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The merits of active investment management

We recognise that, in some situations, passive approaches may be appropriate for some investors. However, we assert that there is a strong case for most investors to employ a proven active approach in pursuance of their investment objectives.

We have recently written a paper on the merits of active investment management (versus passive alternatives) and this article is a synopsis of that paper. The debate about the merits of active and passive investment management has received much attention recently in the aftermath of the global credit crisis and in light of the failure of a number of active strategies to meet investors' requirements during that crisis. The likely consequences of changes in credit conditions, which are captured by our *all change* theme, are wide-ranging but, while they give rise to threats, we believe also that they generate opportunities for investors.

We argue in the paper that:

- investors are usually served best by proven active investment management
- in the ***all change*** world, in particular, an emphasis on simple and transparent, actively managed investment solutions will be essential
- there are some significant flaws in the arguments that purport, on return grounds, to justify the switching of investors' assets from active to passive funds
- the concept of 'market efficiency' (which is supported by proponents of passive investing) is erroneous
- passive funds do not 'neutralise' risk; active management allows 'risk' to be managed appropriately in the context of investors' specific objectives.

We think that investors are right, given the recent turmoil in financial markets, to consider carefully the strategies via which they seek to fulfil their various investment objectives. However, it is our conviction that in doing so they would be mistaken to suppose that 'passive' investment approaches are more appropriate than active investing. We believe that proven active investment management expertise is highly valuable, particularly in the ***all change*** world.

The concept of efficient markets

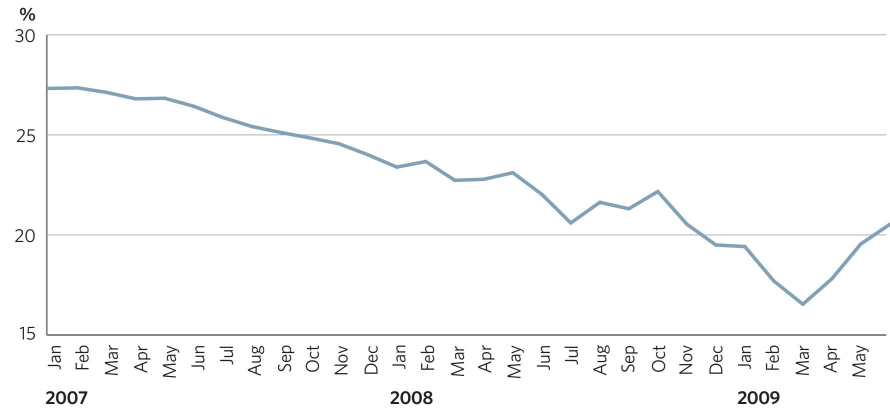
The advocates of passive investment argue that markets are 'efficient' (they 'discount' fully all known factors that might influence the pricing of securities), that it is impossible for an investment manager to outperform consistently and that investors should invest passively as a result. At any point in time, we recognise that some markets are likely to be ***more*** efficient than others (for example, large-cap markets in general are more efficient than small-cap markets). However, no market is ***entirely*** efficient because that would imply not simply the availability of all relevant information that might influence the fortunes of particular securities, but that investor psychology and behaviour are entirely rational in the interpretation of that information. We believe there are nearly always mispricing opportunities in markets, particularly for investors who are prepared to investigate asset markets thoroughly and who are equipped to use long-term perspective.

Concepts of risk

It seems extraordinary to us that arguments about risk tend to focus almost exclusively on the security selection 'risk' inherent in active management and very little upon the benchmark 'risk' that is unavoidable in taking a passive approach. A passive investor who suffers a 40% decline in the value of their portfolio should take little comfort from the fact that they have avoided security selection risk, and an active investor who 'achieves' a return of -38% against that 40% decline in the market is unlikely to be mollified by the relative 'strength' of their investment return. Both scenarios equate to pyrrhic victories.

Passive investment approaches reflect the 'here and now' (the prevailing make-up of the indices they mirror). Long-term changes in the world may not yet be reflected in indices, but an active investment manager can seek to take advantage of them; at Newton, our active approach seeks to anticipate the forces of change and the opportunities that derive from those forces. By contrast, a passive approach would tend to favour stocks that have already done well, amounting in effect to using a rear-view mirror rather than looking at the road ahead.

FINANCIALS AS % OF FTSE WORLD INDEX ($ TERMS)



Sources: WM Performance Services & FTSE, June '09.

