Peterson Research Institute

Global Investment Analysis (GIA)

GLOBAL INVESTMENT ANALYSIS

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The End of Active vs Passive

The Numbers Tell the Real Story

Active-Passive Arguments

There has been considerable discussion and argument over the last 25 years around the question of whether active management adds value to investment portfolios, or whether investing in market index portfolios would give better results.

The 'Active' argument is typically portrayed as being that markets are inefficient, and therefore the opportunity exists for managers to add value. This is an argument that is most strongly supported by the 'revealed preference' of institutional investors in Australia - superannuation trustees and their advisors – in that they have consistently allocated 20-30% of their investment risk budget to manager skill.

The Passive argument is that 'Active is worse' because of the costs involved. It is argued that investment managers do not add value, nor do so consistently, and therefore selecting managers that will add value in the future is too difficult, and in any case, markets are a zero-sum game. In each case the net effect of active management is to reduce returns by the management fees paid. Therefore, incurring management fees by allocating assets to active management is an unqualified 'bad'.

This Passive argument is most strongly supported by those academics who believe that markets are 'efficient' and by the 2010 Super System Review (Cooper Review) who's investment recommendations primarily focussed on reducing management fees.

The Real Question

What is missing in the whole active-passive debate are answers to the real question – **'Do portfolios with more manager skill outperform or underperform those with no, or lower levels of, manager skill?'**

The Active case is supported by the strong returns produced by superannuation funds, with the argument being that, "if the system works don't change it". The key difficulty with this argument is that it makes **no comparison between actual portfolios with different levels of manager skill**.

The Passive case is based on arguments about market efficiency, and the lack of skill demonstrated by investment managers under various measures. The passive argument is that, “if active managers cannot beat markets indices consistently, then the after fees return of a portfolio **must decline as more active skill is included**”. Again, the key difficulty with this argument is that it makes **no comparison between actual portfolios with different levels of manager skill**.

The Numbers Tell the Real Story

The Global Investment Analysis system allows us to analyse **actual outcomes**. The following charts look at the ‘Balanced’ and ‘Growth’ style portfolios that represented the vast majority of assets managed by superannuation funds in Australia.

Chart 1 plots the **actual after fees returns** for the 10 years to June 2013, against the **proportion of Manager Skill** (Manager Risk divided by Total Investment Risk) in those portfolios as at June 2009 (approximately the middle of the period).

Chart 1

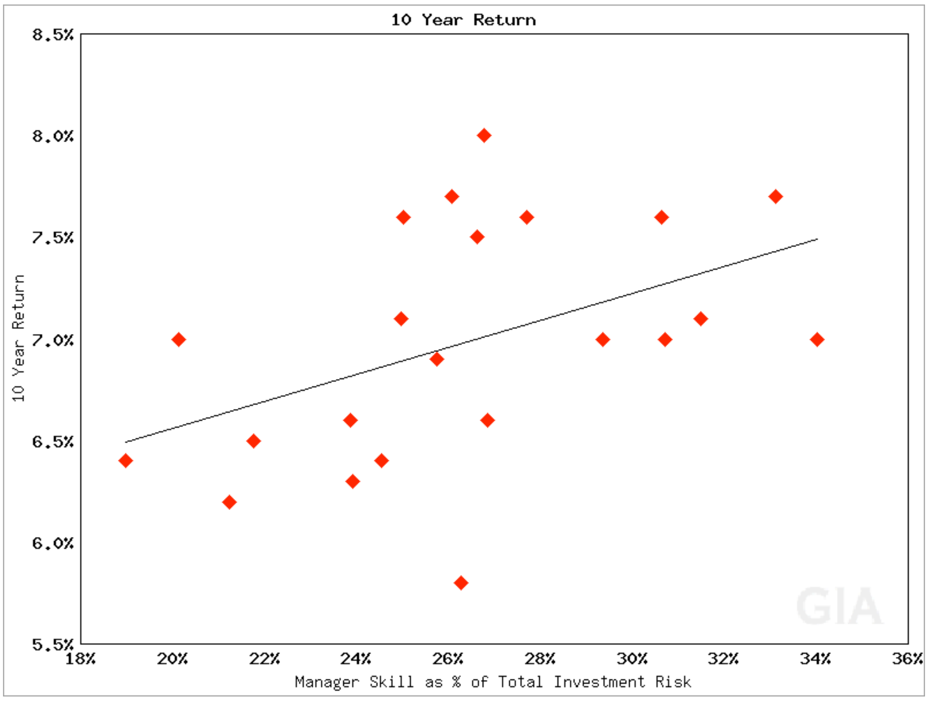


Chart 1 shows that **Manager Skill has added value** over this 10 year period, with the level of after fee returns increasing as funds increased their allocations to active Manager Skill.

Moreover this **value added has persisted**, with the investment returns in the 5 years to June 2005 (Chart 2: Manager Skill as at June 2004) and June 2010 (Chart 3: Manager Skill as at June 2009) both showing that the **after fees returns of actual investment portfolios has increased as more active Manager Skill is included**.

