

Viewpoint

Russell Research

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JANUARY 2010

When should investors consider an alternative to passive investing?

We present a framework for considering alternatives to passive investing in capitalization-weighted indexes within any particular asset class. We identify five reasons investors seek alternatives; three reflect situations where a passive index is either unavailable or unsuitable, and two relate to investor expectations that active management can outperform passive benchmarks. Our discussion centers on how the debate over active versus passive investing needs to be broadened beyond a focus on the average performance of active U.S. equity managers.

In the investing arena, “active versus passive” is a perennial subject of debate. This debate is often pitched in heated, adversarial terms, as if there were ultimately just one “correct” way to manage investments. Discussions can devolve to a kind of war between competing factions, with battles fought mostly on the equities front, where data happens to be readily available and quite visible. Meanwhile, much of the academic literature focuses on the performance of active U.S. equity managers. Although these studies deliver mixed results, generally they cast doubt on managers’ overall ability to reliably add value after costs.¹ The passive-management contingent takes up such studies as banners for “active management doesn’t add value,” with the implication that investors should thus buy indexed products.

We take issue with the conduct of this debate in two ways. First, we think it unreasonable to base broad conclusions about the relative efficacy of passive indexing on active managers’ average results in a single asset class or sub-class, such as U.S.

¹ For instance, Wermers (2000) uncovers some evidence of added-value by U.S. mutual funds, although he observes that the majority of earlier studies conclude that actively managed funds underperform.

equities. What holds true in one market segment may not hold in another. Second, we object to the implicit assumption that in the absence of demonstrable stock-selection skills among managers, passive index replication provides optimal exposure for investors. Why? Because this assumption does not take into account differences in investor objectives and circumstances. What is missing in the debate is recognition that appropriate structuring and management of investments may well depend on investors' relative situations.

In this article we seek to reconfigure and broaden the “active versus passive” debate by presenting a framework for a more comprehensive consideration of alternatives to passively replicating a standard capitalization-weighted index in any particular asset class.² We illustrate our framework with examples of circumstances under which a particular alternative might be preferred. We offer no conclusions as to whether any specific approach is intrinsically superior. Indeed, the overarching message is that best choices can vary across asset classes, investor circumstances and perhaps even time.

Some context

There are two perspectives on why passive investment in cap-weighted indexes is the default or benchmark position. One is the “theoretical” view, which considers cap-weighted portfolios as optimal under the tenets of modern portfolio theory. Of particular influence has been the role that the capital asset pricing model gives to the market portfolio.³ Here passive becomes the default because it delivers the closest possible replication of slices of the market portfolio at the lowest possible cost. The other perspective might be dubbed the “industry” view. In practice, investors do not directly aim to hold the market portfolio. Rather, portfolios are constructed from the primary building blocks of asset classes, expressed in the strategic asset allocation that best aligns with investor objectives and preferences. Under the industry view, passive becomes the default because it is the lowest-cost option for achieving exposure to an asset class.

Under both views, the default role given to passive investing in a cap-weighted index rests on the three assumptions noted below. A breach in any of these assumptions could justify giving consideration to alternative approaches.

1. MARKET EFFICIENCY

Cap-weighting should be chosen under an assumption of perfectly efficient markets, where prices are always correct. Investors may consider alternatives if they believe markets are not fully efficient, and that the repercussions of any inefficiencies can be either avoided or exploited.

2. CAP-WEIGHTING IS ALIGNED WITH INVESTOR OBJECTIVES

The assumption that cap-weighting is aligned with investor objectives is often implicit. But it does not always hold. For example, a pension fund investor may wish to invest in a bond portfolio that matches cash flows. An endowment or foundation may have sustainable or ethical investing goals that preclude investing in the index.

² See Oberhofer (2001) for Russell commentary aimed specifically at the choice between active and passive investments in a mean-variance framework.

³ A broader view of the theory sees investors holding a series of portfolios that span the efficient frontier, and (in a multi-period world) hedge against changes in the investment opportunity set.

