Why true active managers can thrive in the world of beta

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The active versus passive debate is often presented as a schism of the investment world, involving two intractable factions. However, my view is that active and passive must not be opposing forces.

« I believe it is better to be among the best asset managers, than among the biggest.»

While the rise of passives presents a challenge, true active managers should not fixate on the mounting forces of beta, and, instead, focus on delivering value for investors.

The passive era had a singular moment of inception. In 1975, John C. Bogle, founder of Vanguard, inspired by a research article published in 1974 by the Nobel Prize-winning economist Paul Samuelson, revolutionized the world of finance by creating the management of automatic market steering without an active manager.

Since then, the rise of passive investment vehicles has been a force for positive change: a natural evolution forged through greater innovation and heightened scrutiny around fees and charges. Passives have offered cost-effective stock market exposure and greater access to more esoteric asset classes. But perhaps their greatest legacy will be the democratisation of the investment world – which is allowing a greater number of smaller investors to enter the market via emerging 'robo-investing' brokers.

And now, more than forty years since their introduction, increasingly data is highlighting how passives have outperformed the vast majority of actively managed funds. This raises the question of the appropriateness of management fees, especially in times of sluggish growth and ultra-low rates. Never before has the scrutiny been greater on the active world. Now is the defining hour when active management must demonstrate its value.

Threat of extinction

With the emergence of passives and evolving smart beta, asset allocators have rightly questioned the existence of active 'closet trackers' or 'benchmark huggers'. For the active industry, the numbers are foreboding. According to a SPIVA study looking at S&P indices versus active strategies, over a period of 5 years, only 25% of active managers beat the S&P Europe 350 index, while only 11% have prevailed over the indices in emerging markets. And most alarmingly, less than 10% of active managers have outperformed the major US indices.

Against this backdrop, active managers must consider whether they are actually delivering value or what is becoming known as "true alpha or active" management. For some, this may pose deep questions about company philosophy and the construction of investment processes. Meanwhile, asset allocators need to consider what is true active management and where to find it. And for those who continue to mirror the indices, the threat of extinction is real and imminent.

Ascent of 'true' active alpha

So what is true active management? One metric that illustrates how different a portfolio is from its benchmark is active share. ESMA decided on a threshold higher than 60% for a fund to be considered an active fund – currently our funds retain an active share over 80%.

In terms of process, active managers can achieve true alpha through consistently exploiting pricing inefficiencies and taking active positions relative to the benchmark on information based on company fundamentals. And instead of suffering from sectorial rotations, which can catch out factor investing styles, such as momentum investing, active managers are able to take advantage of them. True active managers can also incorporate proprietary internal research and take contrarian positions to unearth valuation anomalies.

Another area where active managers can play a role is in employing effective asset allocation calls where dynamic multi-asset investment teams react to fluctuating environments.

Size matters

Research shows that size has a major impact on the ability to generate alpha. Quite simply, in most cases, thebigger a fund is, the more difficult it is to exploit inefficiencies.

For example, the average size of the ten largest funds in European equities, according to Lipper, is \leq 4.6 bn. The active return generated by these ten players, over the last five years, amounts to 1.5% per year, net of fees. However, if we take the ten best performers in the universe over the last five years, the average active annualised return is 13.3%, but the average size of the ten funds amounts to only \leq 311 million. Then, if we extend the selection to the best 30 funds over five years, the average size remains still modest (at \leq 500 million), but the average return, per year, remains at a very high level (+9%).

To address this endemic problem, two things need to happen: firstly, fund selectors need to begin reversing the trend of bias toward large active funds; and secondly, active fund houses need to re-consider their capacity controls to ensure active processes can continue to generate true alpha.

M&A: the enemy of true alpha?

I believe it is better to be among the best, than among the biggest. Asset managers are becoming more and more differentiated in the current context. In the rush to grow assets, spectacular mergers are creating huge asset management houses – suggesting the only possible choice for the active industry is to go big.

I see this as a concerning trend. It may lead to further pooling of large amounts of capital, accelerating liquidity constraints and a reduction in the ability of active managers to exploit market inefficiencies and invest in undiscovered stocks or out-of-favour sectors. More managers will be forced to invest in large and liquid assets and become index-like, with limited differentiating factors.

Passive facing headwinds

We do not oppose passive investment, instead true active managers can benefit from its growth by sticking to their DNA as alpha creators and providing durable, complementary solutions to investors.

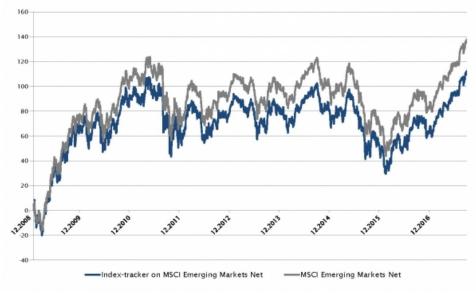
However, it is also important asset allocators don't overlook the passive world's limitations. While the focus has been heavily on active management's shortcomings, passives, I believe, will face headwinds on a number of issues.

One potential problem is the market directionality which has helped to underpin the growth of passives since the financial crisis: passive management or pure beta on equities has been driven by a rising bull market from the beginning of 2009. Since then, the S&P 500 has seen annualised performance of 14.9%, while the STOXX Europe 600 delivered 11.9% respectively (Bloomberg, 31.12.2008 - 30.09.2017). Unfortunately for investors, stock markets do not go up in straight-lines forever – and we could see rotations hurting index performance. Also, not all ETFs are ten or fifteen basis points. Fees can still hurt. For example, some emerging market ETFs have TERs of 72 basis points.

What the rise of passives does not represent is an existential threat to true active managers dedicated to delivering consistent alpha to investors. On the contrary, it has created a defining hour, helping to better differentiate asset management and support the ascent of true active management in the minds of investors.

The more the active industry identifies and addresses its short-comings, the greater it cements its long-term credibility. This means demonstrating its value and promoting true active solutions to clients. Only then, will confidence be restored in the ability of active managers to create consistent returns worth paying for.

Be aware: some trackers do not meet their objective



Source

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