The active advantage: the case for having your money actively managed

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Preface

Simon O'Grady, CFA
Chief Investment Officer, Kiwi Invest

As an investment manager, Kiwi Invest is strongly committed to putting clients first, from the safekeeping of assets through to delivering strong investment outcomes within each client's risk appetite. The client-first philosophy has been a constant from the day Gareth Morgan founded GMI in 2000, through the Kiwi Group acquisition, the rebranding from GMI to Kiwi Wealth and the launch of Kiwi Invest as Kiwi Wealth's wholesale investment management arm.

Central to our goal of achieving the best investment outcomes for clients, the belief in active management has also been a constant through our firm's evolution. We believe actively managed portfolios are a far better deal for clients than passive portfolios, even after the slightly higher fee level active portfolio management demands – and that many current discussions around active investment are ill-informed.

Our quantitative strategy lead Steffan Berridge has looked through the evidence – as part of our genuine commitment to help every Kiwi investor access the best information available, and make decisions based on a clear understanding of the strategies and considerations that best align with their priorities, individual values, and long-term goals.

Steffan Berridge, PhD – Author
RI Lead and Senior Investment Strategist, Kiwi Invest

The "active versus passive" debate has been a fixture in the investment industry for nearly 50 years. Passive investing is one of the cheapest ways to access equity markets globally, and has helped to drive down fees across the board. Passive investment managers and their suppliers have gone further than just offering low cost products however, and have portrayed actively-managed portfolios as a bad option for investors.

We disagree, and believe, headlines supporting passive investing are largely driven by passive investment managers and index providers looking to frame the debate to their own advantage.

We believe that the research behind the headlines is inadequate and highly biased, and a poor source of advice for investors – but a frequent darling of the press, due to its headline-grabbing sense of disruption. To make matters worse, the bull market over the last nine years does a great job of masking the risks of passive investing.

We think investors moving to passive funds are going to be disappointed in the long run, and that the headlines that have driven the move will eventually prove to have been incorrect. While passive equity investing can be a better option than just leaving money in the bank, investing for the long term without considering the benefits of active management is a significant lost opportunity, both in terms of like-for-like comparison with passive, and when considering the benefits of holistic, multi-asset portfolio optimisation. As with many other products offered at a discount, passive investment comes at a price.

Highly credible academics first made the case for passive investing in the late 1960's. A number have since turned their back on passive, but the legacy today is a large investor base who have left their long-term savings languishing in passive products. As an investment manager, we feel a strong duty to our clients to achieve the best outcomes based on the level of risk each client is willing to take, and strive to create top performing portfolios for investors without losing the benefits to high costs and fees.

We also believe in our obligation to provide high-quality, evidence-based information to the market – and as such, we hope this paper will be useful to investors and those interested in investing, to understand our decision, and help you come to yours.

Passive vs Active

What is passive investing?

We'd define a passive investment strategy as one that primarily weights companies according to their size – and uses indices (such as the MSCI World, or S&P 500) as a simple benchmark for the fund's decisions – reducing the need for expert analysis and decision-making, and reducing management costs as a result.

Passive investing at its core is investment in the "market portfolio", essentially a basket of stocks which is a scaled-down miniature version of the entire stock market – for example with very large companies like Apple and Microsoft having the biggest weight, and very small stocks such an average New Zealand listing having the lowest weight. The biggest attraction of a passive portfolio for investors is that it's very cheap to run – a factor with considerable appeal to some investors in the late 20th century, when fees for active management were high.

The case for passive investing was made most iconically by Burton Malkiel who claimed in 1972 that "A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts". He contended that not only were investment managers no better than monkeys at investing, but the fees they charged and the lack of tax efficiency meant, on average, they were bound to underperform their benchmarks.

