RAYMOND JAMES®

John Street

Active v Passive Investing

Active or passive investment has been a long-standing debate in the investment community but has recently come to the fore again as the proportion of global equity assets managed passively moves towards 50% (up from below 20% ten years ago).[1]

Passive investment typically involves buying all the constituents of a desired index, in the same weighting as they appear in the index. Active investment involves managers actively selecting their favoured stocks whilst avoiding those they do not like. Due to the mechanical nature of simply buying an index, passive investment often comes with lower costs than active management, where often teams of people are needed to identify stock risks and opportunities.

Within our portfolios we look to utilise a combination of active and passively managed funds. We firmly believe there are many managers out there who can consistently beat their index and are confident our methodology identifies them. This outperformance justifies the slightly higher costs. However, we fully accept that many of these managers will not beat the index year after year and so patience is needed when excellent managers have been identified.

Passive investment is a very useful tool to hold alongside these actively managed funds, typically in very efficient markets where it is difficult for an active manager to have a consistent edge. For example, US equities and government bonds are such large markets, with so many participants that it becomes very difficult to outperform the index. Given the size and efficiency of these markets we are happy to hold passive investments to help reduce the costs of our overall portfolio. We would be uncomfortable using passive investments in less developed markets as with less coverage on each company in the index, it provides active managers excellent opportunities to identify undervalued companies and outperform over a reasonable timeframe.

During the bull market of the past 10 years, we have seen a huge move out of actively manged funds and into the cheaper passive funds. This move has been exacerbated by the fact that many passive funds have outperformed their active counterparts in recent years.

Whilst we acknowledge that passive investment certainly has a role to play in efficient portfolio construction, we are particularly cautious at this juncture and limit it to the largest and highest quality

[1] Morningstar Asset Flows, showing registered funds Worldwide including the US in US Dollar.

markets. There are several reasons we are nervous about using too many passives right now, but our primary concern is with valuations and liquidity. Since the lows of 2009, most markets have had an incredible rally and now stand close to all-time highs. This explains the excellent performance of index funds but also presents an obvious concern that should markets fall these index funds will feel the full brunt of any sell-off.

As passive investment has seen huge flows over the last decade, by their very nature, these flows are invested disproportionately into the largest index constituents, the ones that have already performed well and are often overpriced. This is the opposite of buy low and sell high. Meanwhile, smaller constituents of an index see less inflows and become relatively cheaper.

This phenomenon has continued for many years, and is, to an extent, a self-fulfilling prophecy. As more money flows into passives, the more gets allocated to the largest stocks pushing the market up further and further, driven by a small number of stocks. However, by their very nature, these passive funds have no option but to buy the stocks, even if they are overpriced. This works fine whilst money continues to flow in, but the problems might occur when this wall of money tries to leave. The largest stocks will then have to be disproportionately sold and it's not clear where the buyers for these overpriced stocks will be found.

This potential liquidity problem could be painful in all markets but is almost certain to be especially troublesome in the more niche, less developed passive markets where buyers will be a lot scarcer and liquidity has never really been tested. We believe our active managers, who continue to use fundamental analysis to discover the fair value of a stock, should be able to avoid the worst of any sell-offs and significantly protect the value of the fund by avoiding stocks that sit in an index, or form a large part of an index. It is this capital preservation in falling markets which really gives the active manager the foundation to outperform over the long-run, as most of our managers have done despite the huge rally we have seen in all markets.

In conclusion we like passively managed funds in the right markets and at the right times. In our opinion this tends to be in the largest, most liquid markets and especially when the market has had a big fall and looks cheap. These are not the conditions we see today – nearly all markets are close to all-time highs and most valuations look stretched. This can continue for many years and we are by no means calling the top of the market, we are just taking the prudent step of avoiding potentially illiquid passives which have not been tested in a major sell-off. Instead we favour our carefully selected, experienced active managers who should be able to better navigate the market in the event of market volatility.

Stuart Saberi