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Authors: Don Ezra – Russell Investments, Co-Chair, Global Consulting
Geoff Warren – Senior Lecturer, Australian National University

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In the investing arena, 'active versus passive' is a perennial subject of debate. This debate is often pitched in heated, adversarial terms, as if there were ultimately just one 'correct' way to manage investments. Discussions can devolve to a kind of war between competing factions, with battles fought mostly on the equities front, where data happens to be readily available and quite visible. Meanwhile, much of the academic literature focuses on the performance of active US equity managers. Although these studies deliver mixed results, generally they cast doubt on managers' overall ability to reliably add value after costs.[1] The passive-management contingent takes up such studies as banners for position that 'active management doesn't add value', with the implication that investors should thus buy indexed products.

We take issue with the conduct of this debate in two ways. First, we think it unreasonable to base broad conclusions about the relative efficacy of passive indexing on active managers' average results in a single asset class or sub-class, such as US equities. What holds true in one market segment may not be obtained in another. Second, we object to the implicit assumption that in the absence of demonstrable stock-selection skills among managers, passive index replication provides optimal exposure for investors. Why? Because this assumption does not take into account differences in investor objectives and circumstances. What is missing in the debate is recognition that appropriate structuring and management of investments may well depend on investors' relative situations.

In this article we seek to reconfigure and broaden the 'active versus passive' debate by presenting a framework for a more comprehensive consideration of alternatives to passively replicating a standard capitalisation-weighted index in any particular asset class.[2] We illustrate our framework with examples of circumstances under which a particular alternative might be preferred. We offer no conclusions as to whether any specific approach is intrinsically superior. Indeed, the overarching message is that best choices can vary across asset classes, investor circumstances and perhaps even time

[1] For instance, Wermers (2000) uncovers some evidence of added-value by U.S. mutual funds, although he observes that the majority of earlier studies conclude that actively managed funds underperform.

[2] See Oberhofer (2001) for Russell commentary aimed specifically at the choice between active and passive investments in a mean-variance framework.

SOME CONTEXT

There are two perspectives on why passively investing in cap-weighted indices provides the default or benchmark position. One is the 'theoretical' view, which considers cap-weighted portfolios as optimal under the tenets of modern portfolio theory. Of particular influence has been the role that the capital asset pricing model gives to the market portfolio.[3] Passive becomes the default because it delivers the closest possible replication for slices of the market portfolio at lowest possible cost. The other perspective might be dubbed the 'industry' view. In practice, investors do not directly aim to hold the market portfolio. Rather portfolios are constructed from the primary building blocks of asset classes, expressed in the strategic asset allocation that best aligns with investor objectives and preferences. Under the industry view, passive becomes the default because it is the lowest cost option for achieving exposure to an asset class.

Under both views, the default role given to passive investing in a cap-weighted index rests on the three assumptions listed below. A breach in any of these assumptions could justify giving consideration to alternative investment approaches.

1. ***Market efficiency*** – Cap-weighting should be chosen under the assumption of perfectly efficient markets, as prices are always correct. Investors may consider alternatives if they believe markets are not fully efficient and that any inefficiency can be avoided or exploited. This is the traditional reason for contemplating alternatives to passive investing.

2. ***Cap-weighting is aligned with investor objectives*** – The assumption that cap-weighting is aligned with investor objectives is often implicit. But it does not always hold. For example, a pension fund investor may wish to invest in a bond portfolio that matches cash flows. An endowment or foundation may have sustainable or ethical investing goals that preclude investing in the index.

3. ***Index efficacy*** – The view of passive indexing as the default assumes that an index is available which satisfies the intended purpose. The theoretical view calls for indices which provide an effective embodiment of the market portfolio. The industry view requires indices that deliver the desired type of asset class exposure. In practice, it is possible that no market index could exist, or that available indices might suffer shortcomings related to index construction.

