wagstaff [23] and recently updated for this report and presented in Figure 15.

It shows that three *Threadneedle UK Equity Funds* have consistently beaten the FTSE benchmarks since 1999. It also shows that the margin of outperformance has, if anything, improved over time as well.

Similarly, M&G's Recovery Fund and Charity Fund have also significantly outperformed the FTSE All Share total return benchmark (Figure 16).

These examples are not isolated cases by any means, but just a random selection of many active managers around the world, continually

Figure 13: Persistency has been relatively abundant for American Funds



	1-year	3-year	5-year	10-year	20-year	30-year
Outpaced indexes	2,588	2,382	2,366	1,736	926	318
Total no. of rolling monthly periods	4,160	3,969	3,823	2,635	1,129	365

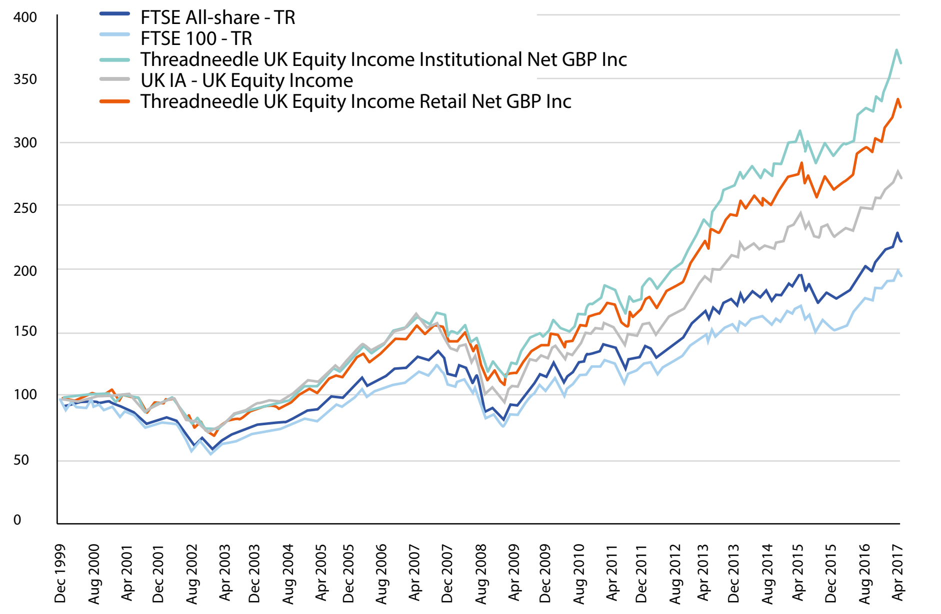
Source: Capital Group, 2016

Figure 14: Annualised excess returns of Vanguard active equity funds over their stated benchmarks, net of fees, 1985-2014

	Past 10 years	Past 20 years	Past 30 years
Equal-weighted *all funds*	0.19%	0.89%	0.33%
Asset-weighted *all funds*	0.80	1.11	0.45
Market-proportional-weighted* *excludes sector funds*	0.24	0.63	0.11