3. INDEX EFFICACY

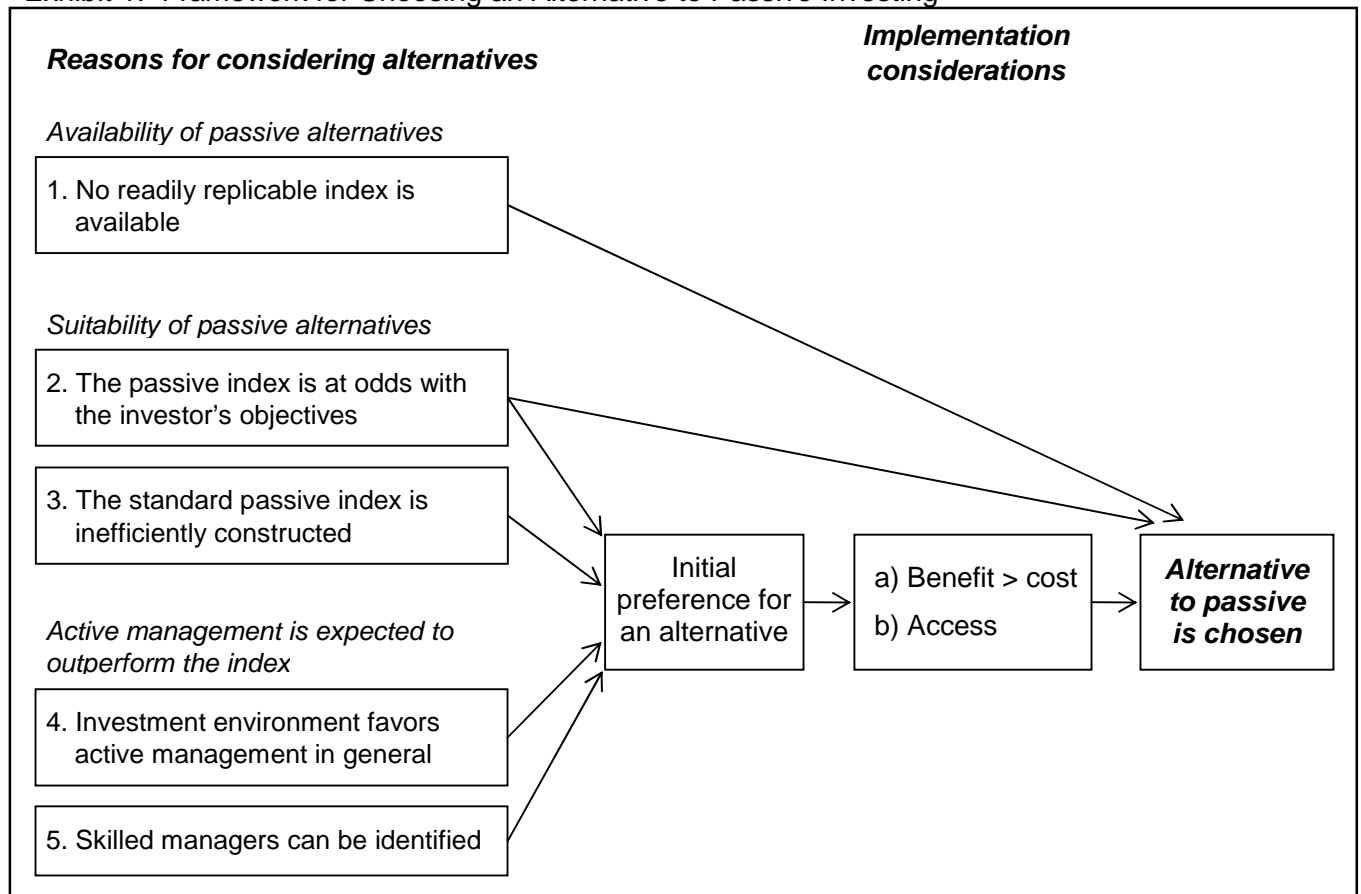
The view of passive indexing as the default assumes that an index is available for the intended purpose. The theoretical view calls for indexes that effectively embody the market portfolio. The industry view requires indexes that deliver the desired type of asset class exposure. In practice, it is possible that for a given asset class no market index exists, or that available indexes have shortcomings in their construction.

