Ashmore

The Emerging View
Passive

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Passive: being subjected to action without response; not participating; lethargic.

Employing an active manager comes at the price of higher fees than for a passive manager. Is the difference worth it? This is not a new debate. There are those who claim that on average active managers do not beat passive index managers. Yet there are holes in the theory backing this up and, certainly in emerging markets, convincing evidence to the contrary.

Asset Class Gaps and Distortions

The sources of many arguments lie in different (often implicit) starting assumptions - this one is no different. The 'market portfolio' is a theoretical portfolio which includes all possible investments, weighted in proportion to size. Such a portfolio has 'systematic risk' (risk affecting the market as a whole) but no non-systematic or 'specific' risk. The existence of the 'market portfolio' is assumed for much of modern portfolio theory and the Capital Asset Pricing Model (CAPM). However, it is a fiction, with managers in practice invariably able to find assets not included in the proxies used to represent the 'market portfolio'. Emerging debt is a case in point. At $11.4 trillion it is 11.7% of global fixed income, as measured in US Dollars. Though this is larger than the US Treasury market some still do not consider it an asset class. Also, only 12% of the emerging market debt universe is represented by the major emerging debt indices, and proxies of the 'market portfolio' omit the bulk of the opportunity set.

What determines an asset class? There is no clear process. Rather it is a matter for convention: what has been and is considered an asset class by one's peers. This conservative and unscientific process has led to change in the set of accepted asset classes over time but this change has been slower than, and has lagged changes in, the growth in underlying financial markets.

The building blocks for the 'market portfolio' proxies are indices, which not only do not exist for some investment opportunities (there is for example no index yet for emerging market local currency denominated corporate debt, despite this being a $4.1 trillion and accessible market) but also leave out many investments in the asset classes which are included. This is in part because indices are designed to be easy to invest in (erroneously called 'investible') rather than comprehensive. For those willing to do a bit more work, there are other opportunities outside the indices.

If managers are forced to buy only within an index, the index is cap-weighted, there are no changes in the set of managers in a given period, and no other holders of the assets, then the average performance (before fees and transaction costs) must be the index performance. This might lead one to prefer passive management for those no better than average at selecting managers. However these assumptions do not hold and the argument is false.

Active Management to Reduce Risk

The commonly used two stage process of asset allocation using indices as proxies for asset class choices, followed by manager selection where managers are selected on the basis of performance vis-à-vis benchmark indices, can create sub-optimal outcomes. This can be illustrated by considering so called 'benchmark risk' (a misnomer for benchmark deviation). Risk is represented by volatility (not the only or even the most important way to express risk) and is assumed to be always increased by a manager deviating from a benchmark. Yet active management can reduce volatility and risk compared to the benchmark and indeed compared to the wider portfolio. So one could have lower absolute volatility than the benchmark but this would still show up as positive benchmark risk.

Take the example of sovereign risk. Countries do not default or restructure out of the blue. We know months in advance normally that there is such a risk. Policy-makers try other policies before running out of other more acceptable options. So the first job of an active manager is to reduce risk and this is often much easier than increasing returns. Passive managers however, do nothing and lose out in the default.

Asset Allocation v Manager Selection

A well-known paper by Brinson et al (1986) showed that asset allocation (between asset classes) can explain around 93.6% (the R^2 result of the study) of the variability of pension fund returns over time. For pension funds the argument often drawn from this, though it does not follow, is that asset allocation policy is much more important than manager selection. The 93.6 R^2 says nothing about relative performance, merely that on average the good performers and the bad move in line with the strategic asset allocation. Other studies show that active management can add hundreds of basis point excess return over this. The Brinson result is simply consistent with pension funds sticking to strategic allocations over time.

Over any given period some asset classes will do better than others. If pension funds do not change asset class allocations at all during the period, and if they are equally good (or bad) at manager selection such that they get average returns, then 100% of the differences between them will be down to different allocations. Yet this means neither that tactical asset allocation wouldn't work, nor that better managers cannot be found, nor that there are not better opportunities none of the pension funds studied invested in.