Source: Vanguard; Daniel W Wallick, Brian R Wimmer CFA, James Balsamo

Figure 15: Threadneedle UK equity funds since the turn of the century

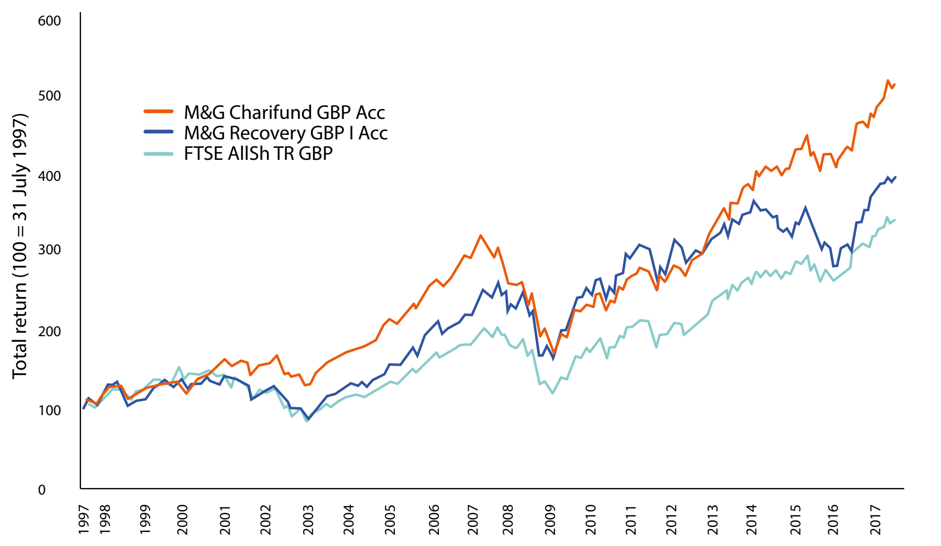


Source: Columbia Threadneedle Investments 2017

"Active fixed income funds have done much better in this decade, compared to active equity funds."

An interview quote

Figure 16: M&G's Recovery Fund and Charity Fund



Source: M&G

delivering impressive results over prolonged periods.

They and others serve to make a simple point: active investing faces existential threats no more than equity investing did on two highly publicised occasions in living memory, when their performance was sub par.

The first one involved a legendary cover story first published in Business Week magazines' August 13th 1979 issue when the Dow Jones Industrial Average was languishing at 875, following a period of extreme volatility

“Volatility would return and benefit active managers as the policy rates continue to rise in the US.”

An interview quote

after peaking in January 1973. Headlined *‘The Death of Equities’*, the story attracted worldwide publicity due to its dire prediction:

“At least 7 million shareholders have defected from the stock market since 1970, leaving equities more than ever the province of giant institutional investors... For better or for worse, then, the U.S. economy probably has to regard the death of equities as a near-permanent condition—reversible some day, but not soon. The implications for the U.S. economy could not be worse.”

Instead, three years later witnessed the start of the longest equity bull market in history. Stocks went on to multiply 14 times over the following twenty years.

Fast forward to August 2012, Bill Gross, then CIO of PIMCO, said in his Investment Outlook, following extreme market volatility:

“The cult of equity is dying. Like a once bright green aspen turning to subtle shades of yellow and then red in the Colorado fall, investors’ impressions of ‘stocks for the long run’ or any run have mellowed as well.”

Since then, equity markets have hit their all time highs, once again cautioning against projecting the here and now into the future when it comes to investing.

b. Performance of active fixed income funds has remained impressive

Active bonds have not featured strongly in the current active-passive debate.

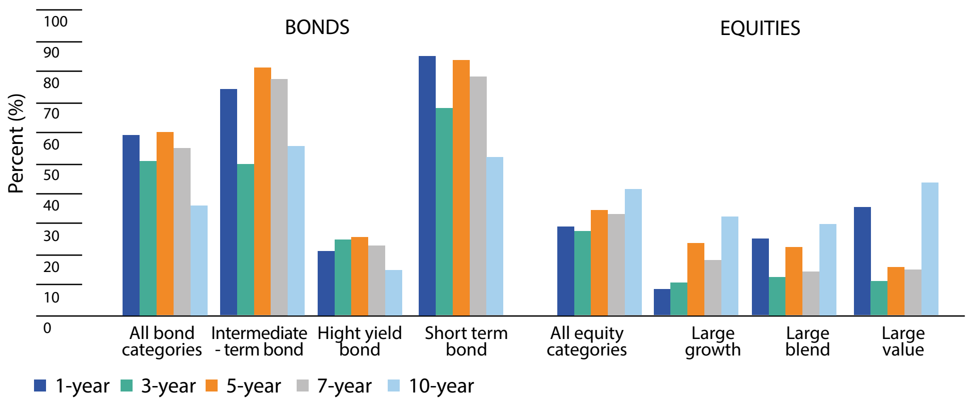
The ability of many active managers to invest in an unconstrained manner has delivered long term alpha generation – a strategy that passive funds cannot execute.

The experience of active fixed income funds bonds has been markedly different from active equity funds, according to a recent study from PIMCO [24]. The Morningstar data that it has collated shows that active bond funds and ETFs have largely outperformed their median passive peers after fees (Figure 17, left panel).

The figure prompts two points. First, active bond funds have done much better at beating their benchmarks compared to their equity peers (Figure 17, right panel).

Second, the extent of outperformance

Figure 17: Percentage of active mutual funds and ETFs that outperformed their primary prospectus benchmarks after fees



Source: Morningstar, 2016

is high across most bond categories. In part at least, the favourable performance of active bonds is due to the differences in the composition of their investor universe. The bond universe covers three categories of investors: passive, economic and non-economic.

