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Active versus passive

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The debate over active versus passive investment management has been part of the financial landscape for quite some time. It is probable that the advent of the very first stock market index coincided with the very first argument, or perhaps fist fight, over whether or not someone could "beat the market." This long-raging debate is not likely to end any time soon. The increased availability of financial market information has raised individual awareness of these markets and there are now more market participants than ever before. Nevertheless, the addition of many more new players to the game does not necessarily translate into an improvement in market efficiency and evidence continues to support arguments for taking an active investing approach.

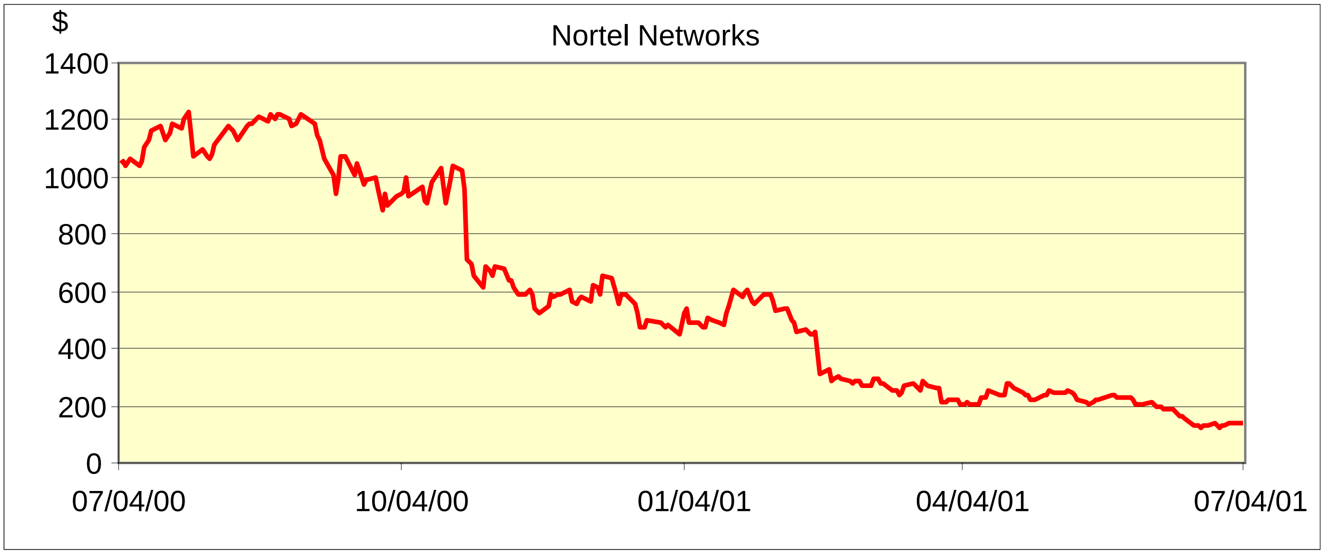
Market efficiency

Arguments for passive investing presuppose that markets are efficient. The efficient market hypothesis postulates that the market price of a stock, bond or other security fully reflects all available information with respect to that security. Efficiency of the market implies that it is impossible to systematically "beat the market" through active management. That is, if an active manager can gain insight or knowledge through their research into a security, and that information should influence the security price, everyone else already has this information. Further, the argument goes, the current market price of the security already fully reflects this information, and changes in market pricing are immediate reflections of any changes in information. Not surprisingly, many of the studies that look into the efficiency of the financial markets have focused on the U.S. equity markets where both data availability and reliability are greatest. It is reasonable to argue that the U.S. equity markets are the most efficient of all. Other studies have shown that active managers of both fixed income and equity mandates can add value on a consistent basis even within the "efficient" U.S. markets[1] [2]. It would appear that while a debate over the efficiency of some of the better-developed capital markets may be worthwhile, these arguments break down further when the geography changes. Even proponents of the efficient market hypothesis agree that certain markets, particularly emerging markets, are not efficient[3]. Further research has shown that even "local knowledge" can also play a role in improving performance[4].

A quick trip across the border can highlight that cases of market inefficiency seem all too prevalent. It would appear that market participants had some difficulty in arriving at an appropriate valuation for common shares of Nortel Networks between mid-2000 and mid-2001, as indicated in the graph on the next page. The market had priced the shares at $1,231 per share[5] on July 26, 2000. In three months time it had been re-priced 50% lower and by mid-February 2001 the re-pricing had reached a massive 75%. The

[1] **AllianceBernstein, No time to be passive – get active now, January 2009.**
[2] **PIMCO, Active versus passive bond management: a look at the numbers. February 2008.**
[3] **Burton Malkiel, Investment Opportunities in China, July 16, 2007.**
[4] **Bae, Stulz & Tan. Do local analysts know more? A cross-country study of the performance of local analysts and foreign analysts. Journal of Financial Economics. June 2008.**
[5] **Adjusted for the reverse 1:10 split on December 1, 2006.**

company's market capitalization, in Canadian dollars, fell from $398 billion in September 2000 to less than $5 billion in August 2002. This challenge to efficiency took place in a market with considerable access to information and proximity to the U.S. market. In fact, during the period, Nortel's stock traded in the U.S.