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Focussing more on return, Ibbotson and Kaplan (2000) have shown around 40% of the variability among funds of the sample they used was caused by asset allocation policy - a far cry from 93.6%. They also though did show that near 100% of pension return levels is determined by policy - i.e. that on average active managers returned the benchmark return. This is not surprising given the restricted off-benchmark allocations pension funds typically allow managers, and may simply reflect their poor ability, in practice, to pick good managers. The result does not hold for all types of investors. Not only should we look harder for good active managers, but if policy (asset allocation) is so important in explaining returns relative to other factors then maybe we should pay more attention to the taxonomy of asset classes. Perhaps one could do better by having a more inclusive universe to choose from. Also, perhaps allocations should change in light of events, not remain static. Many asset allocators do exactly this, but by no means all.

This is not the only or even the standard interpretation. The frame of debate is often restricted to whether active managers can add value. A sub-plot of the debate is whether consultants, who advise on asset allocation, are more valuable to a pension fund client than the fund managers employed to invest the assets.

The Precise Value of Nothing

Fiduciaries want to maximize returns at minimal risk. Volatility is a measurable proxy for risk, but an imperfect one - risk is much more complex and harder/impossible to measure. Fiduciaries want to avoid extreme loss events, but may not know what is likely to cause extreme events. The big picture is muddy but the smaller picture often easier to understand. Being conservative (doing what others do, following advice in preference to thinking from first principles, and doing what has been done before) is not the same as being prudent (avoiding the potential of future risks), but is a proxy. Decisions with equal impact on investment outcomes are equally important, yet some questions are calculable and others not. So we measure what we can and all too often over-weight measurable factors at the cost of a more balanced view. And focus on measurable factors may lead to a false sense of certainty, often exacerbated by a dose of over-confidence.

Avoiding the Psychological Pain of Unsolvable Problems

Matching our liabilities is important but we do not know what they are going to be. We can however measure the future promised repayments on our domestic government bonds and estimate our future liabilities. We do both imperfectly in real (after inflation) terms let alone in purchasing power terms. If one cannot match liabilities what are the pros and cons of nearly matching them? Matching liabilities is often subject to 'mental accounting' where different portions of a portfolio are assigned different objectives: some to match liabilities, some to create income, some to build reserves for example. Such a sub-optimal allocation decision process may be to avoid rogue or overly emotional decisions. Likewise conducting reviews of asset allocation periodically, say every one, three or five years, may clearly not match the timing of underlying changes in the investment landscape, but can impose discipline and avoid irrational decisions. Likewise passive investing can be justified as a way to avoid bad decisions.

So perhaps, in part, passive investing is a psychological defence by those who do not trust themselves or their organisations to think in real time and react to events as they unfold and make appropriate adjustments. But it is one thing not to try active management oneself, another not even to delegate it to those who are better able to do so. Insofar as active decisions need to be taken not delegated (such as changing asset allocation more then occasionally if events dictate) then one should perhaps look at mechanisms to avoid behavioural biases in decisions rather than avoid making such decisions.

Passive Investing & Systemic Risk

Passive investing may be riskier than active investing (just as driving with one's eyes closed is more dangerous than with them open) both for single investors and markets as a whole. Indices are highly biased representations of available investment opportunities and the processes of asset allocation is often conservative rather than prudent. We place too much faith in tradition, numbers and the approaches of our peers. A consequence is that passive investing appears to be safe for long periods of time followed by periods when it is clearly very wrong-headed. Passive investing by many may help foster long periods of stability where imbalances build unnoticed. This can increase systemic risks. Given the state of the world today in which imbalances are rife, we can expect more surprises, more divergences from projections extrapolated from past data. Money market funds were not meant to dip below par, large Wall Street banks were not supposed to go bust, the US Treasury market is meant to be safe and passive investing is meant to be safer than thinking (apparently). The challenging (and to some unpleasant) reality is that there is no substitute for engaging ones intelligence to problems which are not reducible to number crunching. Being passive is an active decision: a danger which masquerades as safe.

Brinson, G.P., Hood, L.R. and Beebower, G.L., 1986. Determinants of Portfolio Performance. *Financial Analysts Journal*. July/August. pp. 39-44.
Ibbotson, R. G. and Kaplan, P.D., 2000. Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance? *Financial Analysts Journal*. January /February. pp. 26-33.

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