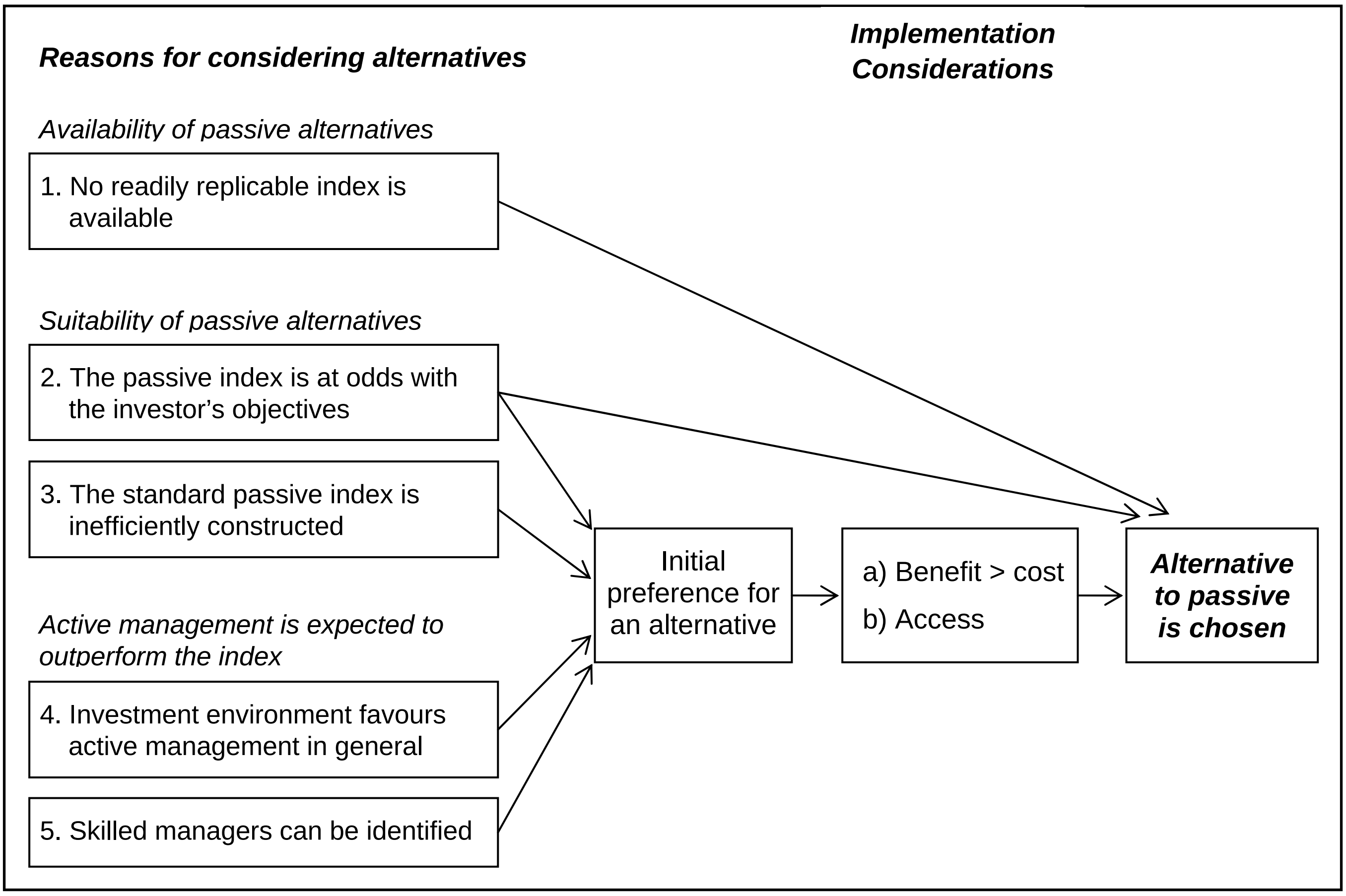
Below we propose five specific reasons why an investor might prefer an alternative to a passive approach in any particular asset class. These reasons all relate back to failure to satisfy one, or some combination, of the three assumptions identified above.