Below we propose five specific reasons why an investor might prefer an alternative to a passive approach in any particular asset class. These reasons all relate to a passive approach's failure to satisfy at least one of the three assumptions identified above.

Reasons for choosing an alternative to passive investing

Exhibit 1 summarizes our framework. In it, we identify five reasons for investors to consider some alternative to passive investing in the initial instance. The ability to implement the alternative at a cost less than the expected benefit is addressed separately. In other words, the framework aims first to work out whether there is a case for rejecting a passive default, and then to ask how much an investor is willing to pay and how the alternative can be accessed. In most cases this alternative will be what is traditionally known as "actively managed investing." In other circumstances this need not be the case, or the skills-based component may be minor.

Exhibit 1. Framework for Choosing an Alternative to Passive Investing



To date, industry debate has focused on whether active management can outperform an index, with particular emphasis on the performance of active management in general (i.e. reason #4). The framework appreciably widens the range of reasons for choosing an alternative to passive investing. In particular, the first three reasons relate to the availability and suitability of the passive option. We now examine in turn the conditions listed in Exhibit 1.

Reason #1: No readily replicable index is available

The first reason to consider an alternative captures the more extreme instances of lack of an effective index. Passive investment assumes an index exists that can be readily replicated. Some alternative becomes the only option if no such index is available. Most unlisted assets, such as private equity, private real estate and private infrastructure fall into this category.⁴ For listed markets that are relatively illiquid, index construction and replication can be problematic. Included in this category are small cap and emerging markets equities and high-yield debt. While passive products may be available, they might not deliver a faithful replication of the asset class at low cost. Such products sit in a gray area, where an evaluation of the suitability of the index as a candidate for replication is required.

Reason #2: The passive index is at odds with the investor's objectives

A second reason for considering an alternative could be that the passive index is poorly aligned with the investor's own objectives. In such situations, some alternative approach may better meet these objectives, perhaps via employing active managers to help "tailor" the portfolio. While the possibilities are somewhat open-ended, we discuss four notable examples below.

TAILORED FIXED INCOME MANDATES In fixed income, an investor may prefer a set of exposures that differs from that implicit in the standard index. A prime example is the desire to match a series of cash flows reflecting an explicit liability of the investor, such as with a defined benefit pension plan. Not only are the durations of the liability and the index typically substantially different; the annual cash flow patterns are typically also very different. These differences will no doubt have been reflected in the initial modeling work from which the strategic asset allocation is derived, making the passive index inappropriate for implementation of the strategic asset allocation. Or, more simply, the investor may prefer to explicitly control the magnitude of exposures like credit in recognition of its influence on the risk profile of the overall portfolio. Such objectives might be better achieved through building portfolios with a different structure to the standard passive index.

LISTED INFRASTRUCTURE Some investors may want exposure to infrastructure for its particular characteristics, namely reliable cash flows and a degree of inflation hedge. Investors who look to the listed markets for their infrastructure exposure face the challenge that parts of the universe (e.g., U.S. utilities) do not provide these features. Investment products that better align the portfolio with the desired attributes, through restricting the investment universe to certain securities, might be preferred.

SUSTAINABLE AND ETHICAL INVESTING Sustainable and ethical investing is a classic example of where objectives other than pure wealth maximization may create a desire to hold an alternative to the standard passive index.

⁴ We refrain from discussing hedge funds on the basis that they can be considered a collection of strategies to access asset classes, rather than an asset class in their own right.