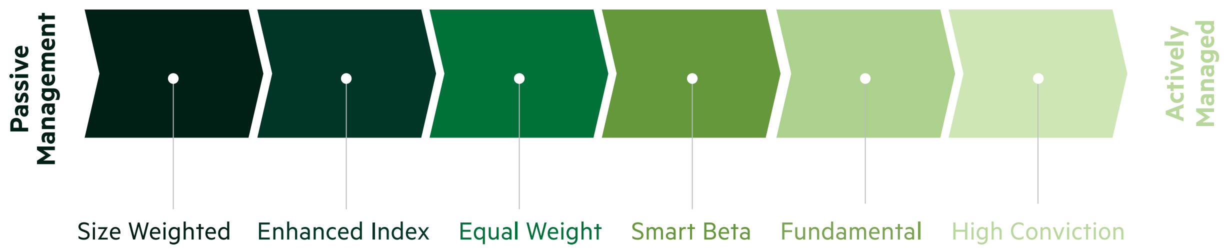
(Ironically, it turns out that the blindfolded monkeys actually produced smarter portfolios than passive funds - as detailed in "The Surprising Alpha from Malkiel's Monkey and Upside-Down Strategies" (Journal of Portfolio Management 2013). This is because as monkeys throw hundreds of randomly-directed darts at the stock listings, the portfolio ends up looking very much like an equally-weighted portfolio and benefiting from the uplift this approach usually creates.).

To draw a parallel, passive investing is a bit like going into a supermarket and buying one of everything. No matter how expensive, no matter how healthy, no matter how much destruction was wrought in production, no matter what your own tastes happen to be. The passive approach requires no research into any of these areas, saving you a lot of time getting to know what you like and deciding which products should be in your trolley. Ultimately, though, you probably won't be very happy with the result.

And while in the 1970's, high management fees made passive investing a smarter choice – reduced fees, and improved tax efficiencies over the following 40 years have led both academic and industry researchers to conclude, that the balance has tipped – with active management beating passive benchmarks on average, passive strategies sometimes failing to meet their own benchmarks, and the "fee spread" between active and passive strategies becoming so small, it fails to compensate for passive approaches being a poor investment strategy.

As a result, the false economy created by low-cost passive investing has become increasingly clear – with Burton Malkiel himself, converting to an approach by becoming chief investment advisor for US-based active investment manager Wealthfront, in 2018.

Figure 1: The Active Investment Spectrum



Passive vs Active

What is active investing?

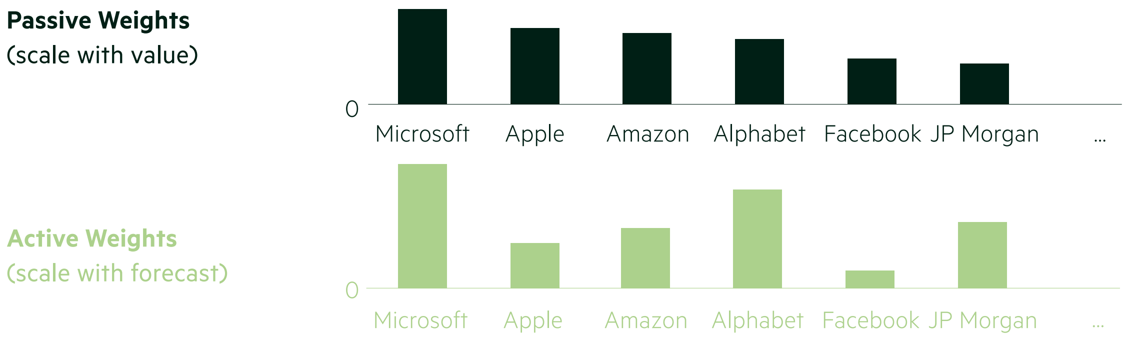
As the name suggests, an active investing approach to equities replaces the "passive" following of company size and basic benchmarks, with highly engaged, expert judgement – not just on the overall opportunity a particular stock or company represents, but should also be on its fit with the needs and priorities of the investor.

