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Has the death knell of active management been rung too soon?

Robert Pozen and Theresa Hamacher

Robert Pozen and Theresa Hamacher say active management is essential for making markets efficient

The death knell of active portfolio management has been rung. But with recent studies suggesting that the costs of passive management are rising, has the bell tolled too soon?

Last year, Charles Ellis seemed to predict the imminent demise of active management when he wrote that “the costs of active investment are so high and the incremental returns so low that, for clients, the money game is no longer a game worth playing”. Mr Ellis, a longtime commentator on asset management trends, suggested that investors would be better served if investment professionals shifted their focus toward financial planning and away from stock picking.

Mr Ellis’s comments only reflected what was happening in the investment world. Investors have been steadily shifting assets from actively managed funds into passive. At the end of 2013, index funds accounted for one dollar of every five invested in US mutual funds overall and, stunningly, more than one-third of the assets in US equity funds.

While the interest in index funds is understandable, the disdain for active management is ironic. Active management is what makes index funds attractive in the first place.

How is that? Proponents of passive investing argue that index funds are the only logical alternative when markets are efficient, meaning that asset prices accurately reflect all information. Active managers have a tough time making money in efficient markets because asset mispricings are rare. In efficient markets, index funds generate the same returns while costing less.

Yet markets are efficient only because active managers buy underpriced assets and sell overpriced ones. Hence the irony: by making markets more efficient, active managers are creating an environment where index fund investing is more appealing. The more active management, the more efficient the markets.

Conversely, as the level of passive investing increases, markets become less efficient. Index funds change their holdings mainly in reaction to investor inflows and outflows, so they are much less responsive to changes in stock price or company information than are actively managed funds.

And the impact is not just theoretical: recent academic studies have concluded that the rise of index funds has affected the US stock market adversely in several ways.

For example, a study by Russ Wermers and Tong Yao, professors of finance at the University of Maryland and the University of Iowa respectively, found that stocks owned heavily by index funds “exhibit more long-term pricing anomalies”.

Academics Itzhak Ben-David, Francesco Franzoni and Rabih Moussawi examined a different indicator of market efficiency, namely stock price volatility. Their research concluded that a one standard deviation increase in ownership of a stock by exchange traded funds — most of which are passively managed — leads to a 16 per cent increase in daily stock trading volatility.

A third aspect of market efficiency — the degree of correlation of US stocks — was the subject of a study for the CFA Institute by Rodney Sullivan, vice-president at AQR, the hedge fund, and James Xiong, head of quantitative research. at Morningstar, the data provider. It observed increasing correlations among stocks, which make it more difficult for investors to reduce risk through diversification and thereby increase systemic market risk. The authors concluded that the trend was the result of the growth in index funds.

All three of these studies show that the costs of index funds are much higher than generally perceived, because index funds increase market volatility and risk. However, the costs of decreased efficiency are borne by all investors, not just index fund owners. The costs of active management are paid entirely by the investors in such funds, while active investing benefits all investors — including shareholders of index funds — by increasing market efficiency.

Put another way, the active versus passive debate needs to be reframed to include both the direct expenses paid by the investors in each type of fund and the indirect costs incurred by all investors. Although competition from index funds may keep costs down for investors in active funds, actively managed funds are essential for making markets efficient for everyone.

It is not a question of either/or; it is a question of balance.

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