TAX EFFECTIVENESS Tax positions can drive a wedge between the index and the portfolio that best meets investor objectives. Conceptually, managing for tax efficiency should produce more optimal portfolios. However, this requires the capacity to actively manage the portfolio in a tax-aware manner. (Conversely, passive approaches tend to be more tax-effective than active management on a pre-tax basis, as the latter may generate extraneous taxes through greater turnover.)

Reason #3: The standard passive index is inefficiently constructed

A passive approach can lack efficacy in situations where the index is itself thought to be inefficient. There is no point passively tying your investment to an index that represents a suboptimal approach, providing there is an alternative that can deliver a better outcome. Two potential reasons why an index might be inefficient are: (a) the index is built on a narrow or unrepresentative universe; (b) the index is constructed in a way that builds in some inefficiency. With the latter, the case for considering an alternative can also relate to a belief in market inefficiency. These issues are best outlined through discussion of three examples below.

EQUITIES The proponents of fundamental indexation⁵ argue that cap-weighted indices are necessarily flawed because index weights are correlated with pricing errors, i.e. cap-weighted indices overweight over-priced stocks and underweight under-priced stocks. At its core, this is an argument that the market is inefficient, which is closely related to the case for value investing. The implicit suggestion is that a more efficient portfolio can be built by an alternative weighting scheme.

FIXED INCOME While fixed income indexes suffer from a plethora of shortcomings, two in particular strike at the issue of efficiency. First, some standard fixed income indexes are partial representations of the available universe. Thus they fail to fully represent the asset class, and so there may be scope to build more efficient portfolios by including off-benchmark assets. Second, index composition is driven by cycles of issuance and retirement of debt. There is no guarantee that the available mix of fixed income securities will amount to an efficient portfolio. Indeed, an argument might be made that the largest issuers may be less attractive, either because they are most in need of funding (and hence of lower quality), or are issuing debt to take advantage of low interest rates which are unattractive to the investor. These features may give some investors reason to believe that a relatively efficient fixed income portfolio may be achievable under a more active approach. Indeed, such features appear to have contributed to the comparative unpopularity of passive approaches to fixed income.

COMMODITIES Collateralized commodities futures funds have become a significant area of passive investment over recent years. As commodities do not have “market caps” in the usual sense, the link between commodity indexes and the concept of a cap-weighted passive investment is problematic. We confine our discussion to certain production-weighted indexes, such as the S&P Goldman Sachs Commodity Index, because they most closely resemble the notion of cap-weighting and are widely used by passive funds. Such commodity indexes might be viewed as inefficient for two reasons. First, they may be heavily skewed toward energy and hence poorly diversified: the S&P Goldman Sachs Commodity Index was around 70% weighted in oil and gas as of November 2009. Second, a rules-based approach to rolling contracts can leave the index exposed to distortions associated with short-term supply/demand pressures. Investors who accept these points may conclude that an actively managed collateralized commodities futures fund offers potential to construct a broader and

⁵ See Arnott et al (2005).

probably more efficient portfolio through avoiding the concentration of exposures by commodity and futures contracts.

In each example discussed above, preference comes down to investor beliefs about the suitability of the standard index, and whether a more efficient portfolio can be delivered through an alternative approach. We offer no comment on whether such beliefs may be justified.

Reason #4: The investment environment favors active management

Our final two reasons address the more traditional question of whether investors can access managers that can be expected to outperform the index. We break this discussion into two parts. Reason #4 focuses on features that could lead to active investment managers outperforming the passive alternative in aggregate. It asks whether there are any generic reasons to favor active management in a particular asset class or sub-class. Reason #5 addresses the issue of individual manager skill.

It is self-evident that active investment, broadly defined, is a zero-sum game relative to the market portfolio before transaction costs, and therefore a negative-sum game after costs. In this sense, active investment as a whole cannot outperform. However, this is a broad constraint that need not apply to any subset of investors or assets. It is conceivable that there will be situations where sub-groups of investors can produce sustained outperformance versus an index, perhaps in part because the index does not capture the entire market.

