COLUMBIA THREADNEEDLE INVESTMENTS

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What's been happening and what's on the Horizon in the world of pensions

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The long-running active-passive fund management debate will never be solved if its either/or framing, which incorrectly treats the two approaches as mutually exclusive, isn't revised. The debate has also become skewed owing to the tendency to narrowly focus on cost rather than net value added. In this edition we revisit the pros and cons of each approach, with the notable inclusion of how each seeks to incorporate increasingly important environmental, social and governance risk factors into its methodology and examine why this further skews the debate.

The misframing of the active-passive decision

First up, the active versus passive fund management debate, with its either/or framing, incorrectly treats the two approaches to managing money as mutually exclusive – which they aren't. Indeed, the appropriate active-passive mix for any investor – and it will often be a mix – depends on: the investor's investment beliefs – particularly how markets function, the degree to which the asset classes in focus are efficiently priced[1] and the value of diversification; their investment goals; their investment governance budget[2]; their risk appetite and how they frame risk.[3] Indeed, most investors will approach the active-passive decision on an asset class by asset class basis and construct portfolios that comprise both actively and passively managed asset classes.

Next up is the tendency to approach the decision problem through a narrow cost, rather than a wider net value added, lens. Doing so has resulted in a skewing of the debate, with many investors taking the line of least resistance and opting for a low-cost passive, or index tracking, solution. Rather, a focus on the ability to sustainably generate net value added – that is, delivering sustained superior risk-adjusted performance after fees while meeting desired investment outcomes and risk appetites – is how the active-passive decision should be approached.

So, with those two elephants given their marching orders, let's take a step back and evaluate the pros and cons of passive and active approaches to fund management, and then a step forward by bringing into the debate the incorporation of increasingly central environmental, social and governance (ESG) risk factor considerations. As equity fund management has been the principal focus of the debate and generated the most research, let's start with managing equities on a passive basis before moving onto active equity management.[4]

[1] The idea of efficient markets dates back to the pioneering work of Alfred Cowes in the 1930s, Harry Roberts and Harry Markowitz in the 1950s, and Bill Sharpe and Eugene Fama through the 1960s and 1970s and is encapsulated in the efficient markets hypothesis (EMH). The EMH states that market prices continually reflect all available and relevant information. They therefore move randomly and independently of past prices as investors react rationally and instantaneously to new market news. While the EMH acknowledges that market participants do make random mistakes, it assumes people learn from their mistakes and do not repeat them. Crucially, these random errors are presumed to offset one another. Even if not offset, the contention is that transactions costs would render the opportunity unprofitable. If correct, and it is a big if, the EMH has obvious, damning implications for those investors seeking to outperform the market. After all, if market prices continually reflect everything known or knowable about the market's constituent securities, then investors cannot hope to consistently beat the market unless they are very lucky or are prepared to take higher risks, which may or may not be rewarded.

[2] The finite investment governance budget of any decision-making board or committee is commensurate with its collective capabilities, its specialist investment knowledge, the efficacy of its time management and how well it organises itself.

[3] Risk means different things to different people. After all, risk, being multi-faceted, isn't fully captured by any one number. In the context of manager benchmark risk, also known as active risk or tracking error, whereas there is little risk of an index tracking manager deviating significantly from their chosen benchmark index, the same isn't true of many active managers, especially when the conditions are right to fully utilise their active risk budget. Indeed, the higher the active manager's tracking error, the greater the potential for both significant outperformance and underperformance.

[4] For a more detailed technical overview of active and passive fund management, please see: Brave new world: Why active managers are well placed to take advantage of social, economic and political regime change. Chris Wagstaff. Columbia Threadneedle Investments. February 2017.

Passive fund management

Passive management, or index tracking, involves constructing a portfolio of securities that replicates or tracks the total return of an equity index, on the premise that securities are efficiently priced. On the plus side, index tracking minimises the risk of underperforming the benchmark index before fees and costs by only transacting when necessary, such as when new money and investment income is received, to meet investor redemptions and accommodate periodic changes to the index being tracked. On the flip side, however, once fees, costs and a number of minor technical factors are taken into account, underperformance of the market often results. Moreover, being fully invested in the chosen index means trackers follow the market down as well as up.

Most equity index tracker funds are based on market capitalisation-weighted indices, such as the S&P 500 and FTSE All Share, where the largest stocks in the index by market value have the biggest influence on the index's value. However, tracking market cap-weighted indices is not without its problems. Index trackers cannot be customised to meet all investor objectives and risk appetites – the index chosen is the index tracked. As we'll see, this can be particularly problematic for investors seeking to integrate ESG risk factors into their portfolios. Also, diversification is often compromised by the index being highly concentrated in a few sectors – although the opposite extreme, overdiversification, is true when tracking more broadly based indices.