REASONS FOR CHOOSING AN ALTERNATIVE TO PASSIVE INVESTING

Figure 1 summarises our framework. Five reasons are identified for considering some alternative to passive investing in the initial instance. The ability to implement the alternative at a cost less than the expected benefit is addressed separately. In other words, the framework aims first to work out whether there is a case for rejecting a passive default, and then asks how much an investor is willing to pay and how the alternative can be accessed. In most cases, this alternative will be what is traditionally known as 'actively managed'. In other circumstances this need not be the case, or the skilled-based component may be minor.

[3] A broader view of the theory sees investors holding a series of portfolios that span the efficient frontier, and (in a multi-period world) hedge against changes in the investment opportunity set.

FIGURE 1. FRAMEWORK FOR CHOOSING AN ALTERNATIVE TO PASSIVE INVESTING



To date, industry debate has been focused around whether active management can outperform the index, with particular emphasis on the fourth reason addressing the performance of active management in general. The framework appreciably widens the range of reasons for choosing an alternative to passive investing. In particular, the first three reasons relate to the availability and suitability of the passive option. We now examine in turn the conditions listed in Figure 1.

REASON NO. 1: NO READILY REPLICABLE INDEX IS AVAILABLE

The first reason to consider an alternative captures the more extreme instances of a lack of an effective index. Passive investment assumes there is an index that can be readily replicated. Some alternative becomes the only option if no such index is available. Most unlisted assets fall into this category, such as private equity, private real estate and private infrastructure.[4] For listed markets that are relatively illiquid, index construction and replication can be problematic. Included in this category are small cap and emerging market equities, and high yield debt.

While passive products may be available, they might not deliver a faithful replication of the asset class at low cost. Such products sit in a grey area, where an evaluation is required of the suitability of the index as a candidate for replication.

[4] We refrain from discussing hedge funds on the basis that they can be considered a collection of strategies to access asset classes, rather than an asset class in their own right.

REASON NO. 2: THE PASSIVE INDEX IS AT ODDS WITH THE INVESTOR'S OBJECTIVES

A second reason for considering an alternative could be because the passive index is poorly aligned with the investor's own objectives. In such situations, some alternative approach may better meet these objectives, perhaps via employing active managers to help 'tailor' the portfolio. While the possibilities are somewhat open-ended, four notable examples are discussed below.

- ***Tailored fixed income mandates*** – In fixed income, an investor may desire a set of exposures that differ from that implicit in the standard index. A prime example is the desire to match a series of cash flows reflecting an explicit liability of the investor, such as with a defined benefit pension plan. Not only are the durations of the liability and the index typically substantially different; the annual cash flow patterns are typically also very different. These differences will no doubt have been reflected in the initial modelling work from which the strategic asset allocation is derived, making the passive index inappropriate for implementation of the strategic asset allocation. Or, more simply, the investor may have a preference to explicitly control the magnitude of exposures like credit in recognition of its influence on the risk profile of the overall portfolio. Such objectives might be better achieved through building portfolios with a different structure to the standard passive index.

- ***Listed infrastructure*** – Some investors may want exposure to infrastructure for its particular characteristics, namely reliable cash flows and a degree of inflation hedge. Investors who look to the listed markets for their infrastructure exposure face the challenge that parts of the universe do not provide these features, e.g. US utilities. Investment products might be preferred that better align the portfolio with the desired attributes through restricting the investment universe to certain securities.

- ***Sustainable and ethical investing*** – Sustainable and ethical investing is a classic example of where objectives other than pure wealth maximisation may create a desire to hold an alternative to the standard passive index.

- ***Tax effectiveness*** – Tax positions can drive a wedge between the index and the portfolio that best meets investor objectives. Conceptually, managing for tax efficiency should produce more optimal portfolios. However, this requires the capacity to actively manage the portfolio in a tax-aware manner. (Conversely, passive approaches tend to be more tax-effective than active management on a pre-tax basis, as the latter may generate extraneous taxes through greater turnover.)