As managers of other people's money, our role is first to assess how much risk they are able and willing to take and look to build the best-performing investment portfolio within this risk budget. For those with short horizons looking to spend their money in the next few years, a portfolio of cash and high-grade bonds may be most appropriate. For those with long horizons who are not planning to spend their money for decades, a portfolio of equities and some alternative investments is more likely to give them the best outcome. A good active manager will always focus on those investments with the greatest potential for positive returns and the least potential for losses. Achieving a sufficient level of portfolio diversification, and keeping risk in check as market volatility waxes and wanes, is also core to achieving this best outcome.

How "active" a particular manager or fund's approach is, depends on the degree to which they add value, relative to the index by actively making decisions to deviate from it.

Figure 2: Comparing weighted portfolios

A passive portfolio allocates to companies in proportion to their market value, meaning big companies like Microsoft can dominate portfolios due to their size. On the other hand, active portfolios are weighted towards companies assessed as having the best chance of being top performers.



*Weights shown are for example only

A key marker for knowing how active a fund is being managed is measuring "Active Share" - developed by two Yale professors, Martijn Cremers and Antti Petajisto, in their 2009 paper. They showed that the harder fund managers were working to be different to their benchmark, the better they tended to perform, before accounting for costs and fees.

The lower the Active Share, the closer to the benchmark and the less effort the manager is putting in. The higher the Active Share, the more different to the benchmark and the more effort the manager is putting in.

According to Cremers, success as an active manager is built on the three pillars of Skill, Conviction, and Opportunity. Managers need the skill to pick outperforming stocks, the conviction to take a position big enough to make a difference, and the existence of such opportunities in the first place.

Petajisto's research found that the most active of managers tended to outperform their benchmarks by about 2.4% before accounting for costs and fees. We can't take this fact for granted for all high Active Share managers, but it does provide evidence they tend to outperform on average.

Secondly, it turns out that while strategies with a low Active Share might create a slight outperformance to their benchmarks, their own costs and fees turned this into a 1.4% drag. Petajisto names these managers "closet Indexers"; running a low-cost benchmark-like strategy but nevertheless charging the same level of fees as a manager running a more expensive highly active strategy.

Passive vs Active

Key Insights

Good portfolio design isn't just about active versus passive

Building a good portfolio starts at a higher level than where the active-versus-passive debate is happening. Portfolio design should aim to create the best return for a client based on the amount of risk they're willing and prepared to take and, ideally, uses a range of asset classes and an adjustment of market exposure through the investment cycle to keep risk on target.

Investment selection, and portfolio construction, count.

A key advocate of the passive investing approach in the 1960's, Eugene Fama, showed in 1993 that there are certain indicators that allowed investors to generate long-term outperformance of the benchmarks that passive funds follow. Factors like the size of a company (smaller companies did better), the valuation (cheaper companies did better), the growth rates of its earnings, or its governance quality and exposure to other economic factors (interest rates, oil prices etc) were important - and were not very hard for a fund manager to calculate.

Combining known return generators with a solid risk control framework, not to mention the occasional stroke of investing genius, creates a solid case for long-term outperformance over passive benchmarks.

There's a place for passive - in tactical allocations, and risk management

The great benefit of passive investments in a comprehensive portfolio build is that they are cheap to trade, as passive indices are weighted toward more liquid, cheaper-to-trade underlying securities. Because of this, passive investments are central to the cheapest and most liquid assets for transferring market risk: futures exchanges.

The merits of futures are two-fold. Not only are they incredibly cheap to trade, meaning investment managers and hedgers can adjust their positions without incurring significant trading costs in the process. They also allow variable leverage, either to take short positions which reduce market exposure or to take exposure greater than the funds available.

In some countries, it can also be more tax efficient to separate out your passive and active investments, in order to move the tax burden more toward capital gains which tends to be taxed at a lower rate.

