Seed Weekly

Active versus Passive Investing by Lisa

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Why active / passive investing shouldn't be an either / or

The debate over the respective merits and shortcomings of active and passive investing is one that has been raging in the financial industry for decades. 46 years, to be exact. When Jack Bogle, Vanguard Founder, created the first index mutual fund in 1975, the world of investing changed from mostly active management to include passive options. Ever since, the two strategies have been pitted against each other as many investors and financial advisors tend to strongly favour one strategy over the other.

While their names say a lot about what each approach entails, the table below provides a quick summary of the main characteristics of each :

	ACTIVE INVESTING	PASSIVE INVESTING
Objective	To outperform the market, or a chosen benchmark	To track the performance of a specific market index
Technique	Portfolio is formed through independent analysis of each investment	Portfolio is formed by mirroring the representative index
Expertise required	Superior skills needed to perform thorough research, proprietary modelling, data analysis, etc.	Requires efficient implementation to track index as close as possible. Minimal research or analysis involved
Pro's	• Potential of higher risk-adjusted return (ability to outperform the market) • Downside protection • More Flexibility • Active managers can help to keep companies in check and drive healthy competition within industries	• Comparatively lower operating costs • Index funds are generally more transparent than active funds • In aggregate, passive typically outperforms active over the long run
Con's	• Higher operating costs • Risk of human error/poor judgement • In aggregate, active typically underperforms passive over the long run	• Less likely to outperform the index after fees • Investors are unable to act if markets decline (no downside protection) • Limited flexibility

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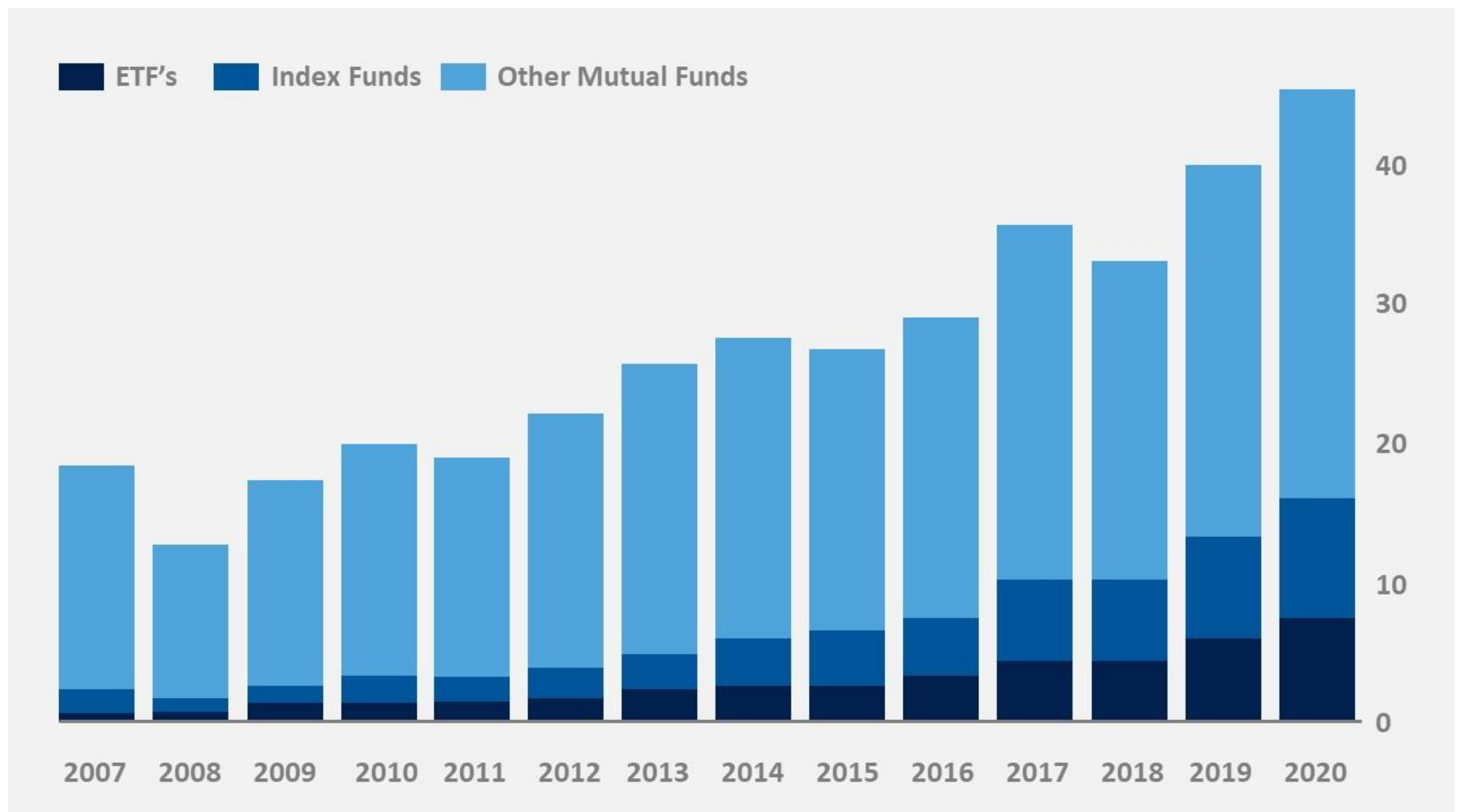
The past few years have seen a substantial shift in the asset management industry from active to passive investment strategies, with investors around the globe buying an increasing number of passive products, such as Exchange Traded Funds (ETFs) and Index Funds. This is illustrated in the graph below :



