Central to the notion of Modern Portfolio Theory (MPT) is this belief that markets are efficient and that the average active managers are incapable of outperforming passive managers (Whitehead, 2012: 5). Market efficiency can be described as the degree to which stock prices reflect all available information (Baird, 2012: 2). In a perfect world, where markets are efficient, it is impossible for an active manager to outperform a passive manager, while in an inefficient market where pockets of inefficiency exist, active managers should outperform passive managers. Passive investing can be characterised as an attempt to replicate an index or hold the market capitalisation of a certain number of stocks, whereby the investor has no particular view with regards to the risk and return prospects of the investment universe, while active investing is defined as constructing a portfolio that intentionally deviates from the market portfolio with a particular view of the future risk and return prospects (AFM, 2011: 5). Moreover, it is important to note that passive investing is designed to match the market with the intention of not outperforming it, while active investing is designed to outperform the market. Following the lessons of the 2008 Global Financial Crisis, which exposed the investment world to the limited diversification benefits of traditional assets, the increasing nature of portfolio risk, as well as substantial losses amongst investors, it is no surprise that many investors have adopted a passively managed investment strategy (Kolanovic and Wei, 2013: 7). Due to the underperformance of active managers relative to their passive alternatives, active managers have been and continue to be under pressure to deliver results that justify their high management fees (Whitehead, 2012: 4). As a result, this has led to a radical change in the way money has been invested over the last couple of years (Whitehead, 2012: 4).
This article serves as the first part of a three-part series, where the first article will revisit the debate between active and passive investing by outlining the purpose of each approach as well as understanding the arguments for and against each approach. The second article will test the efficiency of style investing by addressing four factors, namely value, growth, quality and momentum as it is important to understand each respective style as investors have been inundated with smart beta offerings, while the third article will look at blending both active and passive alternatives as a long-term approach for an investor’s portfolio.

The literature concerning active and passive investing is extensive, where the majority of research has been conducted on data compiled on mutual funds in the United States of America (USA). Mutual funds can be characterised as a company that pools together investors’ assets in order to invest in asset classes such as equities, bonds or property, where the combined holdings constitute a portfolio. Moreover, the universe breadth available to an investor in this market is far bigger relative to the South African market. Essentially, mutual funds in the USA are directly comparable to unit trusts and collective investment schemes in SA as they have the same function and purpose.

“The premise of active investing is that skill and analytical resources translates into higher returns as skilled fund managers can identify profitable opportunities in the market” (Kremnitzer, 2012: 2). Passive investing is an attempt to replicate an index or hold the market capitalisation of a certain number of stocks without having a specific view of the future risk or return prospects of the respective investment universe (AFM, 2011: 5). The efficient market hypothesis (EMH) states that all information provided by past prices is already priced into current security prices whereby it is near impossible to achieve abnormal returns (if the market is efficient) by adopting a position based on previous returns (Kremnitzer, 2012: 3). Active investing includes high management fees and analytical costs, which fails to compensate investors when comparing the net returns of the active investment (returns after management fees are subtracted) relative to the its respective benchmark returns (Kremnitzer, 2012: 3). According to Kremnitzer (2012:3), “this paradigm has given rise to the burgeoning industry of passively managed funds. Passive management over the last couple of years has proven a viable strategy, whereby it has challenged the traditional approach of portfolio construction which strictly advocates investing in active managers (Baird, 2012: 1). Furthermore, passive management has placed a greater emphasis on low transaction costs and tax efficiency (Baird, 2012: 2).

Both active and passive management have their own relative strengths and weaknesses when addressing the contentious debate of outperformance, however, this is all dependent on the market segment as well as the economic environment. For this reason, a narrow focus on the arguments for and against the outperformance of active and passive management is required.
Active management

Active investing places an emphasis on buying and selling where this takes the form of actively investing in equities, bonds or property with the objective of exploiting profitable market conditions. Moreover, active managers rely on methods such as fundamental and quantitative analysis, shareholder activism, technological edge and a superior understanding of the macroeconomic or geopolitical developments in order to generate positive returns (Kolanovic and Wei, 2013: 7).

Arguments for active management outperforming

One of the main arguments for active management is based on how well informed investors are. This argument states that investors who are poorly informed remain in poorly performing funds, while well-informed investors capitalise and move into better performing funds, thereby allowing active investing to outperform passive investing, but only for those investors who are well-informed (AFM, 2011: 16).

Financial markets today are complex and very different from those a couple years ago (Kolanovic and Wei, 2013: 59). “The strong growth in active assets under management over the past two decades has led to an unrelenting search for alpha and pockets of weakly correlated assets” (Kolanovic and Wei, 2013: 7). As a result, there may be an important role for active managers, even beyond the scope of the EMH. This role, especially in today’s environment involves risk management, where active managers are cognisant of how much risk they are taking on to achieve a certain level return. In addition, active managers might be able to exploit what promises to be a different and a more complex economic and investment environment (Whitehead, 2012: 5). Furthermore, the outperformance of active management relative to passive management is all dependent on how well active managers are able to adapt and anticipate the specific industries and companies that will benefit from globalisation, expanding populations, new technology and alternative energy trends (Whitehead, 2012, 5).