We observed earlier that the “active versus passive” debate has tended to focus on the historical performance of the average equity manager, particularly in the U.S. While the studies are instructive, it is worth emphasizing the dangers of making broad generalizations based on these results. A forward-looking evaluation of the potential for active managers to outperform in each asset class (or sub-class) is required. Here it can be helpful to examine the environment in which managers operate, with a view to establishing whether as a group they have any competitive advantage that could generate sustainable outperformance. Features that might support such a situation are discussed below, grouped under headings that link them to possible breaches in the three assumptions identified at the outset.

1. **MARKET INEFFICIENCY** While market inefficiencies offer the potential for active managers to outperform the index, inefficiency is not in its own right sufficient reason for choosing an active alternative. An additional requirement is that active managers should be better placed than other investors to capture any mis-pricing. Aspects of less than fully efficient markets that might provide active managers with a competitive advantage include:

Information advantage. This can occur when the market is widely populated by less-informed investors who can double as both a source of inefficient pricing, and as candidates for taking the other side of trades. Examples of assets where this seems more likely include some emerging markets and small cap equities.

Preferential access to desirable assets. In listed markets, preferential access usually means having first chance at IPOs, lines of stock and so on. In unlisted markets like private equity and private real estate, existing relationships and ability to provide capital or skills can help in sourcing attractive assets.

Partially segmented markets. Such markets may have greater scope for prices to get out of kilter under the influence of localized forces, e.g.

domestic economic cycles and politics. An active manager operating across market segments may take advantage of any related mis-pricings. Emerging markets and global property are examples of the type of asset class that may offer potential from this standpoint.

Economic value-add. In some situations, active management can add value to the underlying asset itself. This occurs mainly for unlisted assets like private equity.

2. **OPPORTUNITIES ARISING FROM DIFFERING INVESTOR OBJECTIVES** Active managers might benefit where differences in objectives give rise to a pool of investors who are comfortable earning a below-market return. For example, active managers may be able to generate returns by offering liquidity to those requiring immediacy,⁶ or by accepting risks that other investors are less willing to bear. Differing time horizons could offer up some opportunities; for example, value investors may exploit the short-term focus of markets if they have the latitude to wait patiently for value to be realized. Some players may be driven by non-fundamental criteria, e.g. public money.
3. **INDEX FAILS TO COVER THE OPPORTUNITY SET** Whenever existing indexes are not comprehensive in their coverage of the available market, there may be potential for active managers to outperform by investing outside the index universe.

In addition to the above, consideration should be given to the intensity of competition between the managers themselves. Too much competition can mean that opportunities quickly evaporate, or cannot be accessed in sufficient volume. Success is more likely when there are not too many active managers attempting to do the same thing. This aspect warns against extrapolating from uninspiring performance by active managers in highly institutionalized markets such as U.S. equities, into other markets or assets where competition between managers may be less fierce.

The cyclical dimension to active returns should also be borne in mind. Active management tends to struggle under certain conditions, such as when cross-sectional volatility and valuation spreads are relatively low, or when markets are driven by “thematic” forces of a non-fundamental nature.⁷ The possibility that active returns may rebound following such periods could give rise to a transitory preference for active management. While cyclicality has limited relevance for the long run, it may add a timing element to any evaluation of active versus passive investment.

Reason #5: Skilled managers can be identified

Where a passive alternative exists, a belief that skilled managers can be identified may become important in two ways. First, the ability to identify skilled managers could be a sufficient condition in its own right for choosing active over passive management – regardless of how the average manager is likely to perform. Second, some capacity to evaluate manager skill is desirable in any situation where an active alternative is being contemplated. On the basis that both “good” and “bad” active managers exist, at the very least, bad managers should be avoided, as choosing them could defeat the whole point of opting for active management.

⁶ Returns to providing liquidity also relate to a form of market inefficiency, i.e. costs involved with transacting immediately.