Far and away the biggest problem though, is that the largest positions in the index are concentrated in those sectors and stocks that the market perceives to be the most successful, even though these may transpire to be yesterday's winners rather than today's. Indeed, with rapid product innovation and lower barriers to entry for potential new entrants in many industries, industry pre-eminence can often be a temporary phenomenon. Moreover, the resultant misallocation of capital and subsequent drag on performance is particularly acute in momentum-driven equity bull markets. This is because market cap-weighted index trackers are forced to allocate more money to what prove to be increasingly overpriced market favourites and less to those sectors and stocks likely to be undervalued.

Active fund management

By contrast, the basic premise of active management is that markets are inefficiently priced. That is, securities are not correctly priced, at least not in all markets and not all of the time. Therefore, active managers seek to profitably exploit these mispricing opportunities by taking positions in stocks different to their weight in the index or in off-benchmark positions not represented in the benchmark they seek to outperform. In so doing, actively managed funds address many of the criticisms levelled at index trackers.

Firstly, they can be positioned to meet stipulated investor objectives, risk appetites and defined outcomes. Indeed, investors are increasingly looking for asset managers that can deliver defined outcome-based investment solutions, increasingly with ESG risk factors fully integrated into the decision making. More on that shortly.

Crucially, however, active managers can potentially capitalise on prevailing and expected market conditions and provide diversification in varying degrees, as appropriate. The challenge, of course, is to find talented active managers who have and will continue to demonstrate skill, while remaining acutely aware of the capacity constraints that can compromise their strategy.

To explain. Active management in aggregate after fees is positioned as a negative-sum game. However, given the increasing prevalence of closet trackers and asset gatherers,[5] the potential reward for selecting a genuinely talented truly active manager can be a significant and sustained uncorrelated source of investment return. Indeed, truly active managers – those who invest to win, rather than invest not to lose – live by the 'three Cs': high conviction portfolio positions; contrarian/independent thinking – thinking at odds with the consensus view; and high portfolio concentration. This means they are well placed to not only take advantage of fundamental social, economic, demographic and geopolitical regime change and paradigm shifts, but also, as part of their active stewardship, diligently manage the ever-increasing array of financially material risks. This they do by proactively engaging with companies on all aspects of their operations and strategy, not least their ESG (most notably their climate change) risk management.[6]

Crucially, the heightened volatility and greater dispersion in stock returns that inevitably accompanies a reassessment of the equity market's winners and losers, exacerbated by so much dislocation and fundamental change,[7] is exactly the environment that plays to the strengths of those active managers who more fully utilise their active risk or tracking error budgets. Not only that, truly active managers typically add more value in down than up markets, evidenced by a positively skewed long-term return profile. Additionally, those operating within a dynamic, cognitively diverse and genuinely collaborative environment which encourages rigorous debate and genuine challenge to portfolio positions and consensus thinking are at a significant advantage to those who don't.

[5] On average, one might expect half of active managers to outperform and half to underperform their benchmark. So, before fees, active fund management would seem to be a zero-sum game. If so, then after fees, by definition, it's a negative-sum game. That is, one should expect more than half of all active fund managers to underperform. However, the idea of active fund management being a negative-sum game is not clear cut given the increased prevalence of the bane of the active management industry – the low conviction, index hugging, closet tracking managers – and those that simply gather assets on the back of good performance, rather than be aware of the capacity constraints of their strategy, ironically to the detriment of future returns.

[6] Engagement in its many forms is simply enacting purposeful dialogue to influence positive change.

[7] For instance, the normalisation of monetary policy and globalisation being replaced by a more inward-looking world.

Active-passive in fixed income

Fixed income asset management in all of its guises tends not to receive the same attention in the active-passive debate as it does in equity fund management. This is surprising as the multiplicity of the fixed income opportunity set offers considerable scope for truly active managers to sustainably generate net value added, not least in those areas of the market, such as corporate credit, where the risk/return trade-offs are asymmetric. Regardless of whether its publicly traded government bonds, investment grade credit, high yield bonds, emerging market debt or the multitude of private credit strategies – including direct lending, credit opportunities, distressed debt, specialist leasing and specialty finance – a high conviction, research-intensive approach that positions against appropriate fixed income benchmarks for duration[8] and rigorously assesses the credit quality, liquidity and volatility risks of sectors and stocks against available credit spreads can generate considerable value add. Not least in avoiding deteriorating fundamentals and sidestepping the very worst losses, ultimately defaults.

