



The Passive Versus Active Debate

DR AKBAR ZAMIN ALI, Director of Undergraduate Finance Program at The University of Adelaide, tells Fundsupermart about his take on the passive versus active investing debate.



The increasing popularity of index funds, otherwise known as ‘passive’ funds, has sparked off a debate on whether index funds are a better choice than actively-managed funds. Advocates of index funds, of which the most famous would be John Bogle, founder of US-based Vanguard Investments, have long insisted on the superiority of index funds over actively-managed funds – some research studies on the US equity markets (e.g. S&P 500 Index) have shown that the majority of the active fund managers in general are not able to outperform the S&P 500 Index in a given year, lending credence to this argument.

But proponents on the other side of the camp point out that fund managers with superior stock-picking skills have a good chance of beating the market – think Bill Miller, the legendary investment manager whose fund beat the S&P 500 Index for 15 consecutive years, from 1991 through 2005. In addition, the perceived inherent inefficiencies of the equity markets allows fund managers of actively managed funds to seek out undervalued or distressed stocks, which would otherwise not have been “picked up” by managers of index funds.

In simplistic terms, actively-managed funds seek to outperform a particular benchmark, i.e. deliver returns over and

above that benchmark, while index funds simply attempt to do what its name suggests – to track the benchmark. Using an analogy we’re all familiar with – it’s like pitting the swift, glamorous and outwardly-confident hare (actively-managed fund) against the slow, dull but quietly confident tortoise (index fund) in a race to the finish. With the benefit of hindsight (we all know how that story ended), we might place our dollar on the tortoise winning the race eventually, but in this context, the hare has some tricks up his sleeve that just might lead him to win the race (i.e. outperform the benchmark) ahead of the tortoise.

But a point worth noting is that the bulk of the research on index funds has been based on the developed markets of the US, Europe and Australasia; relatively lesser research has been conducted on the efficacy of index investing in the developing equity markets. Hence until there are more conclusive studies done on this subject matter, one would be hard-pressed to conclude if one investing strategy is more superior over the other when it comes to developing markets.

To probe deeper, Fundsupermart spoke to Dr Akbar Zamin Ali, Director, Undergraduate Finance Program at The University of Adelaide, about his views on the active and passive investment strategies. >>

>> Dr. Akbar Zamin Ali is Director of Undergraduate Finance courses at the School of Business, The University of Adelaide, and is also an Adjunct Professor at the University of Indonesia. His research focuses mainly on financial planning, funds management and investors' behaviour, and capital markets. He is a consultant to the financial planning and funds management industry in Australia and Indonesia, and has published academic and industry research in various international journals.

STEPHANIE THNG (ST): FROM A BEHAVIOURAL FINANCE PERSPECTIVE, WHAT ARE THE MOST COMMON MISTAKES ALL INVESTORS MAKE?

DR. AKBAR ZAMIN ALI (DR. ALI): Retail investors, as well as institutional or sophisticated investors, are both impacted by information processing and behavioural biases. It should be noted that this field has been refined considerably since 1979 when Kahneman and Trversky published their seminal paper on Prospect Theory in *Econometrica*. However, there are several aspects that retail investors need to be careful of:

- a) **Overconfidence:** Retail investors, and especially males, tend to become overconfident of their own estimates regarding future outcomes. This usually results in high turnover of their portfolios and reduced net returns. Overconfidence also results in a concentrated portfolio, usually consisting of a few stocks that have performed well in the past couple of weeks or days. This not only leads to a higher risk portfolio, but also comes net low returns.
- b) **Regret Avoidance:** Investors do not want to regret any investment decisions they have made. This results in selling their well-performing assets too soon and holding their losing investments for far too long. The strategies investors use to decide which assets to hold, and which assets to dispose off, also results in high turnover, and thus low net returns for the risk taken.
- c) **Multiple portfolios:** Most retail investors hold multiple portfolios, each representing a future investment objective. For example, individuals would have a conservative retirement fund, an annuity education fund for their kids, a speculative portfolio for their luxury needs etc. This means that individuals see their various needs (both current and future) represented by separate investment strategies. This in turn results in multiple portfolios that are inefficient as one invest-

ment (inefficiency implies that the risk and return is not optimised).

Although I have chosen the three most common behavioural and information processing issues, investors generally ignore the fundamentals: they should ignore the past and focus on the future (hence avoid momentum trading), hold investments for a long period rather than short periods, and consider a diversified portfolio rather than a concentrated portfolio.

ST: BASED ON YOUR RESEARCH, WHAT IS THE RATIONALE FOR INVESTORS TO EITHER ADOPT PASSIVE OR ACTIVE INVESTMENT STRATEGIES (OR BOTH)?