REASON NO. 3: THE STANDARD PASSIVE INDEX IS INEFFICIENTLY CONSTRUCTED

A passive approach can lack efficacy in situations where the index is itself thought to be inefficient. There is no point passively tying your investment to an index that represents a sub-optimal approach, providing that there is an alternative which can deliver a better outcome. Two potential reasons why an index might be inefficient include: (a) the index is built on a narrow or unrepresentative universe; or (b) the index is constructed in a way that builds in some inefficiency. In the latter case, the case for considering an alternative can also relate to a belief in market inefficiency. These issues are best outlined through discussing in the context of three examples.

- ***Equities*** – The proponents of fundamental indexation[5] argue that cap-weighted indices are necessarily flawed because index weights are correlated with pricing errors, i.e. cap-weighted indices overweight over-priced stocks and underweight under-priced stocks. At its core, this is an argument that the market is inefficient, which is closely related to the case for value investing. The implicit suggestion is that a more efficient portfolio can be built by an alternative weighting scheme.

- ***Fixed income*** – While fixed income indices suffer from a plethora of shortcomings, two in particular strike at the issue of efficiency. First, some standard fixed income indices are partial representations of the available universe. Thus they not only fail to fully represent the asset class, but there may be scope to build more efficient portfolios by including off-benchmark assets. Second, index composition is driven by cycles of issuance and retirement of debt. There is no guarantee that the available mix of fixed income securities will amount to an efficient portfolio. Indeed, an argument might be made that the largest issuers may be less attractive, either because they are most in need of funding (and hence of lower quality), or are issuing debt to take advantage of low interest rates which are unattractive to

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[5] See Arnott et al (2005).

the investor. These features may give some investors reason to believe that a relatively efficient fixed income portfolio may be achievable under a more active approach. Indeed, such features appear to have contributed to the comparative unpopularity of passive approaches to fixed income.

- ***Commodities*** – Collateralised commodities futures funds have become a significant area of passive investment over recent years. As commodities do not have 'market-caps' in the usual sense, the link between commodity indices and the concept of a cap-weighted passive investment is problematic. We confine our discussion to particular US production-weighted indices such as the S&P Goldman Sachs Commodity Index, as they most closely resemble the notion of cap-weighting and are widely used by passive funds. Such commodity indices might be viewed as inefficient for two reasons. First, they are heavily skewed towards energy and hence poorly diversified: the S&P Goldman Sachs Commodity Index was over 70% weighted in oil and gas as of June 2009. Second, a rule-based approach to rolling contracts can leave the index exposed to distortions associated with short-term supply/demand pressures. Investors who accept these points may conclude that an actively managed collateralised commodities futures fund offers potential to construct a broader and probably more efficient portfolio through avoiding the concentration of exposures by commodity and futures contracts.

In each example discussed above, preference comes down to investor *beliefs* about the suitability of the standard index, and whether a more efficient portfolio can be delivered through an alternative approach. We offer no comment on whether such beliefs may be justified.

Our final two reasons address the more traditional question of whether an investor can access managers that are expected to outperform the index. We break this discussion into two parts.

Reason No. 4 focuses on features that could lead to active investment managers outperforming the passive alternative in aggregate. It asks whether there are any *generic* reasons to favour active management in a particular asset class or sub-class. Reason No. 5 addresses the issue of individual manager skill.

REASON NO. 4: THE INVESTMENT ENVIRONMENT FAVOURS ACTIVE MANAGEMENT

It is self-evident that active investment, broadly defined, is a zero-sum game relative to the market portfolio before transaction costs, and therefore a negative-sum game after costs. In this sense, active investment as a whole cannot outperform. However, this is a broad constraint that need not apply to any subset of investors or assets. It is conceivable that there will be situations where sub-groups of investors can produce sustained outperformance against an index, perhaps in part because the index does not capture the entire market.