Around 47% of the $102 trillion global bond market comprises non-economic investors – such as central banks, commercial banks and insurance companies – who are subject to various accounting and regulatory criteria regarding holding periods and the quality of their holdings.

They are often forced sellers of '*fallen angels*' that are victims of periodic downgrades by rating agencies, creating opportunities for active bond managers to sell them quality high-coupon bonds.

"Cyclical nature of the markets favour actives and passives at different stages."

An interview quote

The pendulum often swings, once either passive or active dominates the markets

There are three reasons why the swing towards passives may slow down by the end of this decade. At the very least, active investing could well see some reversal in its fortunes, as investors become more pragmatic in their portfolio construction, with changes in the macro environment.

a. The changing stance of central banks will reconnect market prices with their fundamentals

The US Federal Reserve is already shifting into lower gear by continuing its rate hike cycle and starting to run down its mammoth balance sheet. The ECB and Bank of England are not there yet, but their policy stance is inching in that direction.

On their part, governments in the West are dropping their austerity rhetoric and becoming more averse to deficit spending. The new US administration has ambitious plans for tax cuts and infrastructure investment.

According to a recent research paper from Morgan Stanley Wealth Management [25]:

"We are in the early stages of a major regime shift, from monetary to fiscal policy, from deflation to inflation, and from low volatility to high volatility. History suggests that this is when active managers have the best potential to find mispriced securities".

Old style volatility is set to come back, widening the dispersion of returns and reducing correlation within indices (as we saw in Figure 2 in Section 1).

History shows that this newly-evolving environment could be especially conducive for active managers who can spot mispriced assets, avoid the bloated behemoths and earn their keep.

b. There is no bright light between active and passive due to their interdependency

In a classic paper, Grossman and Stiglitz [26] argued that markets cannot be informationally efficient. Stock prices can't perfectly reflect available information. Because if they do, there is no incentive for anyone to acquire and process the information, in which case the market becomes entirely passive.

However, as new information becomes available, mispricing arises. To capture it, it becomes profitable to acquire information. Thus, the authors argue, investors have a stronger incentive to go active when most investors go passive and vice versa.

> *"Not all active managers can compete in the core asset classes. So specialism is essential in non core areas."*
>
> An interview quote

Therein lies a *Catch 22* that argues for a revival in the fortunes of active investing: if markets are perfectly efficient, then there is no reason to research them; yet markets can remain efficient only so long as they are continuously researched. This means that active or passive styles can dominate only over a certain market phase, not indefinitely.

Markets are *'efficiently inefficient'*, according to Antti Ilmanen [27]. His view is that the average investor has no hope of beating the market. But those who have the skills and computer resources can exploit the anomalies that result if the pendulum goes too far in either direction.

Once again, we hear an argument that passive investing can create inefficiency and hence opportunities for active. Conversely, active investing creates efficiency and hence opportunities for passive investing. So long as markets are cyclical, each style will go in and out of fashion over time. That is what history shows.

As Pozen and Hamacher sum it up [28]:

"While the interest in index funds is understandable, the disdain for active management is ironic. Active management is what makes index funds attractive in the first place."

That the pendulum will swing back somewhat in favour of active investing is likely. But there will always be uncertainty about two aspects of the pendulum: how far it will swing in one direction and when it will reverse. But as Martin Flanagan argues [29]:

"The extended period of the active-passive movement has probably gone too far. It is not going back to where it was, but it will moderate. There will be a very strong place for active capabilities too."

c. Rise of pragmatism favours both actives and passives

There is a widespread recognition that constructing a portfolio is not a binary active-passive decision for most investors.

Nor is it wise to lionise a particular strategy when it is riding high. Prudence argues for a pragmatic balance between active and passive investing, as well as between different asset classes.

Indeed, the CREATE-Research Programme shows that the traditional core–satellite model commonly used to construct a diversified portfolio is morphing. Passive investing is increasingly becoming part of the core portfolio and specialist strategies are becoming strategic satellites (Figure 18) to be accessed via active investing.

Well-functioning markets need the Warren Buffets out there picking individual companies and securities, and less-informed investors relying on low-cost indexers. They can – and indeed do – complement each other and allow for tilts to capture emerging opportunities.

The emerging core–satellite model shows that some asset classes are typically – but not always – best accessed through low-cost indices while others have the potential for excess returns and are thus consistently suited to active management.