Myths vs Facts

MYTH:
Active can underperform - while passive doesn't.

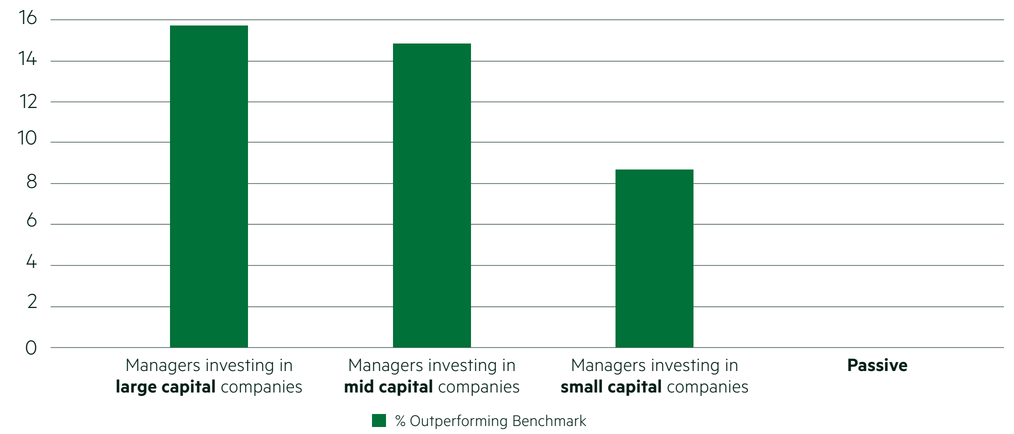
A familiar headline in the active-vs-passive debate is as follows: "85% of active managers underperformed their benchmark last year". At first glance, this statement looks bad for all active managers, but considering the equivalent statement for passive managers, that number goes up to 100% underperformance since they charge fees, albeit small ones, on their benchmark return. The equivalent headline should therefore read "100% of passive managers underperformed their benchmark last year".

FACT:
All passive investors underperform the market once fees are taken into consideration.

The below tables shows average actual performance - and the dynamics that create those outcomes.
In addition, active managers often take lower absolute risk than their benchmarks - which may lead to lower returns during bull market runs, but should be matched with better protection in down markets.

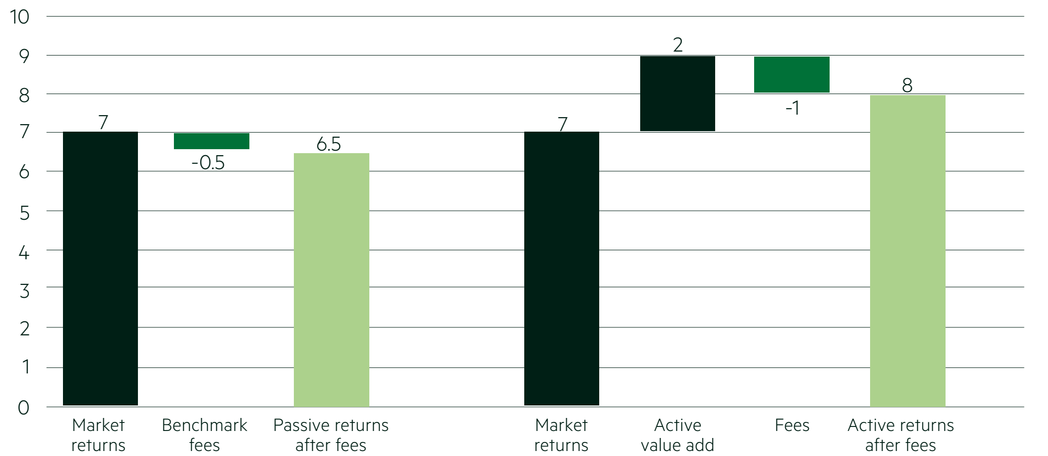
It's worth noting that we've recently seen the advent of zero-fee passive funds. This has been achieved through a combination of so-called self indexing, which reduces or removes the independence of index calculations and replacing fee revenues through stock lending. So zero-fee funds don't come for free: self-indexing represents poorer quality indexing and stock lending creates additional risks for investors that aren't in the benchmark. To call such funds "passive" is a little disingenuous.