It was observed earlier that the active versus passive debate has tended to focus on historical performance by the average equity manager, particularly in the US. While instructive, it is worth emphasising the dangers of making broad generalisations based on these results. A forward-looking evaluation is required of the potential for active managers to outperform in each asset class (or sub-class). Here it can be helpful to examine the environment in which managers operate, with a view to establishing whether they have any competitive advantage as a group that could generate sustainable outperformance. Features that might support such a situation are discussed below, grouped under headings that link them to possible breaches in the three assumptions identified at the outset.

1. ***Market inefficiency*** – While market inefficiency provides the potential for active managers to persistently outperform the index, inefficiency is not a sufficient reason to choose an active alternative in its own right. An additional requirement is that active managers are better placed than other investors to exploit any mis-pricing. Aspects of less-than-fully-efficient markets that might provide active managers with a competitive advantage include:

    - *Information advantage* – This can occur when the market is widely populated by less-informed investors that can double as both a source of inefficient pricing and as candidates for taking the other side of trades. Examples of assets where this seems more likely include some emerging markets and small cap equities.
    - *Preferential access to desirable assets* – In listed markets, preferential access usually means having first chance at IPOs, lines of stock, and so on. In unlisted markets, like private equity and

private real estate, existing relationships and the ability to provide capital or skills can help in sourcing attractive assets.

- *Partially segmented markets* – Such markets may have greater scope for prices to get out of kilter under the influence of localised forces, e.g. domestic economic cycles and politics. An active manager operating across market segments may take advantage of any related mis-pricings. Emerging markets and global property are examples of the type of asset class that may offer potential from this standpoint.
- *Economic value-add* – In some situations, active management can add value to the underlying asset itself. This mainly occurs for unlisted assets like private equity.

2. ***Opportunities arising from differing investor objectives*** – Active managers might benefit where differences in objectives give rise to a pool of investors who are willing to accept below-index returns. For example, active managers may be able to generate returns by offering liquidity to those requiring immediacy,[6] or accepting risks that other investors are less willing to bear. Differing time horizons could offer up some opportunities, e.g. value investors may exploit the short-term focus of markets if they have latitude to wait patiently for value to be realised. Some players may be driven by non-fundamental criteria, e.g. public money. While deviating from the market is a zero-sum game in return space, this need not be the case when measured in terms of utility if investors are heterogeneous.

3. ***Index fails to cover the opportunity set*** – Whenever existing indices are not comprehensive in their coverage of the available market, the potential may exist for active managers to outperform by investing outside the index universe.

In addition to the above, consideration should be given to the intensity of competition between managers for opportunities. Too much competition between the managers themselves can mean that opportunities quickly evaporate, or cannot be accessed in sufficient volume. Success is more likely when there are not too many active managers attempting to do the same thing.

This aspect warns against extrapolating from uninspiring performance by active managers in highly institutionalised markets, such as US equities, into other markets or assets where competition between managers may be less fierce.

The cyclical dimension to active returns should also be borne in mind. Active management tends to struggle under certain conditions, such as when cross-sectional volatility and valuation spreads are relatively low, or when markets are driven by ‘ thematic’ forces of a non-fundamental nature.[7] The possibility that active returns may rebound following such periods could give rise to a transitory preference for active management. While cyclicality has limited relevance for the long run, it may add a timing element to any evaluation of active versus passive investment.

REASON NO. 5: SKILLED MANAGERS CAN BE IDENTIFIED

Where a passive alternative exists, a belief that skilled managers can be identified may become important in two ways. First, the ability to identify skilled managers could be a sufficient condition in its own right for choosing active over passive management – regardless of how the average manager is likely to perform. Second, some capacity to evaluate manager skill is desirable in any situation where an active alternative is being contemplated. On the basis that both ‘good’ and ‘bad’ active managers exist, at the very least, bad managers should be avoided, as this could defeat the whole point of choosing active management.

To the extent that markets can never be perfectly efficient, some room should exist for outperformance through skill.