After all, unlike passive portfolios, which have no discretion to adjust in declining markets, an actively managed fund could hold more cash, do defensive positioning against bear markets, and provide the price discovery and liquidity vital for well-functioning markets.

Active makes sense in volatile, unpredictable or illiquid markets.

Passive makes sense in rising markets. Active makes sense in inefficient markets. Passive makes sense for highly efficient asset classes, or where reputational and regulatory considerations disfavour active funds.

Besides, there are also illiquid asset classes where passive is inapplicable (e.g. real estate, private equity). Indeed, there is a wide range of mid, small and micro cap companies beyond the reach of the index that have all been shown to outperform large cap over the long term.

Active managers are better placed to act on fundamental drivers of performance and spot specific opportunities. They can sidestep a single region, country industry or company of concern. They can avoid the zero-sum problem by seeking alpha in different asset classes at different times.

Hence, Vanguard supports the emerging pragmatism in preference to a simple binary choice [30]:

"When an investor attaches a positive alpha expectation to a manager, adding some indexing to the mix can mitigate manager risk. Conversely, when an investor attaches a negative market expectation, adding some active risk to the mix can mitigate market risk."

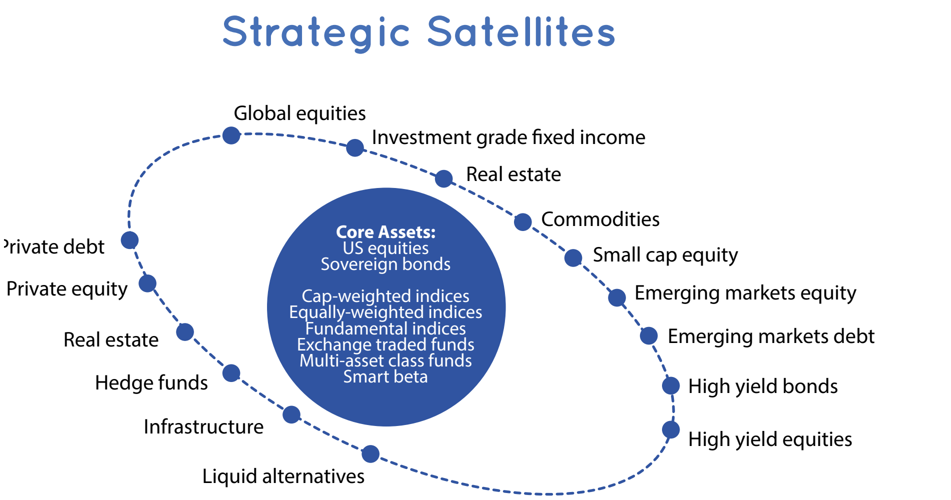
Ultimately, the optimum combination chiefly depends on exactly what problem needs to be solved. We return to this point in Section 5.

In the meantime, active managers cannot just wait for the rising market inefficiency to swing the pendulum back in their favour. There are actions they can take to enhance their capabilities so as to remain relevant, as we shall see in the concluding section.

"Active managers have more degrees of freedom than passive managers."

An interview quote

Figure 18: The stylised version of the emerging core-satellite model



Source: CREATE-Research programme, 2017

5. Active managers are upping their game:

What are the guiding principles for success?

Stock picking isn't going away. But the burden of proof is shifting. It must deliver value for money to demonstrate its worth.

That requires active managers to improve their capabilities to deliver better net returns and cost-effective growth.

"M&A is not a one-size-fits-all solution."

An interview quote

Consolidation is inevitable. Three recent big mergers – between Henderson Global Investors and Janus Capital, between Aberdeen Asset Management and Standard Life Investments, and between Amundi Asset Management and Pioneer Investments – herald a new wave among asset managers.

There are plenty of players who are either too big to be small or too small to be big. For them, M&A could be a viable option.

Indeed, a recent study from Citi [31] predicts a trifurcation of the investment universe, with fees being a defining characteristic (Figure 19). Its forecasts imply that the active core could well shrink from $44.6 trillion in 2016 to $41.3 trillion in 2021. The implication is that the size of the pie may well shrink for active managers.

