Active vs. Passive Investment Management

There are two hypotheses for the winning investment strategy. The generally accepted view held by individual investors is that active managers, through superior skills at share selection and market timing, can add value by outperforming their appropriate benchmark index. The other hypothesis is that the competition between all of these very bright active managers makes it difficult to add value. In other words, the markets are efficient, and efforts to outperform the market over the long term are highly unlikely to succeed. Believing in this hypothesis results in the conclusion that the winning investment strategy is to own passive asset class funds that buy and hold all of the stocks that fall within risk parameters that the investor is willing and able to accept.

Market Efficiency

Today's leading financial economists fall clearly in the camp of efficient markets theorists. Their basic belief is that the vast majority (97%) of portfolio returns are determined by the asset allocation decision — primarily, what is the mix of shares, bonds, property and cash. But more precisely, how the shares within a portfolio are allocated to the three specific asset classes of large and small companies (measured by market capitalisation) and value companies (measured by book to market rations, P/E ratios or the like).

Accounting for less than 3% of returns are stock selection (e.g. which value stocks will be the top performers within the asset class of value stocks) and market timing. In fact, these efforts are counterproductive (reduce returns) because the expenses and taxes incurred exceed the value added. Professors Eugene F. Fama and Kenneth French have built a three-factor model, which they believe supports this view.

Hypothesis vs. Market Reality

The idea of market efficiency is a hypothesis created by academics who have spent a great deal of time researching decades of statistics to explain the reality of market forces in pricing shares listed on the world stock exchanges. As a hypothesis, it should not be misunderstood as a scientific law; it is simply a model. But it's a great model that works remarkably well. While it doesn't make sense for all prices to be right all of the time, it does make sense for investors to act as if the prices are right. To do anything else is a waste of money. Why? Read on.

Higher Costs for Random Results…

Trying to gain an edge on the market by forecasting the next price move of an individual security, or the direction of the market as a whole, is demonstrated to produce random results more synonymous with chance than anything else. The data does not identify the existence of skilful professional investors with ability to consistently produce excess returns over the market.

The most authoritative studies conducted by financial economists demonstrate that the returns of funds employing active management strategies under-perform the returns of the relevant market indices as a whole. That may be no surprise as mathematically the higher costs of active strategies will detract from the sum of all returns reflected in the index. However, more troubling is the evidence that managers with winning bets against the market in any single year don't tend to repeat, whereas losing performers usually do repeat.

Efficient amount of Inefficiency

The idea can perhaps best be encapsulated by the idea of an "efficient amount of inefficiency" first encapsulated by finance professor Sandy Grossman. There are far too many active managers wasting resources trying to identify pricing mistakes (for example there are more actively managed funds comprising multiple stock selections than there are stocks on the New York Stock Exchange). The activity of these managers is making market prices even more efficient than it needs to be – we don't have enough inefficiency.

Conclusion

The allure of the active management is a function of overconfidence. People are chasing returns based on numbers that offer no predictive information at all. Yet there is a pervading belief that being bright and hard working, or paying a 'professional' money manager to do this on your behalf, will be rewarded. This belief is reinforced by the vested interests of the investment industry seeking to sell funds and products.

Despite years of poor performance most investors miss the lesson. This is because they never measure the performance they receive compared to the returns available from the index itself or from holding a diversified portfolio of low cost passively managed securities.