The 'concentration risk' of taking a passive approach to investment may be significant. Financial stocks, for example, accounted for 27.3% of the FTSE World Index (in dollar terms) at the beginning of 2007, but only 16.5% of that index by the end of February 2009 (see chart 1). A passive approach would have 'dragged' the values of investors' portfolios down with the fate of the financials sector during the credit crisis.

In our full-length paper on the merits of active investment management, we explore the nature of investment returns in more detail. In short, we observe that good active managers have been successful in generating consistent, long-term outperformance. In any event, we believe that the environment we now face is more challenging than that in which passive funds have tended traditionally to do well, and we assert that excellent opportunities exist for research-driven active managers to add value on behalf of their clients in the ***all change*** world.

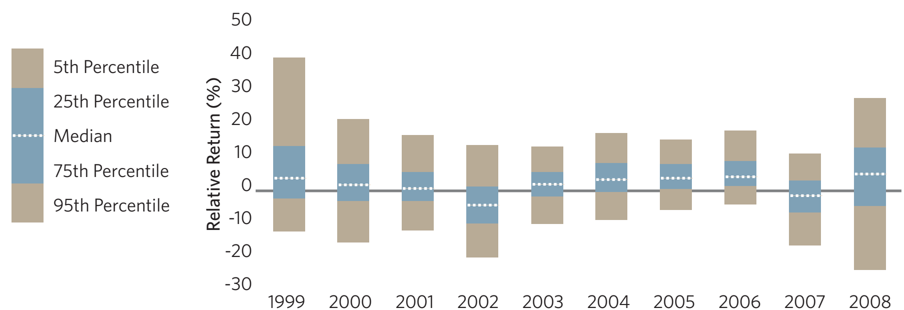
The characteristics of the ***all change*** world are substantially different from those of the 'becalmed' era of 2004-2006 in which investors embraced risk in the context of their perception that the economic 'cycle' was dead and in which asset markets exhibited remarkably low volatility. Chart 2 illustrates that the distribution of returns from stocks in the FTSE All-Share (UK equities) Index widened amid heightened equity-market volatility in 2008. The greater volatility and the wider dispersion of valuations and returns increase the potential for good active investment managers to add value.

At Newton, we have employed a global, thematic philosophy and process over three decades and we believe that our approach is vital in generating strong risk-adjusted returns in wide-ranging market conditions.

The nature of investment returns

Countless studies have been published which aim to 'prove' that active investment management produces higher returns than passive management and vice versa. In reality, the debate about which approach has been more successful is often argued along flawed lines. If all active managers are trying to beat an index-based return, it clearly becomes harder for each of them to exceed that return; the best will do so, but it is unrealistic to expect them all to do so. In relation to 'peer group' benchmarks, a majority of funds simply cannot exceed the median of themselves.

CROSS SECTIONAL DISTRIBUTION OF STOCK RETURNS 1999-2008



The cross-sectional distribution is the highest it has been since 1999. These charts indicate that the opportunities for active management (both on the upside and on the downside) are greater than they have been for a number of years. This 'opportunity' is also clearly revealed in the range of active returns in each region and show in the analyses that follow. In each case, the range of returns displayed over 2008 is far greater than in any year since 1999.

Sources: WM Performance Services & FTSE, June '09.

Trustees' duties

The burdens upon trustees have increased significantly over the last two decades. In seeking to discharge their duties, trustees of defined-benefit schemes face a number of key ***risks***, including:

- that life expectancy continues to rise and that trustees face the headwind of ever more challenging actuarial demands
- that markets generate insufficient returns to allow trustees to meet their objectives
- that the strategies and asset allocations they choose in seeking to meet their objectives prove to be ineffective

Trustees may be vulnerable to the first of these risks, but we contend that they are able to lower the impact of the second two areas of risk. Active investment management is capable not simply of generating outperformance ('alpha') versus a stipulated benchmark, but it allows the risks inherent in the adoption of a benchmark (the 'beta' of a portfolio's performance) to be managed as well.

Good client service and solid investment performance should allow trustees to overcome some of the pressures that might otherwise arise in their oversight of active investment management; a transparent and intelligible investment approach should be beneficial in helping trustees to contend with periods in which investment performance is disappointing. The services of a consultant may also help clients to achieve their objectives (particularly if such services work in tandem with the relationship between investment managers and their clients, which we believe is critical to the effective fulfilment of clients' investment objectives).