Source : Financial times, Morningstar Direct (30 June 2021)

With investors becoming increasingly cost conscious, it is no surprise that low fees are the primary reason for the surge in passive funds' popularity. The growth of passively managed assets has also enhanced the scrutiny of active asset managers, especially in low return environments. While it is true that the scope for outperformance from active management is limited in efficient markets, economists have rigorously shown that the financial markets cannot be perfectly efficient, implying that opportunities for active management to produce alpha certainly exist.

It is important to note that the definition of what constitutes as active or passive investing is increasingly indistinct. In the early days of the debate, there were index trackers on one side, seeking to capture the returns of a market-cap weighted benchmark (like the JSE/FTSE All Share index, for example) and active managers striving to beat the market on the other. That is no longer the case.

Today, many passive funds make exclusions from the index from which they are constructed (for example, excluding certain sectors or investment vehicles), or they make explicit tilts to certain sectors, geographies, etc, to deliver a return greater than the market – the traditional domain of the active manager.

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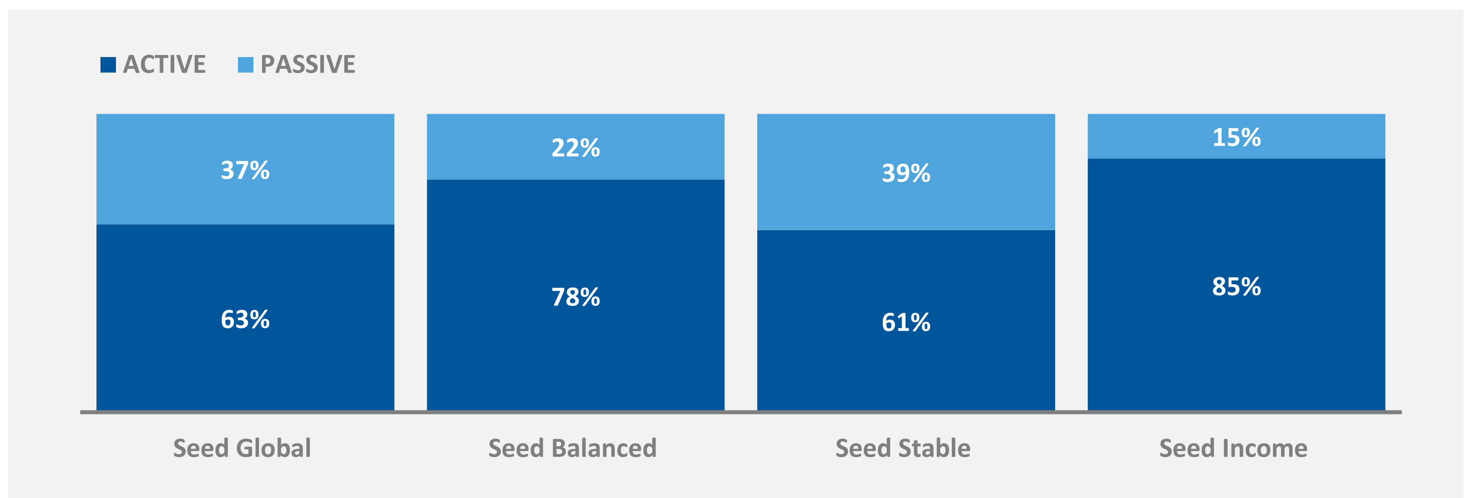
The choice between using an active or a passive strategy can, and should, thus not be framed as a binary one. Advisors should focus on the benefits related to each method, combining both for greater efficiency and diversity. Instead of looking at fees in isolation, the aim should be to achieve the highest net of fees risk-adjusted return subject to the client's risk appetite. Having an entire portfolio managed either passively or actively could prove sub-optimal.

As an Investment Multi Manager, Seed is agnostic as to whether assets should be managed actively or passively. Instead, when we are looking to allocate to a certain asset class, we sift though the entire universe of suitable funds, looking at both qualitative and quantitative metrics to determine which fund or manager is most appropriate.

Active makes sense if we can, through proper due diligence, identify strong managers in a certain asset class who we believe can really add value. Historically, our active managers have outperformed their benchmarks over the long term, even after all fees. On the other hand, if we want to include exposure to certain areas of the market and we don't see scope for outperformance from active management, we prefer to allocate to passive managers, taking advantage of the lower fees.

The result is a product that combines the benefits of both approaches where appropriate. As illustrated below, our unit trusts currently all have a component of both the passive and active investing styles. Each approach has its benefits, and we assess each allocation on its merits.



Kind regards,

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