Solving the active versus passive management debate

Ever since index funds - also known as passive investments - have existed, there has been an endless debate about their merits versus active management.

Proponents of active and passive investment management styles have made exhaustive and valid arguments for and against both approaches. At Bank Syz, we do not endorse one style over the other. Rather, our goal is to understand and define the characteristics of each approach in order to determine which best suits our client needs.

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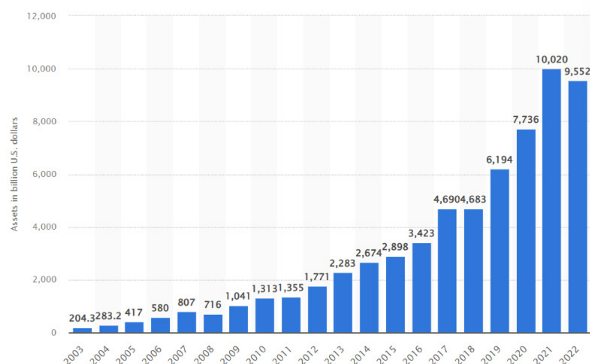
The principles of active and passive management

The proliferation of passive management strategies in recent years is well documented by the exponential growth of assets invested in ETFs (Exchange Traded Funds).

Growth in ETF assets under management between 2003 and 2022 (in billions of dollars)



Source: Statista

Passive management attempts to replicate the performance of an index (e.g., the S&P 500) as closely as possible, generally by buying most or all the securities with the same weighting as the index. The intellectual basis of passive management is the conviction that, over the long term, an active investment strategy cannot outperform the market. This is due to market efficiency and the impact of higher turnover, which increases trading costs and capital gains taxes (in jurisdictions where such taxation exists).

Active management, on the other hand, does not seek to replicate an index, but rather to buy securities with weightings different from those of the index, with the aim of outperforming the index or a benchmark.

The intellectual foundation of active management is the belief that the market is inefficient, and that those skilled in stock or sector selection can add value through their management, enabling them to outperform a benchmark such as the S&P 500.

As the table below shows, both approaches have their advantages and disadvantages.

Passive management replicates the performance of a market but offers no potential for outperforming the benchmark (or protecting against downside). Active management offers the possibility of outperforming the market but carries the risk that the manager may fail to beat (or even significantly underperform) the benchmark index.

Active and passive management - advantages and disadvantages

	Active Management	Passive Management
+	Allows manager to exploit inefficiencies Not forced to own the "bad" stocks Can be more defensive during market turmoil	Low fees/low turnover High certainty of getting the market rate of return Easier to understand
-	Typically higher fees than passive Mistakes do happen as managers make bad decisions It is challenging to find managers that beat the market	Pro-cyclical (most heavily invested in recent winners) Some ETFs are exposed to counterparty risks No managerial control exercised during market turnover

Empirical research

Starting from the conclusion that both active and passive management are strategies with their own merits, the question is where and when one is more appropriate than the other.

At the end of 2009, Baird & Co carried out an interesting study. It examined several major asset classes to determine which are best suited to active management, and which to passive management. To do this, they measured how often the median mutual fund in a given asset class was able to outperform its benchmark (see the second column of the table below). In the third column, they defined the degree of efficiency of each asset class. Market efficiency is the ability of asset prices to reflect all available information.

As the table below shows, the probability of success of active management depends on the degree of efficiency of a market. In efficient markets, such as US large-cap value equities or bond management, the percentage of periods during which the median fund outperforms is fairly low. On the other hand, less efficient markets, such as emerging markets or US small caps, offer a high probability of outperformance for active managers.

Asset Class	% of Periods Median Fund Produces Excess Return	Efficient (favoring passive) or Inefficient (favoring active) Asset Class	Market Assets (%Active/%Passive)
Tax-Exempt Fixed Income	4%	Highly Efficient	99% / 1%
Large Value	28%	Efficient	92%/ 8%
Taxable Fixed Income	29%	Efficient	79%/21%
High Yield	35%	Efficient	96%/4%
Mid Value	40%	Efficient	94%/6%
Mid Core	43%	Mixed	59%/41%
Small Value	50%	Mixed	82%/18%
Large Core	54%	Mixed	46%/54%
Mid Growth	55%	Mixed	96%/4%
International	57%	Mixed	69%/31%
Large Growth	67%	Inefficient	93%/7%
Small Core	70%	Inefficient	67%/33%
Commodities	72%	Inefficient	47%/63%
Emerging Markets	75%	Highly Inefficient	48%/52%
Small Growth	80%	Highly Inefficient	89%/11%
Real Estate	90%	Highly Inefficient	63%/37%

Active and passive management – historical evidence • Source: Baird

Baird's study led them to ask whether the financial world takes into account the fact that some asset classes are more efficient than others, and therefore whether there is a distinct bias in favor of active or passive management. One way of measuring this assumption has been to determine what percentage of an asset class's assets under management is invested in active or passive managers (see column 4 of the table above).

Surprisingly, some of the most efficient markets are dominated by active management, for example, US large and mid-caps value equities, both with over 90% active managers, while many of the least efficient markets are heavily invested via passive management, for example, emerging markets and commodities, both with over 50% passive assets. And even if these statistics are relatively old, we must admit that this imbalance is more or less the same at the start of this decade.

This position flies in the face of logic and leads us to the conclusion that many diversified portfolios are not optimally constructed.

Pragmatic use of active and passive funds

Our open-architecture philosophy enables us to make pragmatic use of both active and passive management. We use active management where it has the best chance of success, while passive management is used to complement the rest of the portfolio. This approach can lead to optimal portfolios that exploit the strengths of different investment opportunities.

Contrary to industry practice, we aim to emphasize passive management in the most efficient markets (e.g., government bonds), while active management is generally favored in the least efficient markets (e.g., emerging markets).

Funds in the top quartile are more favorable to active management

Based on the mediocre results achieved by active managers in the most efficient markets, it could be argued that active management should be avoided in certain markets, such as US equities or high-yield bonds.

But this hasty conclusion ignores the fact that the results presented in the previous section focused on the performance of the median mutual fund. In fact, these results change radically when we examine the performance of top-quartile funds (i.e., those ranking in the top 25th percentile of the peer group universe).

For example, the average performance of the top quartile fund for US large-cap equities is significantly higher than that of the index.

In this case, the success of top-quartile funds considerably strengthens the case for active management.

Although there is no sure way of identifying and investing exclusively in top-quartile managers, the success rates of the best managers are a strong argument in favor of selecting active managers. We believe that by carrying out thorough due diligence, it becomes easier to identify those with the characteristics associated with consistent, long-term success.

Conclusion

How can an asset manager or fund selector maximize the chances of generating high alpha? It is easy to deduce from the above that being able to select a top quartile manager within a less efficient market (for example, emerging market equities) can create exceptional alpha opportunities.

This is precisely the approach adopted some years ago by large pension funds and other institutional investors with regards to the use of their "alpha budget": they favor passive strategies in the most efficient markets but deploy considerable due diligence efforts to identify the best managers in less efficient markets, such as emerging markets or venture capital.

Active and passive management each have their inherent merits and drawbacks. At Bank Syz, we don't favor one style over another. Rather, we define the characteristics of each approach to determine which best meets our clients' needs.

On the one hand, we believe that active management based on in-depth fundamental research can bring added value. This is particularly the case in less efficient markets.

On the other hand, when alpha opportunities are limited, or when the best available managers are unlikely to generate alpha, passive investments are preferred.

To achieve our clients' investment objectives, it is essential to understand how to balance and leverage active and passive management.

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