Beating the Market

by Matthias Busuttil

It is a long argued debate in the investment management community and amongst investors whether active or passive investment styles produce superior returns.

Passive investing, or indexing, is an investment strategy that seeks to replicate the performance of a market index, such as the Euro STOXX 50 or the US S&P 500. The most common method of passive investing is to invest in an index fund, or index-tracker, whereby the fund would buy the individual stocks that make up the index according to the proportion of each stock within the index.

Given that the index methodology is pre-determined, passive investing involves a rule-based approach with very limited investment management intervention or research efforts. For this reason, the shine in passive investing is in the cheap management fees charged for running the investment.

However, passive investing is illogical for many investors who ascribe to the school of thought that security selection and market timing result in superior performance. Active management entails studying macroeconomic trends, researching market segments, analysing individual companies/entities and ultimately implementing investment ideas with the objective of outperforming the market.

The imperfect market information, the apparent irrational human behaviour and the fact that there are always winners and losers in the market are strong proponents for active management. Passive investing might be cheaper, however, the simplistic approach of “buying the market” is a poor and uneducated manner of allocating capital.

In a hypothetical scenario where a market comprises only of passive investors, the absence of research efforts and blanket buying of securities would result in adverse selection and moral hazard. Market prices would not reflect the underlying risks of the investment. This distortion in pricing and market inefficiency is what creates the scope and opportunities for active managers to beat the benchmark.

On the other hand, the research-intensive approach of active managers is what enhances market efficiency. No evidence suggests that markets are either completely inefficient or efficient – in fact most studies indicate that markets are semi-efficient. Within this paradox, also known as the Grossman-Stiglitz paradox, active managers have the difficult objective of maintaining a track record of outperformance when assessed on a net-of-fees basis.

Aside from the theoretical background, one has to consider the prevailing market environment and the tools available to investors today.

Active investing has always been the predominant approach in investment management. However, passive investing has been on the rise especially through the launch of exchange-traded funds (ETFs) which offer a cost-efficient way of index-tracking.

The issue arises when fund managers portray themselves as active managers and charge higher fees but would in reality be mimicking an index – a practice known as 'closet-tracking'. This has in the past led to probes by authorities to investigate cases of possible mis-selling. In response to this, the industry developed a measure called 'active share', which indicates to investors the percentage of investments within the portfolio that differ from the benchmark.

This debate has also given rise to a new breed of products - Smart Beta strategies. Smart beta can be classified as a semi-passive approach whereby an alternative indexing methodology is used as opposed to the mainstream market-value-weighted indices. This methodology is known as fundamental indexing or valuation-indifferent indexing in a broader sense.

Smart Beta providers claim to have identified a rule-based approach of exploiting market anomalies by systematically selecting securities according to pre-determined characteristics. The core argument against such strategies is that, when a real anomaly is identified, market players would act swiftly to take advantage of the observed mispricing in a way that such benefit is rapidly eliminated, thus removing the scope for such anomalies to reappear.

Investors are presented with a wide range of offerings. Adopting one approach over the other must be done in the context of the current environment and market dynamics.

Until recently, bond markets traded in a one-way direction marking a historical rally in the asset class. An index tracker would have performed as strongly as a well-diversified portfolio. However, in a less complacent market environment where expectations are more widely dispersed, passive strategies offer a suboptimal solution for investors. More so in a market turnaround, which is arguably the case at the moment, passive investing provides no protection to investors who are exposed to the broad market movements.

In the absence of an active manager who can proactively reallocate capital, investors stand to experience losses, at least in some parts of their investment portfolios. This is not to say that active managers only pick winners, but with a proven skill set, they offer investors an educated approach of calculating risk and reward, adapting to changes in market trends and exercising sound judgement in managing capital.

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