Integrating ESG risk factors

One aspect of fund management that increasingly differentiates active from passive management is the approach taken to managing ESG risk factors. Far from being an altruistic exercise, doing so prospectively provides the investor with both short- and long-term benefits. This is not only as ESG considerations become increasingly material to company valuations and efficient capital allocation, but also in minimising the reputational, operational and regulatory risks attaching to many companies. In turn, this should lead to the generation of better quality and more sustainable long-run investment returns. Of course, this also matters as diligently managing ESG risk factors becomes an ever-important consideration in pension schemes' investment decisions and risk management, with regulation a key driver. Indeed, the potential future economic and demographic consequences of global phenomena such as climate change and social risk factors[9] are not only becoming clearer to many investors, but their management is becoming ever more critical to the success of scheme outcomes.

Within the index tracking space, the growth in focus on ESG considerations has seen a proliferation of rules-based screened and tilted ESG index funds. These respectively exclude certain index constituents and/or industries and tilt index weightings to or from certain companies and/or sectors, based on the ESG ratings of one of a multiplicity of ratings providers, each with their own scoring methodologies. While screening, or exclusion, continues to be the most common indexing approach, excluding too many companies or sectors both concentrates risk and may not necessarily have the intended positive impact on company behaviours and business models. Indeed, without engagement both are unlikely to change.[10] Moreover, those broadly based ESG-oriented index funds with a large number of constituents make it less likely that every company will be engaged with. That said, those index ESG index strategies that employ a best-in-class approach, rather than one dictated by ESG scores which often results in entire sectors being excluded, are less likely to concentrate risk unless an unfettered market cap-weighting methodology is applied.

As noted above, an active approach to ESG integration requires a much more research-intensive process, within which engagement is integral. Indeed, given the importance of engagement to better quality and more sustainable long-term returns and the delivery of positive real-world outcomes, truly active managers exert their influence as active owners of invested capital. As such, they are potentially better positioned to have a greater impact on ESG issues than strategies that rely heavily or solely on screening. That said, the level of integration and engagement varies between asset classes – the limiting factor typically being the availability of data.[11] Moreover, active managers can better navigate and reconcile the multitude of complex ESG scoring methodologies employed by different providers. In addition, with the externalities arising from unsustainable and ultimately unproductive corporate activities not being fully internalised into market prices, and financial markets misallocating capital to companies on the basis of incomplete information, integrating ESG into an intelligently applied active approach reinforces active managers' raison d'etre – the potential to exploit the resulting pricing anomalies. At least for now.

Some active managers also engage in impact investing. This goes beyond traditional responsible and sustainable investing by targeting positive real-world environmental and/or social outcomes in addition to financial returns. Areas of focus include climate, energy transition, biodiversity and sustainable agriculture, as well as prominent social/levelling up themes such as financial inclusion, education and public health.

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[8] Expected changes in market yields/interest rates across varying maturities

[9] For an explanation of social risk factors, see: Pensions Watch, edition 20 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-20/

[10] See Pensions Watch, edition 18 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-18/

[11] For instance, although engagement and stewardship opportunities in fixed income are more limited than for equities, there are exceptions. For instance, pooled social bond funds with explicit social impact approaches and defined social outcomes have considerable direct engagement with issuers. Given the heterogeneity of the alternative assets universe and lack of transparency in available ESG data for many of these asset classes, the ESG analysis of alternative investments can be complex and resource heavy. However, as with pooled social bond funds, those pooled real estate and infrastructure funds which have explicitly defined social and environmental outcomes, have robust engagement frameworks.

Why does this matter?

By way of conclusion, let's finish on the note on which we started. Active and passive fund management are not mutually exclusive. Indeed, most investors will approach the active-passive decision on an asset class by asset class basis and construct portfolios that comprise both actively and passively managed asset classes. After all, the appropriate active-passive asset mix for any investor depends not only on their investment beliefs – principally around how markets function, how securities are priced and the value of diversification – but also on their investment goals, governance budget, risk appetite and how they frame risk.

Furthermore, approaching the active-passive decision through a narrow cost, rather than wider net value added, lens, will inevitably result in a sub-par outcome. Indeed, the dichotomy of outcomes resulting from a narrow cost versus wider net value added focus will become ever more significant as approaches to managing ESG risk factors develop. In fact, as this becomes an increasingly prominent component of investment outcomes, the likelihood is that active fund management will become further differentiated from passive.

So where does this leave us? Well, despite the relative merits of active and passive fund management already being one of the longest running investment debates, with much more yet to further differentiate the two approaches to managing myriad asset classes – not least the management of ESG risk factors – it'll no doubt run for a while yet.

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