Francesco Franzoni: «Some Investors Have to Do the Heavy Lifting»

| Written by Claude Baumann

The assets in U.S. passive equity funds have undertaken the assets in active funds. This development may create a sense of disorientation, says Finance Professor Francesco Franzoni. Naturally, the question arises whether there is a future, or even a present, for active asset management.

Professor Franzoni, what is the topic of your next «Master Class» at the Swiss Finance Institute?

In my Master Class, we will discuss opportunities in the active asset management space. This broad topic really encompasses multiple themes. First, we will take a step back and consider from a theoretical point of view what are the foundations of active asset management. In other words, what are the assumptions that underlie the practice of active asset management?

Then, we will give an overview of the strategies that seem to perform well in the active management space nowadays. This part of the class will benefit from the contribution of **Giordano Lombardo**, a professional in the European asset management with multiple years of experience as an institutional investor.

> «These developments are revolutionary and may create a sense of disorientation»

Finally, we will discuss some recent academic results suggesting that it is possible to identify asset managers that generate outperformance. This ability requires specific techniques that will be described in the class.

Why did you choose this topic?

Just recently, the assets in U.S. passive equity funds have undertaken the assets in active funds. These developments are revolutionary and may create a sense of disorientation. Naturally, the question arises whether there is a future, or even a present, for active asset management.

> «I thought that it makes sense at this historical moment to paint a rosier picture for active asset management»

Although the academic evidence on the ability of active managers to generate outperformance was initially negative, the view is now turning more positive on this issue. I thought that it makes sense at this historical moment to paint a rosier picture for active asset management.

Do you expect that active asset management will see a comeback?

Yes. I expect active management to continue to play a role in asset management. Simply put, efficient markets require investors who do the ‹heavy lifting› of digging information and actively trading on it. If that does not happen, prices will be unhinged from fundamental valuations.

> «In other words, active managers are a crucial necessity of well-functioning financial markets»

But that is exactly the time when it is profitable to be an active asset manager. In other words, active managers are a crucial necessity of well-functioning financial markets. We can then debate on how much active management we need… and I don't have (and I don't think anybody has) a definite answer on that.

Active asset management has lately become unpopular not only because of the costs compared to passive investing but also because it seemed that active managers didn't achieve their goals. True?

That's a correct representation of the events. The finance academic literature played a major role in bringing these developments about. First, the efficient markets hypothesis was formulated by **Eugene Fama** (Nobel laureate in 2013). According to this theory, investors should just hold an index fund. Then, abundant empirical evidence was produced suggesting that active managers were not beating their benchmarks.

> «Nobel laureates Robert Shiller and Richard Thaler argue that some investors trade irrationally»

Fortunately for active management, the academic views are different nowadays. Behavioral finance plays a prominent role in the discipline, as testified by the recent Nobel prizes to **Robert Shiller** and **Richard Thaler**. This body of work argues that some investors trade irrationally. This behavior distorts prices creating space for smart active managers to correct valuations and generate profits by doing so.

Moreover, some authors argue that it is possible to identify some active managers that consistently beat their benchmarks. We will discuss this result in the Master Class.

What are the strategies that have generated performance, recently?

For this question, I am relying on Giordano Lombardo's expertise, who is the co-instructor for this Master Class. There seems to be performance in multiple domains. For example: unconstrained fixed income and equity strategies, with loose connection with a benchmark; multiasset and multistrategy portfolios, with a total return/absolute return goal; income yielding strategies, both equity and credit; strategies with a component of illiquid assets (private debt/private debt); and, finally, goal-oriented solutions

Your academic/scientific work is also about ETFs and the questions whether these investments increase volatility in the market. Could you elaborate on that?

To keep a long story short, just consider that demand forces move ETF prices away from the value of their underlying portfolios. For example, a large institutional investor selling ETFs for hedging a long equity exposure puts downward pressure on the ETF price. Then, consider that there is constant trading in the market by specialized firms to keep ETF prices aligned with their underlying portfolio.

> «Daily volatility increases by about 15 percent for stocks with higher ETF ownership»

This trading activity propagates shocks from the ETF market to the underlying securities, even if these shocks are not related to fundamental information, like in the hedging example above.

The propagation of these shocks increases the volatility of the prices of the underlying securities. In a «Journal of Finance» article, we find that daily volatility increases by about 15 percent for stocks with higher ETF ownership.

Would you also agree that in a downturn ETFs might intensify the crash?

Probably ETFs could exacerbate downward price moves and illiquidity in asset classes that are not very liquid, to begin with, such as corporate bonds. There is a lot of money going into bond ETFs these days, operating under the assumption that these ETFs are perfectly liquid.

> «We should expect a survival of the fittest»

One can envisage situations of market stress when the illiquidity of the underlying bonds will become a binding constraint for the liquidity of the bond ETFs. We have not experienced this situation yet. Hence, this is just a conjecture at this stage.

Who is your target audience?

All managers in banks and investment firms that wish to take stock at the recent trends in the asset management industry and to think critically about what the future may look like.

What insights may attendants expect?

Let me just summarize them with one sentence: Active management is not going to disappear. However, we should expect a survival of the fittest. Some of the insights that we discuss in the class pertaining to the ways in which the «the fittest» can be identified.

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