Chart 2

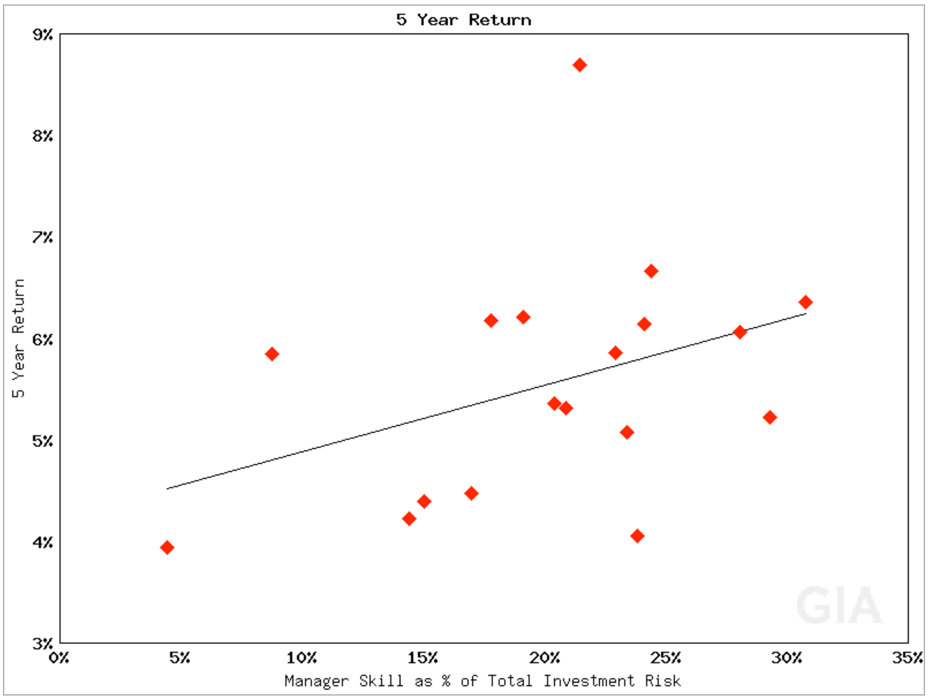
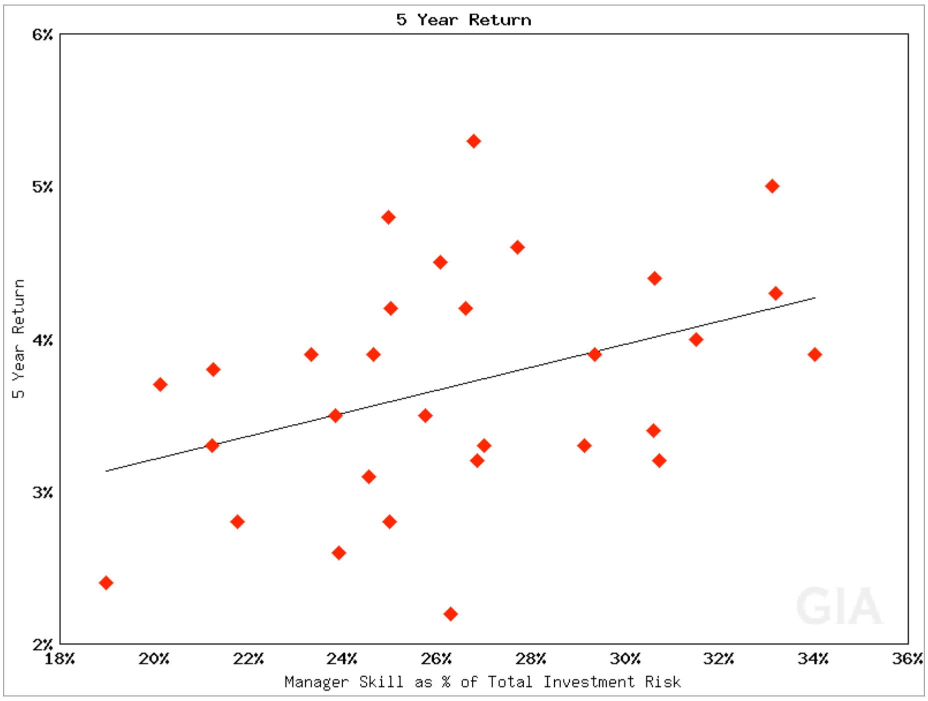


Chart 3



The End of the Active Passive Debate

If any of the three core arguments for Passive Investment Management are correct, then a portfolio's investment returns **must decline** as allocations to Active Management Skill increase. This would be represented in all of the Charts above by the **line of best fit sloping downwards to the right**.

The finding that **in reality funds with a higher allocation to Manager Skill have consistently outperformed** – i.e. that the line of best fit slopes upward to the right – proves that:

First, the **Passive Management arguments are not supported by the actual evidence**. As noted above, if either of the arguments is correct then the line of best fit **must slope downwards**. The fact that it **actually slopes upwards** requires, in logic and statistics, that the Passive Proposition be rejected.

(More precisely, the Passive arguments are incomplete, in that they fail to take into account the actual processes used by Institutional Investors to assess and monitor investment managers. In short, **Institutional Investors do not invest in the 'average manager'**.)

Second, and very importantly, through the processes they have used to select and monitor managers, **Australian Superannuation Funds have successfully identified and allocated funds to Active Investment Managers who have added value after fees**.

Conclusion

The 'Active-Passive Debate' is over. The real numbers tell the real story.

The important questions that now need to be addressed concern the appropriate level of Manager Skill in a portfolio, and the associated processes of manager selection and portfolio construction.

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Peterson Research Institute's Global Investment Analysis (GIA) system is provided free to Institutional Investors at **www.prigia.com**

This article is general information and does not address the personal needs of any individual. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.