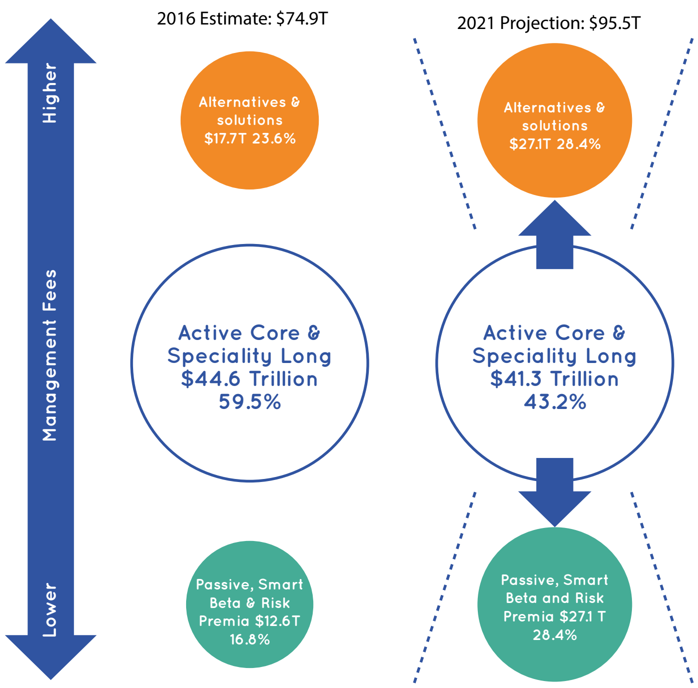
So, M&A activity will continue. Evidence shows that mergers work for some but not others. The latter have to pull themselves up by their own bootstraps in order to prosper in the new competitive landscape described in the Citi study.

Indeed, they are learning from the successes of many active managers who have continued to deliver value for money year-on-year and attract new inflows despite the rise of passives.

Their success provides practical guiding principles for others to consider, as they galvanise their businesses in the face of rising competition, according to our interviews with business leaders.

The principles enjoin active managers to make improvements in seven distinct areas. Some aim to deliver better net returns, others to secure cost-effective growth. Each is taken separately below.

Figure 19: Projected asset pools by management fee tier



Source: Citi Global Investor Sales, 2016 [31]

“Low-cost active funds are already coming on the market in the US.”

An interview quote

Delivering better net returns

Under this heading, four principles have been identified by successful active managers.

a. Investment performance must be the key avenue for building investor trust

Investor confidence has been declining for a long time.

Two of the four worst bear markets of the last hundred years occurred over a span of seven years in the last decade.

In addition, the monetary action by central banks has, as an unintended consequence, sidelined the conventional investment wisdom on diversification and buy-and-hold investing.

Many investors perceive market beta as the main source of returns – a view also endorsed by some regulators.

Yet, ageing demographics and ultra low interest rates have left pension plans and other long-term investors with persistent deficits, even after the second longest bull market in history. Their need for excess return is greater now than ever before.

For them, a trusted brand is much more than name recognition. It also means ‘*a promise kept*’. Good performance is now at the core of a trusted brand. Indeed, performance is the ‘*product*’.

Active managers are striving to deliver a new narrative on what they stand for and what they can deliver.

b. Fees must reflect value added, with skin in the game

Fees have presented a daunting hurdle for active managers in this decade. They often dilute outperformance.

Far and away, the most important change that is demanded is more equitable pricing of funds, as investors are expected to go into a low-return environment as QE winds down.

A previous study of institutional investors, carried out by CREATE-Research [32], found that, at the start of this decade, the majority of them were not too concerned about fees, so long there was good net outperformance.

However, there has been a discernible shift in views in the past three years: many institutional investors are discussing a low base fee and a well-structured performance fee with their active managers to secure a better alignment of financial interests for two reasons.

First, having witnessed the eroding power of fees lately on their excess returns, to the point of attracting regulatory attention, there are worries that this may continue even when the cycle turns. Doubts would linger in the light of recent experience.

Second, adverse media publicity has exaggerated the scale of closet tracking and tarred others with the same brush, notwithstanding the fact that a large number of managers now declare the active share of their portfolios.

c. Investment processes must factor in the new reality of passive investing

Apart from fees, the other key component of value creation is, of course, returns.

Better performance in future requires genuine innovation in investment processes so as to recognise that

“Corporate culture needs to nurture talent and get the best out of it.”

An interview quote

returns may continue to remain a monetary phenomenon driven by central bank action. The unwinding of QE could well turn out to be a slow burn process, given the massive debt overhang in the global economy.