Figure 3: Percentage of Managers outperforming benchmark (for the 5 year period to 2017)



(SPIVA U.S. Scorecard (2017), S&P Dow Jones Indices)

Figure 4: Passive - missing the Alpha



(Indicative representation from Kiwi Invest expectations)

Myths vs Facts

Perhaps the most recent and comprehensive comparison of active versus passive management is the 2018 white paper "Active and Passive Investing – the Long-Run Evidence" by AQR, one of the world's largest fund managers. In this paper, the authors not only consider the much-analysed US mutual fund market, but also the less-often studied categories of institutional equity accounts, fixed income, hedge funds and private equity. **In all cases they find that active managers have beaten their benchmarks after fees, an explicit validation of the benefits of active management.**

Since 2007, Kiwi Wealth's KiwiSaver Scheme Growth Fund has outperformed its benchmark by about 2.5% per annum on average, and our Conservative Fund by about 1.3% (before fees and taxes) – both results highlighting the ability of true active management to outperform the benchmark index.

MYTH:
The market can do all the "thinking" for you.

Passive investing is theoretically motivated by the Efficient Markets Hypothesis, which essentially states that all assets are fairly-priced, because if they weren't then investors would sell the over-priced ones and buy the under-priced ones until the prices were pushed back to fair again. As a result, it states there is no reason why a passive strategy - that essentially substitutes the market's judgement, for that of a fund manager – should underperform.

FACT:
In the real world, markets can't see potential value as well as experts do.

A closer look at this theory reveals that it's highly idealistic and contains big holes. The main departures from reality are that market participants have any level of agreement on how to calculate fair prices, that they have equal access to information and equal ability to process this information, and the fact investors have both variable benchmarks and variable incentives.

It's worth noting that the chief architect of the Efficient Markets Hypothesis in the 1960's, Eugene Fama, essentially disproved this theory with Ken French in 1993, showing that certain indicators could allow investors to outperform, over the long term, the benchmarks that passive funds follow.

But even if the Efficient Markets Hypothesis were true, it still wouldn't mean passive investing was a good idea. This is because building a portfolio isn't just about calculating "fair prices", it's also about balancing risks. Consider an example with three equal-sized companies in the market: A, B and C. All investors agree on the fair prices, and the returns for these all have the same "well-behaved" distribution. Let's assume A and B are in the same industry, hence highly correlated, whereas C is in a very different industry, hence uncorrelated. Since the companies are the same size, a passive portfolio would invest equally in all three, whereas an investor looking to build the portfolio with best risk/return profile would invest just a quarter of their portfolio in A and B, and half in C, with a reduction in risk of some 5% without reducing expected returns

We believe the "active versus passive" debate is a true antique of the investment world - gaining influence in the 1960's, but being only a small piece of the puzzle in comprehensive portfolio design today. While a passive approach can help inform asset allocation and cheap access to liquidity, we believe active has a clear advantage over passive in bond and equity markets - making it a better choice for the bulk of most portfolios.

Myths vs Facts

MYTH:
All “active managers” are equal

When the comparative performance of an “active management” approach is questioned (particularly against the relative cost of fees), this analysis can often result from grouping together a broad range of “non-passive” funds or strategies, and evaluating them as a whole.

But as shown previously, when active management is evaluated by it’s Active Share, we see a wide spectrum – from passive at one end, to high conviction at the other.

FACT:
Some “active managers” may not be that “active” after all.

