The Death of Active Management
Broadly speaking, there are two schools of thought for investment managers: active management and passive management. In this article, we look at the new pressures building up on active management and what it means for institutions trying to design a prudent investment portfolio.

Passive Management Review

As a reminder, passive management is when an investment manager no longer tries to “beat” an index (like the S&P 500) and instead tries to match the performance results of the index. Usually a computer program can do much of the, albeit minimal, trading to keep the portfolio matching the index. The lack of thoughtful decision making and minimal trading requirements means passive investments are intended to be less expensive to operate. Relative to active management, passive management with indices generally has the following advantages:

- It’s generally less expensive
- It’s often more transparent, with easily defined expectations
- Long term performance is usually above the median peer group of active managers
- Passive funds are often granted a lower potential due-diligence burden
- Some investors can benefit from tax-efficiency, given reduced trading costs

Active Management Review

In contrast to the rules driven predictability of passive management, investors can hire active managers to do almost anything. Active managers benefit from human intelligence, foresight, and innovation. Active managers can make specific investments with the goal of beating their target index or they may simply try to equal the index return, with lower risk. They can ignore traditional investments completely and try out alternative strategies to lower the volatility of a portfolio. Relative to passive management, active management has the following advantages:

- Active managers have the potential to outperform the index; passive funds don’t
- Active managers have a greater variety of strategies to meet investor goals
- Some institutional investors benefit from useful revenue sharing agreements

The options – and combinations - for passive and active strategies are limitless.

Pressure on Active Management

Up until now, the advantages for passive or active management, enumerated above, have been well known. So, why has there been increased argument for the end – the death - of active management
during the past year? There are four reasons: absolute performance, relative performance, capital flows, and fiduciary standard advancement.

Since the market bottom of the financial crisis in early 2009, major US equity indices have more than doubled since the market low, and some have tripled in value, without a substantial correction in the meantime. Given this high level of absolute performance, some investors have become complacent about the benefits of low-risk options available through active investment. As noted, active managers also tend to underperform the index and their passive investment counterparts, but the relative performance difference has increased lately. (We will explain some of the reasons why in a moment.) Plenty of institutional and retail investors have noticed these trends and started voting with their pocketbooks. In other words, the capital flows away from active management towards passive investment options have been a significant trend over the past decade. Finally, the ongoing advance of the fiduciary standard should favor passive investment because there is a presumption that active management requires a higher amount of due diligence effort from investors, fiduciaries and consultants.

An Example of Performance

We mentioned the relative performance for active managers versus their indices has been particularly weak this year. We know, in the long term, indices tend to outperform active manager category averages, but usually the outperformance is by a percentage point or so. However, in 2014, the differences between active managers and the index were starker for many asset classes.

Let’s look at an example: the mid cap category. Here, we are looking at the investment returns for US companies which are worth between $2 billion dollars and $15 billion dollars. In 2014, the Russell Mid Cap index earned 13.2% in investment returns. In contrast, the average active manager in the mid cap category earned only 7.8% in investment returns. That is more than 5 percentage point of difference between the index and the peer group. Why did the active managers, on average, underperform so poorly?

One reason for underperformance of mid cap managers stems from market capitalization. Most indices are asset weighted. In plain English, asset weighting and index means the largest companies in the stock market are the largest part of the index. However, active managers can allocate their stock selections however they like. Rather, active manager bets have the potential to be conviction weighted or equally weighted. At least, active managers aren’t required to market weight their selections. For instance, if an active manager thinks that two companies - the very large “IBM” and very small “Bluth’s Banana Stand” - are both going to do well this year, the manager may buy equal dollar amounts of both stocks; the active manager doesn’t need to calculate which company is bigger and weight the bets accordingly.

So why does this matter? In 2014, there was a huge disparity between bigger companies and smaller companies. The largest companies (the IBMs) earned 13.24% in 2014 while the small cap companies (the Banana Stand) earned only 4.89%. Consider the weighted average of the (asset-weighted) index is around $11 billion while the median weight (equal-weighted) of the index is
around $5.5 billion. So, an asset weighted index is going to be more influenced by the largest companies’ performance. Meanwhile, active managers have their bets spread more evenly between all of their best picks, large and small. In fact, the active managers’ weighted average capitalization is around $7 billion, so they are more influenced by the performance of the smaller companies. In other words, active managers have split their bets more equally than the index, which gravitates towards the biggest companies.