Source: Bloomberg

Recent figures have shown that the inefficiency of the Canadian market continues to allow active management to outperform with an *average* of 33 basis points (a basis point is 1/100th of one per cent) of outperformance per quarter for the past 10 years[6]. In particular, the ability to hold flexible cash positions and limit the potential for over-exposure to individual issuers can provide the basis for substantial outperformance in down markets. As the table below illustrates, the average Canadian equity fund has outperformed in all of the recent bear markets. While no one would be happy with an average decline of 25.6% over these episodes, the 6.7% performance cushion provides some measurable protection during the most challenging times.

Bear Markets 1980 - 2009

Start	End	TSX	Funds	Difference
Nov-80	Jun-82	-38.8%	-27.2%	11.6%
Aug-87	Nov-87	-24.9%	-22.4%	2.5%
Jan-90	Oct-90	-20.1%	-15.5%	4.6%
May-98	Aug-98	-25.6%	-21.4%	4.2%
Sep-00	Oct-02	-42.5%	-25.9%	16.6%
Jun-08	Mar-09	-42.5%	-41.5%	1.0%
Average		-32.4%	-25.6%	6.7%

Source: Globe HYSales – Funds include a small number of index funds, calculations are made from month-end figures.

[6] **Russell Investments Canada, press release, April 2009.**

Index issues

The pricing "errors" illustrated above highlight another passive investing issue, a problem with the indexes themselves. Most indexes are market capitalization weighted, which means that larger companies (as determined by number of shares outstanding times share price) have more of an effect on the index than smaller companies. The result is that indexes reveal momentum – the stock that did well yesterday now has a bigger market cap, and accordingly accounts for a greater proportion of the index. This, in turn, forces indexers to then buy more of that stock, driving up demand and the price even further in the process. This must occur in passive investment strategies as the market is viewed as efficient and no actual assessment of veracity of this spiral pricing takes place. In other words, indexers are increasing their allocation to recent winners and reducing their exposures to stocks that have underperformed. They are, in effect, executing a sell low and buy high strategy. Accordingly, when an index is being driven higher by a few select large-cap stocks, the index will outperform a manager who has implemented a more risk-controlled and valuation-centric investment approach. By the same token, when specific sectors are attracting buying interest, they too can begin to represent higher proportions of the overall index than they represent relative to the overall economy. Examining the proportional breakdown of an investment in the index may reveal high levels of investment concentration that would be inappropriate for many investors.

Costs

The reality is, nothing in life is free. Both active and passive investing strategies come with costs. Exchange-traded funds (ETFs) are typically the cheapest strategy. The management expense ratio (MER), a measure of costs, normally ranges from 0.15% to 0.50% on ETFs, with specialized ETFs having higher expenses. Index funds have a range of fee burdens, with MERs from 0.15% to 2.27%[7] and averaging 0.86%. The existence of any fee guarantees that the investor will underperform the target index. Actively managed mutual funds have an average MER of 2.24%. However, the cost advantage that passive investors enjoy is often misunderstood. At its most basic level, passive investing requires virtually no thought or effort. Buying stocks in the weighting that replicates a market index is quite straightforward. Compare this to the work expended by an active management team, as it rarely is a single manager doing all the work and making all of the investment decisions. This team incurs significant research costs, including data sources, model development, third-party research and company visits. Additionally, each of these investment professionals would also be compensated for their work. These costs are paid by investors. ETFs are cheaper than many index funds, which in turn are cheaper than many mutual funds. However, this does not mean that they are the right fit for most investors.

Passive investing strategies are generally best suited to do-it-yourself investors who have the time and skill to perform the requisite tasks described above. This would typically align with the mindset of the do-it-yourself investor as adherents to these strategies are unlikely to value expert advice, as the whole premise for passive investing is that no value can be added in this regard. However, in this case, the desire to keep costs down will extract a price. The number of ETFs available in the U.S. doubled from 200 to 400 between 2006 and 2007[8] and doubled again to over 800 by the end of 2008. Investors planning to construct a well-

7 Globe HYSales

8 Forbes March 20, 2007

balanced portfolio from ETFs will have their work cut out for them, presuming, of course, that they have the aptitude to undertake this chore. Considerable time and effort will be needed to initially set the appropriate geographical, asset and sector weights. Rebalancing the portfolio under timing triggers and/or changing portfolio weights will also be time consuming. This will also have to be done with an eye to limiting the total number of transactions, as any fees associated with transactions – including trading commissions – can quickly eat away at the low fee advantages of such a strategy.

Conversely, active management strategies typically align themselves well with clients who do need and want professional advice and service. This advice and service comes with costs. While there are options, for the most part, Canadians have historically chosen to pay for it by having the dealer and advisor compensation built into mutual fund fees. Accordingly, comparing an ETF to a mutual fund is not an apples-to-apples comparison, regardless of the underlying investment strategy.

Conclusions

- At present, few would argue that the relatively high level of efficiency seen in U.S. markets is evident elsewhere. Arguments supporting active management gain ground where these exploitable inefficiencies exist.
- Passive management means investing in an index regardless of its composition. Indexes can have significant biases that active management can avoid.
- Active investing provides individuals with the opportunity to outperform the market. Passive investing guarantees that an investor will underperform the market.
- The mind-set of the do-it-yourself investor is most likely to align with passive investing, whereas investors who value professional advice and service are more likely to be proponents of active investing.