The issues are whether skilled managers actually exist, and whether they can be confidently identified ex ante. One reason to suspect that skilled managers do indeed exist is the notion that people (or fund managers) were not created equal. If one accepts this proposition, then an ability to identify these skilled managers becomes key.

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[6] Returns to providing liquidity also relate to exploiting a form of market inefficiency, i.e. costs involved with transacting immediately.

[7] Eggins and Gunning (2008) illustrate these concepts with respect to the Australian equity market.

Much of the related literature is based around US equities, and generates mixed evidence on persistence in active manager skill.[8] Furthermore, one cannot extrapolate reliably from narrowly focused research. Even if genuine skill was found to be scarce among US equity managers, it could still potentially exist for managers in other areas.[9]

In any case, manager selection is a skill-based pursuit involving an element of subjective judgment, especially given the unreliability of past returns as a guide and the potential for structural change among the managers themselves. The existence of manager selection skill must be evaluated on a case-by-case basis, and will depend on manager research capability in the particular asset class in question. Inevitably, investors must decide for themselves whether they have sufficient manager selection skill to justify choosing an active alternative over the passive default.

IMPLEMENTATION ISSUES

So far we have discussed five reasons for adopting an initial preference for some alternative to passive investing. Before committing to the alternative, it is necessary to consider whether it can be implemented at reasonable cost.

There are two issues:

(a) ***Cost versus benefit*** – Relative costs are typically lower under a passive approach. It is important that all cost differences are identified and weighed against the relative expected benefits. Costs include not only management fees and trading costs, but also any manager research and monitoring expenses. Such costs may vary significantly across products and investors, in part due to influences such as scale and bargaining power. Account should be made for the possibility that passive strategies need not deliver the index return. Trading costs arise from cash flows, index rebalancing and dividend reinvestment. Furthermore, index replication can sometimes be difficult and costly. The latter particularly applies in fixed income, and for more illiquid asset classes such as small cap or emerging market equities.

(b) ***Access*** – It is not always automatic that an investor can access their preferred alternative. Capacity considerations and existing relationships may be important.

Given that the capacity and cost of accessing various alternatives can differ significantly across investors and products, it is dangerous to generalise. An evaluation must be made in the circumstances.

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[8] While much of the earlier literature uncovered little evidence of performance persistence, more recent papers have questioned this finding. For example, Kosowski et al (2006) uncover statistically significant and persistent alpha among top-performing US equity mutual funds by using a bootstrap approach, while Kacperczyk et al (2005) find evidence pointing to return persistence associated with industry-related selection skill. There is also evidence of persistent outperformance by US growth managers versus their style benchmark (see Davis, 2001).

[9] For instance, Huij and Derwall (2008) find return persistence among US bond mutual funds.

SUMMING UP

The attraction of passively replicating a cap-weighted index is that it can offer a low-cost method for gaining exposure to an asset class (or a slice of the market portfolio, if you prefer). However, there are a number of conditions under which a passive approach no longer becomes optimal. These conditions extend beyond the issue of market efficiency, and the choice between passive and active management as traditionally defined. They include questions of the efficacy of the index itself, and how well it meets investor objectives.

We have suggested five reasons for considering an alternative to passively investing in a cap-weighted index. These reasons include ruling out a passive approach in the first instance because either no readily replicable market index exists, or because available indices are unsuitable due to not meeting the investor objectives or some embedded inefficiency. Even where a suitable index exists, an active alternative might still be chosen due to an expectation that active management can do better. This expectation could arise from confidence in the ability of active managers to add value in general, and/or capacity to identify skilled managers.

Ultimately, the question of whether to choose some alternative to passive investing should not be approached as a single decision. The answer is likely to vary across asset classes, investors, and even time. We trust that the framework presented in this article may assist investors in making choices that are appropriate given their circumstances. We also hope that it prompts a widening in the scope of discussion which, to date, seems too narrowly focused on comparing passive investment with the average returns achieved by active equity managers.

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