Many so-called “active management” strategies operate at very low Active Share – making only a small number of minor departures from the benchmark, thus limiting opportunity to outperform, but often charging a similar level of fees as a manager running a highly active strategy. These players are often referred to as “closet indexers” - and succeed due to the difficulty for individual investors in assessing the after-cost prospects of a fund - as well as factors of convenience, word-of-mouth, or seductive marketing.

In addition, a number of funds are identified as having built their track record and brand on the merits of active management, but transitioned to low Active Share as the fund grew, perhaps due to capacity issues or perhaps to protect the business by reducing the potential for underperformance. For example, Petajisto identifies the Growth Fund of America as having declined in Active Share from above 95% in 1981 to below 50% in 2009 as its assets grew to US $150 billion. Meanwhile, fees are much more competitive across the board - with a May 2017 study from the Washington-based Investment Company Institute, finding that fees for actively managed equity and bond funds have come down 25% and 30% respectively in the past 20 years.

We believe the smartest course for investors is to focus on returns they’re likely to get in their hand at the end of the day, without being swayed by marginal fee discounts, especially when the quality of the investment process suffers.

Key Things to Ask

1. How "active" is your active manager?

While the necessary information about a fund that is required to calculate Active Share can be hard for individual investors to come by – the calculation of Active Share itself, is a fairly simple one – essentially showing how different a manager is to their benchmark:

$$\text{Active Share} = \frac{1}{2}\sum \left| w_{fund} - w_{benchmark} \right|$$

If a manager held no benchmark constituents in their fund, their Active Share would be 100%. On the other hand, if they held all the benchmark constituents with the same weights as the benchmark, their Active Share would be zero. We would encourage all investors to ask their fund manager what their Active Share is within equities - as a general guide to their mindset and approach across other investment classes.

2. What other value is your manager adding?

Another relevant category of "activity" is in understanding what additional features or services may be offered with your investment, such as:

- *A responsible investment approach that actively pursues key Environmental, Social and Governance (ESG) issues – both to reflect your personal values, but also to avoid potential business / reputational risks that may impact a company's performance, and your returns.*
- *Planning tools to help ensure you are invested in the right fund, and how your investment mix should change as you approach key points in your life like buying your first home or retiring.*
- *The level of service and support offered by advisers – how available and willing they are to understand and respond to your queries, and help you resolve them quickly.*
- *An investment team on the ground in NZ, offering full transparency of your investments and the processes that drive them.*
- *A brand you trust.*

The value these add depends on the priorities of an individual investor – but we'd advise any investor to assess the value of a manager's additional features and consider their level of satisfaction with the total package.

3. How much should you be paying in fees?

A good framework for thinking about how much you should be prepared to pay for your fund is to start with the lowest cost fund available, then assess the added value of higher cost funds through weighing up the fee increase against the expected performance gain and the value of added services.

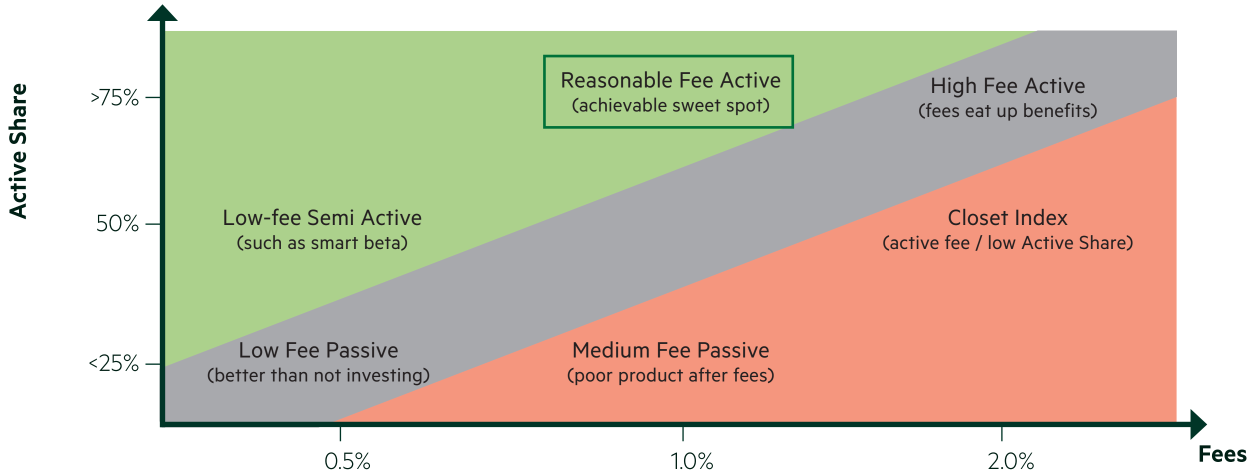
Reasonable fee = Lowest cost fund fee +
$\frac{1}{3}$ Expected pre-fee outperformance of higher cost fund +
Value to the investor of additional services