Costs

Aside from the level of costs incurred by investors, we think it is essential that there is a fairness and transparency in the incurrence of those costs. In seeking to ensure such fairness and transparency, we think active investors may benefit in particular from a performance-related arrangement. The use of such an arrangement should align investors' interests with those of their investment manager, but should serve also to align the fee investors pay for investment management services with the ultimate effectiveness of those services.

The implications of the *all change* world

The ***all change*** world is likely to have significant implications for investors.

Disillusionment with investments

Events in financial markets during the global credit crisis have caused many investors to feel disillusioned with a number of asset classes and with equities in particular. The psychological appeal to investors of a 'passive' approach towards equity investment is understandable on the basis that active forms of management may be perceived by some to add another layer of uncertainty to investors' decision-making in an uncertain world. However, we contend that prevailing conditions are very positive for the long-term investor and that active investment management is key to identifying opportunities in stock markets. In more uncertain environments, greater volatility and the wider dispersion of valuations and returns increase the potential for good active investment managers to add value.

Return solutions rather than products

In the new, ***all change*** world, investors are likely to seek credible return solutions that are developed to meet their specific requirements; they will be less eager than previously to embrace off-the-peg 'products'. Investors are likely to scrutinise investment management approaches more carefully in the years ahead and to be diffident towards products that they do not understand sufficiently. In particular, they will want to ensure that the approaches they adopt bring about appropriate solutions to their own investment objectives rather than the fulfilment of some other purpose (such as growth in an investment manager's assets).

The events of the last two years have thrown into relief the inadequacies of narrowly defined investment solutions and rigid, benchmark-related portfolio structures. In response to the obvious deficiencies of a narrow, product-driven approach, we believe that diversification and flexibility will be privileged attributes in the years ahead. In pursuit of these attributes, we expect to see an increased emphasis upon active, service-orientated approaches and we are anticipating a shift towards real-return types of strategy in particular as investors seek to overcome the shortcomings of approaches that focus only on benchmark-orientated returns.

'Back to basics' and a shift towards simplicity and transparency

Many investors have been frustrated over the last two years by the shortfall of investment returns against the promises made by some investment managers (and versus what, perhaps unrealistically, investors expected). In the less challenging conditions that prevailed in the period preceding the global credit crisis, product

‘innovation’ and ‘proliferation’ had become manifest. In the post-credit-crisis, ***all change*** world, the focus of investors and their advisers is likely to revert to the ‘basics’. Simplicity is likely to be a more highly prized feature of investment approaches given that the complexity and opacity of some investment ‘solutions’ were in part the causes of their failure over the last two years.

A ‘back-to-basics’ approach is not synonymous with a ‘passive’ approach to investing. Instead, we believe that the ‘basics’ of investment management are simple and transparent strategies that are understood by those who invest in them and that are adept at meeting clients’ objectives in a consistent, risk-controlled fashion.

The characteristics of effective active management

It is not our contention that all forms of active management are at all times beneficial to investors, but we do think that proven active investment management is usually advantageous to investors in comparison with passive management. We believe that effective active management requires in all circumstances:

A simple, transparent and robust investment approach
At Newton, we believe it is incumbent on us to help clients to understand the way in which their investments are managed and to reduce the complexity of their investment arrangements without imposing an unnecessary burden upon them. The robustness of our investment approach is grounded in our global, thematic philosophy and process (which afford us the perspective necessary to identify investment opportunities) and in proprietary research which is carried out by our career industry analysts on a global basis.

Rigorous investment selection
While we believe strongly that effective active managers can add value through favourable asset allocation, we believe that good stock selection is also critical in meeting clients’ objectives. At Newton, we do not simply buy ‘equities’ or ‘bonds’, but rather we make judgements about specific investment opportunities (based on their thematic attractiveness, fundamentals and valuation). The ideal company has strength in each of those three areas and strong security selection may generate attractive investment returns, even amid overall market weakness.

Strong performance and appropriate management of risk
As well as employing the expertise of an investment manager with a strong long-term performance record, investors should ensure that their investment manager has in place a robust risk measurement approach. The adoption of a passive approach that aligns investors’ risks with those of a (potentially volatile) index is no substitute for the proper active management of risk in the context of investors’ specific requirements.

For a full length version of “The Merits of Active Investment” please contact johanna_thomas@newton.co.uk

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