Financial theories alone can no longer be relied upon to influence decisions made by asset allocators and stock pickers.

Hence, new lenses are being developed to look at markets from perspectives as diverse as politics, psychology and philosophy.

Investment ideas and their embedded risks are being stress-tested under diverse geopolitical scenarios. Technology, ranging from advanced risk management to machine learning and big data, is now becoming mainstream.

There is another reason why investment processes need closer scrutiny: the rise of factor investing and how it is raising the bar on alpha.

The term alpha is now being defined to come in two distinct versions: the ‘*commoditised*’ one refers to market-beating returns that are increasingly targeted by factor investing; and the ‘*informational*’ version which seeks to beat its commoditised rival by solely relying on managerial skills and proprietary research.

In other words, the definition of alpha is not excess return relative to market cap indices anymore, but alpha relative to a rules-based construct that seeks to harvest premia associated with risk factors such as value, quality, momentum and low volatility.

In a typical portfolio, these two versions of alpha will compete alongside traditional cap-weighted indices and ETFs, as factor investing spreads from pension plans to mass market investors.

d. A superior talent pool and meritocratic incentives must drive the investment engine

Attracting, retaining, motivating and deploying talent should remain at the fore, as active managers seek to enhance their relevance in the new landscape where the separation of alpha and beta becomes ever more pronounced.

Talent thrives in an environment that eschews group-think and herding; and instead encourages diversity of thought and approach.

The right environment is about creating a virtuous cycle of three ‘A’s: autonomy, alpha and accountability: autonomy, to generate high-conviction ideas; alpha, to set clear goals; and accountability, to encourage self-regulating behaviours.

The right environment also has other dimensions.

First, it has a strong employer brand, since talent begets talent.

Second, it has less bureaucracy and hassle, since talent needs wide parameters of control and responsibility.

Third, it needs a culture that encourages debate and dialogue, since ideas breed ideas.

Fourth, it requires meritocratic incentives, since good outcomes are what matters most to end investors.

Finally, it requires nuts-and-bolts leadership above visionary rhetoric, since talented people are more inspired by a boss who builds trust, shows respect for others and matches deeds and words.

Securing cost-effective growth

Under this heading, three further principles have been identified.

a. Cost disciplines are essential

End-investors are increasingly fee conscious as they become better informed. The combination of the rise of passives and regulatory interventions has attracted extensive media coverage.

There is a growing belief that the asset industry may well be shifting from being supply-led to being demand-led.

Active managers with a good track record of outperformance net of fees are unlikely to face strong fee pressures. For the rest, however, fee compression may be inevitable.

They will face competition from two sources: market beta and commoditised alpha (the latter based on factor investing).

The cost base will inevitably come under scrutiny. Obviously, widening the business base to diversify into new areas – as mentioned below – will help if it ramps up the scale.

But, while expanding the scale, new disciplines will be needed to ensure that costs don't run faster than revenue for extended periods.

b. Diversity of innovative products and solutions will help to ride out market cycles

For active managers, clients will continue to demand access to a diverse set of niche asset classes that can provide alpha on top of their passive core portfolio's beta exposure.

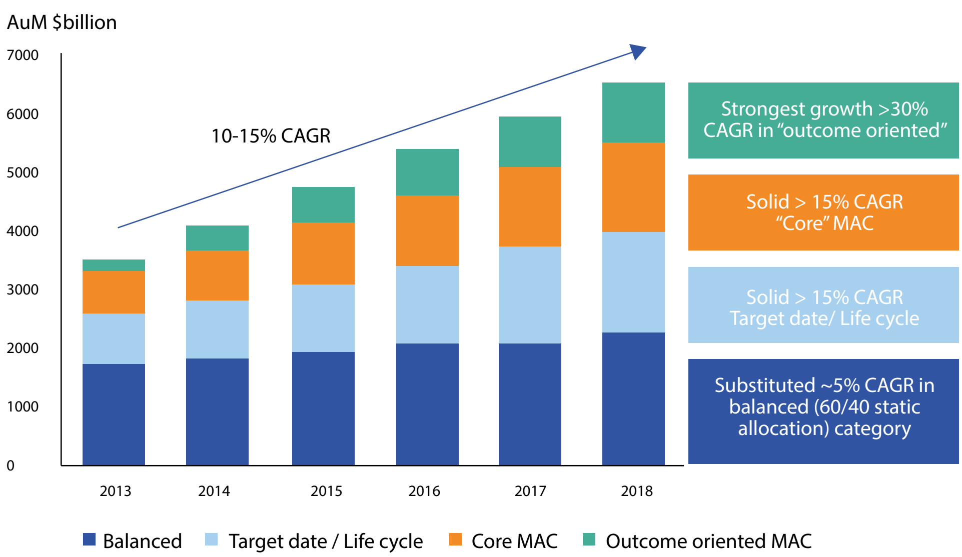
The most obvious action is to widen the scope of the existing business by diversifying into one or more of the following.