The lowest cost fund will generally be a comparable passively managed fund - but be sure to include any underlying manager fees and tax drag which may not be included in the headline fee rates.

The expected pre-fee outperformance is the additional return you should be expecting to achieve in the higher cost fund, before you've paid your fees. The 1/3 multiplier is a rule of thumb for the cost of achieving outperformance; put in your own number here if you like.

Key Things to Ask

Figure 5: Average Impact of Active Share and Fees on Performance



The above diagram maps out the attractiveness of various combinations of Active Share and fee levels. The best possible combination, not surprisingly, is a high-performing portfolio at low fees; the worst is a passive portfolio at high fees. In practice it's quite hard to find providers at these extremes, but many of the other combinations are represented in the market.

We think investors in the closet index and medium-fee passive boxes should be most concerned about their investments. Investors in low-fee passive and high-fee active could be doing better, and should look carefully at their provider to make sure the reduced value they're getting in the product is compensated by value added in other areas, like state-of-the-art planning tools or responsible investment approaches. We think those in the reasonable-fee active and low-fee semi-active are likely to be happiest with their investments in the long run.

4. Risk, performance and stability.

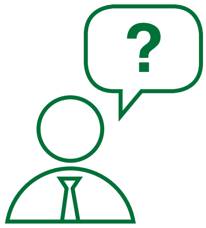
While it's easy to get carried away by a fund that's been performing well – particularly over a recent period – it's also essential to understand the risks that have been taken in achieving this performance. It's useful to divide risks into two groups: investment risk and non-investment risk.

Investment risk can be understood through looking at the worst performance you might expect, say in a bad year, and depends on the riskiness of underlying investments and the amount of diversification between these. Non-investment risk can be understood through looking at safekeeping practises, independence of valuations and the liquidity profile, i.e. how long it might take you to get your money back when you want it.

While potential managers may tend to present performance data over the periods that suit them best – it's the longer-term performance of a fund (ideally, over it's lifetime) that can tell the most reliable story.

This is equally true when judging potential returns. Coupling a strong track record with a stable investment team with a clear philosophy and process is more likely to give you a good result. Extra care should be taken investing with a brand new manager, a manager with a poor performance history or one where significant changes have occurred. Often investors don't know who's managing their money, what process they follow or even what they actually invest in, so this is a good chance to start asking questions of your provider.