Arguments against active management outperforming

Due to the underperformance of active managers relative to their passive alternatives, active managers have been and will continue to be, under pressure to deliver superior returns that justify their high management fees and transaction costs (Whitehead, 2012: 4). In addition, this has resulted in a radical change in terms of the way money has been invested, where active managers are fearful of missing out on the top performing securities or sectors (Whitehead, 2012: 4). There is this realisation that by simply following the herd, active managers potentially expose their investors to excessive and substantial risks (Wells Fargo, 2013:3). Moreover, the asset allocation prescribed by active managers when following the herd, in terms of size and price level, are no longer supported by the underlying fundamentals of a
particular company or industry sector (Wells Fargo, 2013: 3). Fundamentals include qualitative and quantitative information that describes the economic well-being of a company where this information includes revenue, earnings, assets, liabilities, growth and management. Furthermore, when active managers perform poorly as a result of following the herd, they tend to cling to their respective benchmarks which guarantees mediocre returns at best (Whitehead, 2012: 4).

**Passive management**

Passive management attempts to replicate an index or hold the market capitalisation of a certain number of stocks, where the investor has no specific view of the future risk or return prospects (AFM, 2011: 5). Moreover, passive investing has gained market share in the investment world, where the long-term results have favoured this strategy (Whitehead, 2012: 5). According to the EMH, if markets are efficient then it is impossible for active managers to outperform an index (Whitehead, 2012: 5). Furthermore, low transaction costs, tax efficiency and a low turnover of stocks allows passive investing to outperform active investing.

**Arguments for passive management outperforming**

After the 2008 financial crisis, we saw some of the most brilliant and experienced investment managers stumble, thereby calling into question whether it is possible to select those who can consistently outperform in an increasingly complex world (Whitehead, 2012: 3). For this reason, passive investing has the luxury of avoiding all challenges and costs associated with selecting a successful active manager thereby allowing passive investors to outperform an actively managed strategy (Whitehead, 2012: 3).

The crux of the argument for passive investing outperforming active investing is based on low transaction costs and management fees. Management fees are an inescapable fact of investing, where passive management has lower fees relative to active management (Baird, 2012: 5). Generally, actively managed funds that perform relatively well usually involve high transaction costs and high management fees, which implies that the outperformance is wiped out once the respective fees are deducted (AFM, 2011: 12). As a result, the investor cannot benefit from selecting an active manager.

**Arguments against passive management outperforming**

According to Whitehead (2012), the most significant drawback of passive management is that it requires an investor to accept the configuration of an index, regardless of the quality of the individual holdings, risk and the construction process. The process involved when constructing a passive investment
strategy fails to consider the investors' investment style as well as their risk appetite. Indexes are often thought to be representations of a broadly diversified market, however, in actuality, the level of diversification can be much lower than expected, whereby the performance could be driven by relatively few companies (Wells Fargo, 2013: 2). In addition, this implies that passive indexes can actually have their own market-related bets and biases, such as concentration risk to specific sectors or companies (Wells Fargo, 2013: 3). Moreover, this makes them more reflective of certain size and price momentum stocks rather than being a fully naïve passive investment approach (Wells Fargo, 2013: 3). Despite the fact that passive investing is favourable when these trends of size and price momentum hold, the approach could lead to greater volatility and sharper reversals once the size and momentum factors dissipate (Wells Fargo, 2013: 3). Further, it is important to realise that passive investing can never outperform an index purely due to the construction of an index as it is does not cost anything to replicate an index.

Final thoughts

Ultimately, the decision of whether to invest with an active or passive manager lies in one’s view on market efficiency. For the past few years the JSE All-Share Index (ALSI) has trended upwards, but towards the end of 2014 up until the end of 2016, the ALSI has trended sideways. This point is further emphasised in figure 1 below which plots the overall market breadth (green line) against the ALSI (red line).

![Figure 1: Market Breadth vs the JSE All-Share Index](source: I-Net BFA)
Figure 1 depicts the overall market breadth relative to the ALSI, where market breadth can be described as a technique used in technical analysis that attempts to gauge the direction of the overall market by analysing the number of companies advancing relative to the number of companies declining each day. As seen by the market breadth line (green line), it was upward trending from 2010 to the end of 2014, where it recovered slightly to the middle of 2015, but subsequently has been falling off. As a result, the ALSI has been trending up during the same period as the majority of companies closed positively during the respective period, however from the end of 2014, there has been a disjoint where the market has trended sideways but slightly up while the majority of companies were closing negatively. This is the result of market concentration as a handful of shares have propped up the market, which is further illustrated in table 1 below.

Table 1: JSE by Market Capitalisation

<table>
<thead>
<tr>
<th></th>
<th>Q1 2016</th>
<th>Q2 2016</th>
<th>Q3 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5</td>
<td>39.80%</td>
<td>39.85%</td>
<td>36.09%</td>
</tr>
<tr>
<td>Top 10</td>
<td>54.83%</td>
<td>54.45%</td>
<td>50.79%</td>
</tr>
<tr>
<td>Top 40</td>
<td>83.94%</td>
<td>83.35%</td>
<td>80.70%</td>
</tr>
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</table>

Source: I-Net BFA

Table 1 above depicts the concentration of our market, with the Top 40 shares accounting for roughly 80% of the overall market as of the end of the third quarter of 2016. This concentration poses a huge threat to passive investing especially when the overall market is in a downward or side-ways trend.

As with most things in life, the ideal lies somewhere between two extremes. In an upward trending market, passive investing should perform well, but in a downward trending and sideways trending market, one would want to select an active manager with the hopes of creating superior returns. The general idea behind this article is not to advocate for either active or passive investing in isolation, but to create a blended approach using both active and passive management. The idea is to select active managers that the investor has a high conviction in, where the investor buys into the respective manager’s philosophy, investment process and experience, and then couple this with a few passive alternatives to create a long-term investment strategy which will be discussed in detail in the third instalment of this series.
Bibliography

- I-Net BFA