There remain alpha opportunities in less efficient markets where pricing anomalies are ripe. This especially applies to Asia equities, small caps,

"Outcome-oriented investing will remain one of the main growth engines."

An interview quote

Figure 20: Demand for multi-asset solutions from different markets



Source: Morgan Stanley and Casey Quirk, 2013 emerging markets, unconstrained fixed income, and increasingly popular credit instruments like private debt.

Other areas worthy of consideration are long/short funds, multi-asset funds and alternatives – which are forecast to grow over the rest of this decade.

Of particular relevance here are multi-asset and absolute return funds (Figure 20), as evidenced by the marked success of the Global Absolute Return Strategies (GARS) Fund from Standard Life Investments, and similar funds from other managers including Janus Henderson Investors and Aviva Investors.

"New technology will transform asset management over time."

An interview quote

Three components of multi-asset funds are likely to experience strong growth: outcome-oriented products that target specific client goals, core unconstrained funds that target high absolute returns, and life cycle funds that adjust asset allocations in line with the changing circumstances of clients.

Outcome-oriented investing holds significant promise for active managers. Translating investors' goals – be they retirement income, school fees or saving for a special event - into a cohesive plan can result in a '*personal index*' which may or may not have any relation to market benchmarks. Beating a benchmark is a hollow victory, if investors cannot meet their financial goals.

c. New technology should be deployed to create new opportunity sets

So far, the adoption of digital technology in the asset industry has generally been a matter of small steps, not giant leaps.

But the pace is accelerating, as it is widely accepted that a nimble business model needs to take on board innovations with transformational potential in front, middle and back offices:

- Cognitive computing and '*big data*' that can enhance alpha generation capabilities via either better stock selection or factor investing or both
- robotic process automation that can automate all routine manual operations, including custody, trade settlement and fund accounting
- blockchain that can disintermediate trading, payments and settlements in real time and at a fraction of the cost.

Five factors are likely to hasten the pace of adoption by the end of the decade: rising cost pressures, fees and charges becoming a major differentiator, the return of major high street banks into fund distribution, the likely market entry of Fintechs and internet giants, and the rise of Millennials as an important investor group.

With ever more assets predicted to be held by mass market investors over the next 10 years, improving "*client experience*" in this digital age is already emerging as a priority.

Such investors increasingly want one-click, hand device-based advice and execution, with complete transparency around fees and charges. They also demand jargon-free educational tools that help to both manage portfolios and counter their behavioural biases like herding and market timing.

Active managers are therefore adopting a proactive approach to digitisation, as it becomes the new '*heartland*' technology in their industry, with the potential to improve alpha generation, deliver superior client experience, reduce costs and deliver a joined-up business.

Such an approach is all the more relevant since the rise of passives is a structural phenomenon that is here to stay. Scale and low fees will continue to be the main points of competition.

Conclusion

With its binary focus, the active–passive debate has been too simplistic and prone to recency bias: unconditionally projecting the recent performance of active investing into an indefinable future. It ignores the cyclical nature of investing.

Since the 2008 crisis, the pendulum has swung in favour of passive investing due to two inter-related factors.

First, the ultra accommodative monetary policies of central banks in America, Europe and Japan have artificially inflated asset prices and undermined value investing. Second, a prolonged bull market in core equity asset classes has favoured passive investing.

"The new normal will not be the old normal."

An interview quote

Central banks are now preparing for a post-QE scenario that will likely reconnect equity prices to their traditional value drivers. Increased volatility is set to return.

On its part, the current equity bull market has likely entered a late stage, with widespread expectations for lower returns in the near future.

Both developments may swing the pendulum back in favour of active investing, if history is any guide.

However, the recent shift towards passives is a structural one, as costs have decisively moved the asset allocation goalposts in a low-return environment.

To prepare for this eventuality, successful active managers have and are implementing a number of actions to enhance their relevance in the changing investment landscape, setting an example for others to emulate.