Key Things to Ask



	10 things every investor should ask of their fund manager...	...and what you should look out for.
1.	How much could my investment lose in a bad year?	Make sure you're comfortable with the level of risk
2.	What total fees am I paying, including underlying manager fees, and am I getting all available tax credits?	Be suspicious if fees are unreasonably high or tax credits are lost
3.	Do you follow an active or passive investment approach? And what's your Active Share within equities?	Try to avoid passive investments, unless the alternative is very high fees
4.	What are the main factors influencing investment selection in the fund and what is the evidence these work?	Look for evidence of strong investment philosophy and processes
5.	How diversified are the holdings, e.g. what's the largest holding as % of portfolio?	Single company holdings above a few percent creates high concentration risk
6.	Do you diversify away from traditional asset classes like equities and bonds, or reduce risk in a crisis?	Diversification and risk management can help limit losses if benchmarks are down
7.	What responsible investment approaches are used and is the fund RI certified?	Look for consistency with your values, a range of RI activities and independent certification
8.	How has the fund performed, how does risk and return compare to the benchmark?	Look for evidence of outperformance without higher risk and a range of contributors
9.	How long have your investment team been in place, how experienced and where are they located?	Look for evidence of a visible, stable and experienced team
10.	What additional or supporting services are offered?	Planning tools, understandable reporting ... what are these worth to you?

Conclusion

In this paper, we've detailed our thoughts on the merits of passive investing as a standalone investment. It doesn't look pretty; both the averages and our own personal experience frame passive investing as a false economy: a solution with a sole focus on costs that misses out on a range of opportunities for adding value to long term investment performance.

Passive portfolios are constructed according to the size of companies in the benchmark index, it's an academic construct that mimics the overall market, and creates a product that's very cheap to operate. As we've shown however, passive investing isn't a great idea even if one believes in efficient markets, much less if one believes certain companies have better prospects than others due to their pricing or ability to grow rapidly. We believe the only place it should have in a long-term investment portfolio is a temporary allocation to retain market exposure or a means of changing allocations to implement tactical changes to allocations or risk management without incurring significant trading costs.

The chief academic proponents of passive investing have long since departed and left the baton in the hands of conflicted agents: the managers of passive products and index providers who are all incentivised to drive flows into their products without necessarily looking to innovate or deliver any additional value to their clients.

"Passive versus active" is therefore no longer a real debate. It's an anachronism of a real debate that's been resolved over the last 50 years through careful research into making better investment decisions, and a significant reduction in fees across the board.

We can say however, for the long-term investor, that passive is better than not investing at all, as the equity market remains a convincing tool to look to generate capital returns over long horizons. Referencing academic research, the place we do find passive to be superior to active management is where a manager is charging unreasonably high fees for the level of active management being undertaken, particularly "closet indexers" who stick very close to their benchmarks but charge fees at a level requiring much more work.

We can also say that not all active managers are equally good, and offer guidelines on what you should be asking to determine the quality of a manager and the fair level of fees you should be paying.

Finally, we acknowledge that the increased availability of passive investments has brought fees down across the investment industry and this has significantly improved outcomes for investors, which we strongly applaud. If for no other reason, having the passive investment industry supported by investors who are prepared to incur lower long-term returns is a service to all investors in drawing a baseline for fees. Any fee above the passive fee must be made up for by a commensurate boost in long-term performance. Investment managers should ensure they are providing this value, and investors should ensure they hold both active and passive providers to account.

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Disclaimer

OUR INVESTMENT APPROACH

At Kiwi Invest we start by getting a true understanding of your "risk budget" and then designing an investment portfolio mix to help you achieve your goals:

BUILDING UNDERSTANDING

We start by building an understanding – with your dedicated senior adviser making sure they know your financial context now, where you want to get to, and your priorities along the way.

TALKING RISK

Then, instead of focusing only on rewards, we start with a realistic discussion of risk – how much you're prepared for, how much you can afford, and how much you need, to achieve your goals. Your personal "risk budget" informs every subsequent decision we make.

EVALUATING AND SELECTING

Our fund managers look worldwide for investment opportunities based on market performance, global themes, and their different levels of risk.
And, your adviser recommends your ideal investment mix based on your goals, timeframes, and capacity for risk.

PROACTIVE MANAGEMENT

As our analysts and managers actively manage aiming to optimise the performance of their funds, your adviser monitors ongoing performance and ensures your portfolio mix meets your changing needs. Our reporting and genuine transparency keep you closely informed.

Kiwi Invest.®

NZ's smart money.