⁷ Eggins and Gunning (2008) illustrate these concepts with respect to the Australian equity market.

To the extent that markets can never be perfectly efficient, some room should exist for outperformance through skill. The issues are whether skilled managers actually exist, and if so, whether they can be confidently identified ex ante. One reason to suspect that skilled managers do indeed exist is the notion that people (or fund managers) were not created equal. If one accepts this proposition, then an ability to identify these skilled managers becomes key.

Much of the related literature is based around U.S. equities, and generates mixed evidence on persistence in active manager skill.⁸ Furthermore, one cannot extrapolate reliably from narrowly focused research. Even if genuine skill was found to be scarce among U.S. equity managers, it could still potentially exist for managers in other areas.⁹

In any case, manager selection is a skill-based pursuit involving an element of subjective judgment, especially given the unreliability of past returns as a guide and the potential for structural change among the managers themselves. The existence of manager selection skill must be evaluated on a case-by-case basis, and will depend on manager research capability in the particular asset class in question. Inevitably, investors must decide for themselves whether they have sufficient manager selection skill to justify choosing an active alternative over the passive default.

Implementation issues

So far we have discussed five reasons for adopting an initial preference for some alternative to passive investing. Before committing to the alternative, it is necessary to consider whether it can be implemented at reasonable cost. There are two issues:

A) COST VERSUS BENEFIT

Relative costs are typically lower under a passive approach. It is important that all cost differences are identified and weighed against the relative expected benefits. Costs include not only management fees and trading costs, but also any manager research and monitoring expenses. Such costs may vary significantly across products and investors, due in part to influences such as scale and bargaining power. The possibility that passive strategies need not deliver the index return should be taken into account. Trading costs arise from cash flows, index rebalancing and dividend reinvestment. Furthermore, index replication can sometimes be difficult and costly. The latter applies particularly for fixed income, and for more illiquid asset classes such as small cap or emerging market equities.

B) ACCESS

It is not always automatic that investors can access their preferred alternative. Capacity considerations and existing relationships may be important.

Given that the capacity and cost of accessing various alternatives can differ significantly across investors and products, it is dangerous to generalize. An evaluation must be made in the circumstances.

⁸ While much of the earlier literature uncovered little evidence of performance persistence, more recent papers have questioned this finding. For example, Kosowski et al (2006) uncover statistically significant and persistent alpha among top-performing U.S. equity mutual funds by using a bootstrap approach, while Kacperczyk et al (2005) find evidence pointing to return persistence associated with industry-related selection skill. There is also evidence of persistent outperformance by U.S. growth managers versus their style benchmark (see Davis, 2001).

⁹ For instance, Huij and Derwall (2008) find return persistence among U.S. bond mutual funds.

Summing up

The attraction of passively replicating a cap-weighted index is that it can offer a low-cost method for gaining exposure to an asset class (or a slice of the market portfolio, if you prefer). However, there are a number of conditions under which a passive approach no longer becomes optimal. These conditions extend beyond the issue of market efficiency, and beyond the choice between passive and active management as traditionally defined. They include questions about the efficacy of the index itself, and how well it meets investor objectives.

We have suggested five reasons for considering an alternative to passively investing in a cap-weighted index. These reasons include ruling out a passive approach in the first instance because either no readily replicable market index exists, or because available indexes are unsuitable due to not meeting the investor objectives or some imbedded inefficiency. Even where a suitable index exists, an active alternative might still be chosen due to an expectation that active management can do better. This expectation could arise from confidence in the ability of active managers to add value in general, and/or capacity to identify skilled managers.

Ultimately, the question of whether to choose some alternative to passive investing should not be approached as a single decision. The answer is likely to vary across asset classes, investors and even time. We trust that the framework presented in this report may help investors make choices that are appropriate for their circumstances. We also hope that it prompts a widening of the scope of discussion, which to date seems too narrowly focused on comparing passive investment with the average returns achieved by active equity managers.

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First used: January 2010

USI-4232-01-12