Over the next decade, we expect that investors will develop a more balanced framework about active and passive investing, in pursuit of a complementary source of returns within a diversified portfolio.

After all, these two styles are like yin and yang: one defines and sustains the other during different phases of the market cycle.

This is confirmed by a revival in the fortunes of active investing in 2017, implying a more positive outlook going forward.

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Prof. Amin Rajan
amin.rajan@create-research.co.uk

Telephone: +44 1892 784 846
Mobile: +44 7703 444 770

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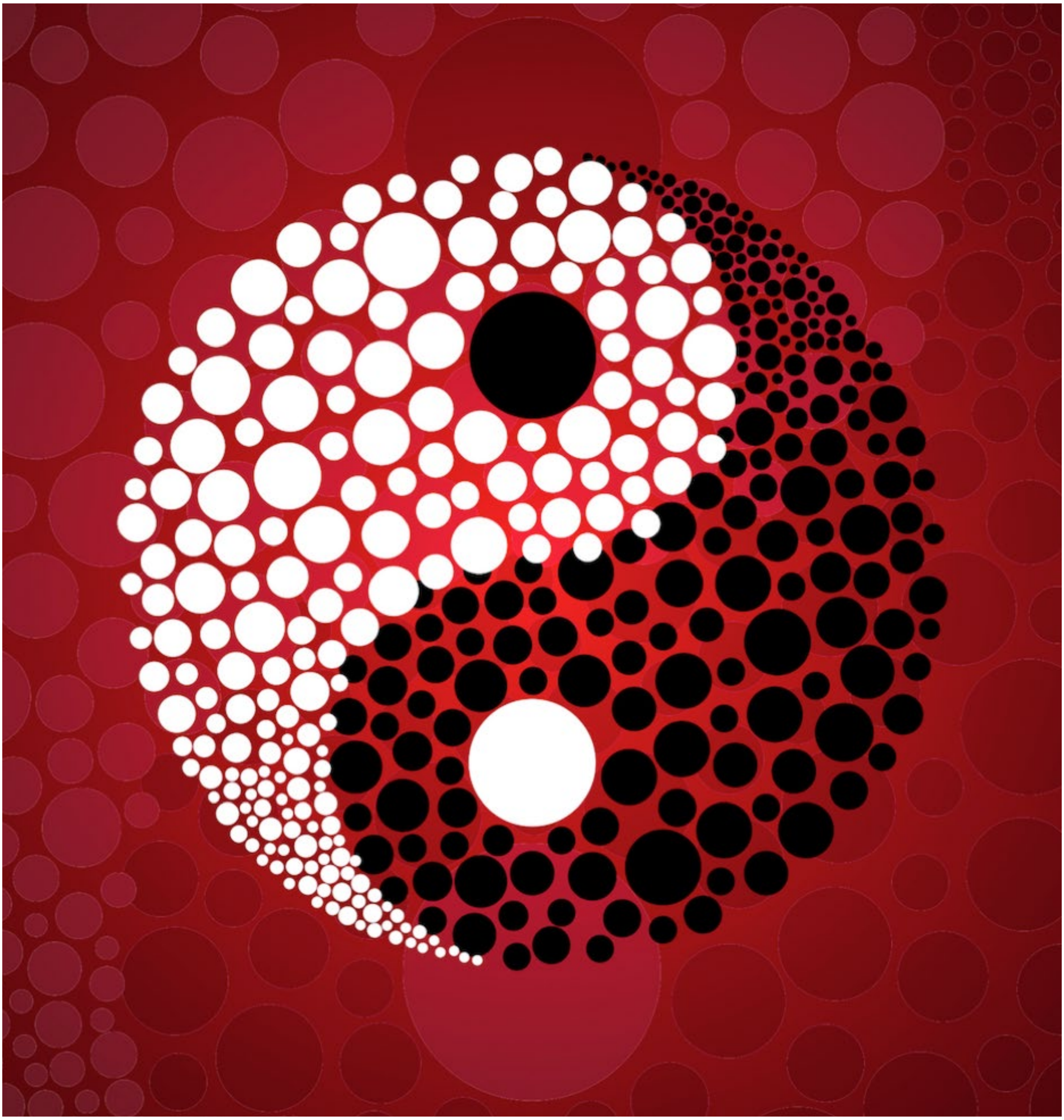

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