Global Matters Weekly

27 February 2023

Is active management dead?

by Gary Moglione, Portfolio Manager

In recent years, there has been a growing shift towards passive investing at the expense of active management. Passive funds have outperformed active funds and achieved this within a lower fee structure. This creates a compelling proposition that has been difficult for investors to resist. Should we accept that active management is dead, and passive is the future? Alternatively, is there evidence to suggest that active versus passive is cyclical and highly influenced by the macro environment?

Let's begin by looking at the drivers of passive outperformance over recent years. Following the financial crisis of 2008, quantitative easing saw the market flooded with liquidity as interest rates moved toward historic lows. This increased the valuation of growth stocks significantly, as the present value of their future cash flows were discounted at lower interest rates. Large-cap technology stocks, such as Apple, Amazon, Microsoft, and Facebook were key beneficiaries. These stocks have driven much of the performance of major indices, such as the S&P 500, and these have been the most heavily weighted stocks in passive funds covering the US and Global markets. Many actively managed funds have been underweight or have avoided these stocks due to concerns about their valuations, or regulatory risks. Over the last decade, this environment has resulted in strong and continual outperformance by lower fee passive products. The result of that outperformance has been significant capital moving from active to passive. It is difficult to quantify the exact amount of capital that has moved from active funds to passive, but in the US alone it is in the trillions. This has created a headwind for active portfolios and a tailwind for passive, compounding the cycle even more. By choosing to invest in a passive product, you are effectively choosing to skew your portfolio to the strongest performing stocks, regardless of valuation. From a factor exposure perspective, you are long momentum and short value. The past decade has been perfect for that factor exposure. From 2010 to 2020 the Morgan Stanley Capital International (MSCI) World Momentum outperformed by almost 5% per annum. The MSCI World Value underperformed by over 2% per annum.

That's pretty compelling evidence of how much better passive has been over the past decade.

But let's have a look at what happens when the environment is less supportive. The momentum-driven market in which the most expensive stocks keep outperforming has recently reversed and we are seeing more valuation discipline. The dominant index stocks are having a much tougher time and have been bringing down overall index returns. Historically, active managers have tended to outperform in market drawdowns*. This change in environment is already having a positive effect on active managers. If we look over the past year to the end of January 2023, MSCI World Momentum Index underperformed by 2.5% and the MSCI World Value outperformed by 6.5%. A clear reversal of the factor exposures driving passive performance. My database of 1,138 US Equity managers (the world's most efficient market) shows 57% of active managers have outperformed[1]. Hardly conclusive proof of a paradigm shift, but an indication that passive may have already moved out of its sweet spot. What if this environment persists? Will the wave of moving capital from active to passive reverse, creating a compelling cycle for active managers?

The second element here is that the active/passive debate is usually evidenced by the percentage of active managers that beat the benchmark. The active market is saturated with poor-quality products that have high fees and low tracking error that have merely been created to satisfy demand. These funds are easily identified and filtered out by a robust screening process. When you focus on talented managers with a clear philosophy and portfolios that deviate significantly from the index, the percentage success rates of active managers increases meaningfully.

Overall, I do believe there is no clear winner between active and passive, and results will vary as the economic environment changes. The key is to understand the drivers of each and construct a portfolio that contains both based on your own risk and cost appetite.

Sources:
1 Momentum Global Investment Management
Unless stated all data from Bloomberg Finance L.P.
* Past performance is not indicative of future returns

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