**Inadequate Excuses**

So, we can explain one reason why the average active manager is underperforming. Is that an excuse? No. At least, it isn’t a sufficient excuse in the long-term. We do not subscribe to the notion where active managers get a pass because of their purchasing tendencies as a group. After all, active managers can do whatever they want to outperform and are paid, handsomely, to win.

We have heard many excuses for continued active manager underperformance, including a market preference for low quality over high quality positions, which active managers tend to favor. (Never mind the actual quality metrics, measured by debt / equity ratios, are nearly identical between indices and active manager averages.) Another excuse, albeit a smaller one, is the petty cash requirements means active managers will always lag behind in strong market rallies. It doesn’t matter if the excuse is true. Simply identifying the forces as an excuse for underperformance is no excuse, it is simply an explanation.

If we could demonstrate the forces which support passive management over active management are dominant forces in the long term, then we are obliged to use passive managers. Consider this logic: what if the reason for underperformance is simply the higher fees for active management. What if, other than fees, long term performance was identical for passive and active options? The problem is perfectly attributed and explained, but it’s not an excuse. To be a valid excuse, active managers need to make the case why the factors influencing their biases are, in the long term, going to provide additional value to their clients.

Given our previous example, where mid cap indices beat their peer groups, there is a valid defense for active management. Smaller companies, which tend to rely on US customers, do better in US-centric rallies since large caps rely on international revenue. However, the large caps did better in 2014 because the valuations were already stretched for small and midsized companies. In the short term, the mid cap space may continue to favor indices over active management, since valuations are still historically high for smaller companies. However, over the long term, the relative strength of various asset classes – growth & value, large & small - move up and down in cycles.

**The Lower Due Diligence on Passive Investments**

Determining prudence is often a function of peer comparison from quantitative and qualitative criteria. We have already established that key quantitative criteria (returns, fees) are generally attractive for passive products. Moreover, the key elements of qualitative criteria are often given a pass from investment consultants for passive investments.
For example, there have been several portfolio manager changes in large mutual funds over the past year. One of the largest active bond funds in the world recently had a shakeup in management which dominated financial news cycles for weeks. By comparison, some of the largest passive equity funds changed their management with hardly anyone noticing or caring. Both products will have failing grades with fiduciary screening tools (like the fi360 toolkit) which expect organizational stability, but nobody cares about the passive fund manager changes. Why? It is because the investment decisions, which are ostensibly the responsibility of a portfolio manager, are actually defined by a transparent, predictable set of rules.

The perception of a lower threshold for due diligence for passive managers is true, but we are concerned that this complacency can lead to significant mistakes. Rather, the philosophy and process for passive funds are, seemingly, so well defined that these products are often improperly vetted. First, there are marginal differences between competing passive products: fees, tracking error, and market depth (important for option trading). However, there are overlooked elements within passive product operations. For instance, some of the largest indexers provide lending of their securities to provide additional alpha, but the implications of this practice is ignored. Another example: one of the largest wirehouse passive bond funds has a time period of surprising underperformance relative to their index, not because of the underlying bond positions, but because of the cash management vehicle’s investment into short term bank and mortgage backed securities during the 2008 financial crisis (i.e. some of the money market fund assets which “broke the buck”).

Is Active Management Dead?

Active management is likely to become less popular over the next decade since fiduciary prudence is well served by low-cost options which tend to outperform peers. The comparisons to cheap and easy indexing isn’t going away. Furthermore, even if some consultants are too permissive with a low due-diligence bar for passive management, that trend isn’t likely to change either. 2014 was a culmination of many strong near-term trends which worked against active managers, but the long term trends aren’t going to provide much relief.

However, active management is certainly not dead. Given the likelihood of a low yield environment for the near future, some investors will invariably be attracted to the possibility of outperformance.

If active managers want to demonstrate their worth, they need to work harder at making the case for their business rather than relying on a presumption of good value (simply providing access to broad market exposure) they had enjoyed in previous decades. In particular, they need to focus on what they deliver which is unique among their peers and, over the long term, better than passive index fund competitors.

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