DR. ALI: Investors need to consider whether they have any capital, information or trade execution advantage. Most investors have none of these three advantages against institutional investors, and hence will always lose against them (most investors will claim how much profits they made in one or two of their trades but will usually not talk about the massive losses they have accumulated. Neither will they talk about the investment in time conducting investment research). Active investment strategies are worthwhile pursuits for institutional investors who are able to gain due to short-term market movements. Keep in mind that there is a large volume of literature that shows that active funds on aggregate underperform passive funds. Although there is methodological issue and assumptions, it does show that mere mortals are unable to outperform a benchmark index.

Finally, active investments also imply concentrated portfolios which in turn increase the riskiness of these portfolios.

ST: ADVOCATES OF PASSIVE INVESTING CITE THE LOW COSTS AS THE MAIN ADVANTAGE OF PASSIVE (INDEX) FUNDS. WHAT ARE THE MAIN ADVANTAGES/DISADVANTAGES OF INDEX FUNDS?

DR. ALI: You are right in saying that index funds do have a cost advantage (both trading costs and management cost or management expense ratios, MERs), but I have listed four other advantages of index funds:

- a) **Diversification:** Index funds give a fairly decent exposure to the market (actually there are now two schools of thoughts with regards to how an index should be constructed but that is another discussion altogether). Investors need to have a diversified portfolio rather than a concentrated portfolio.

- b) Active funds, as they increase in size, show diminishing alphas (or abnormal performances). According to a series of research papers, active funds exist only to benefit the fund managers themselves by increasing their wealth.
- c) Index funds are also available on the exchange (exchange traded funds, also known as ETFs) where they trade as shares, but without the closed ended funds discount normally observed with active funds. This means that investors can enter and exit (or increase or decrease their investment in the index) without high levels of costs associated, either as transaction costs or as discounts.
- d) With an indexed investment, investors are restricted in how much they turnover their portfolios or the level of concentration within their portfolios. Investors are also able to reinvest their dividends with least amounts of frictions. Actually, this point is similar to a).

ST: IS EITHER INVESTMENT STRATEGY SUPERIOR TO THE OTHER?

DR. ALI: I am not quite sure what you mean by superior. If you mean this in terms of the ability of a fund manager, both strategies require a different skills set. A good active fund manager is really hard to come by. And there is a lot of competition amongst them too. A really good active fund also charges a higher MER and may also restrict the quality of investors into their funds. However, a good passive fund manager, especially when the index consists of several hundred assets listed, can be very difficult to come by as well. By this I mean, a fund manager that is able to ensure low tracking errors. This is compounded when the fund is just starting off, or when the inflows and outflows don't matchup on a daily basis.

If you mean superior with regards to risk return performance, there are many research articles that argue under-performance of active funds. Actually, the methodologies used in the past, and the evaluation techniques used in the market really don't give a clear picture. The biggest issue is how should risk be measured and how risk adjusted returns should be computed. This issue is further compounded due to the use of unsuitable benchmarks.

One most interesting point is that indexes are actually an aggregate representation of all active investments.

ST: DO YOU HAVE A PERSONAL PREFERENCE FOR EITHER

INVESTMENT STRATEGY? HOW DO YOU INVEST YOUR OWN MONEY?

DR. ALI: I have two portfolios. One is a defined benefit scheme that my employer offers and manages. My second portfolio consists of real estate, alternate investments in the form of carpets, and a global equity index fund. I have tried to ensure that these two portfolios are considered as one portfolio, and I also ensure that my own human capital is considered when identifying weights for each component of my investment. I find real estate to be a real and usable asset. Although direct real estate has very low liquidity, low yields and long investment horizons, real estate have done remarkably well in Australia and I think this trend will continue, given the large immigration that is taking place and the number of international tertiary students in Australia. I find good quality silk and/or wool carpets similar to art, antique and stamps coins (alternate investments). Finally a global equity index fund provides me with a low cost exposure to the global equity market. This does mean that I am overweight in developed markets and underweighted in developing/emerging markets, but as I make this point above, that indexes are nothing but an aggregated representation of all active investments.

ST: THIS GLOBAL ECONOMIC CRISIS IS PROBABLY NOT THE LAST CRISIS THAT WE ARE GOING TO EXPERIENCE IN OUR LIFETIME. FOR INVESTORS LOOKING TO PROTECT THEIR INVESTMENT PORTFOLIOS IN TIMES OF CRISES, WHAT INVESTMENT ADVICE WOULD YOU OFFER?

DR. ALI: Stop being greedy and consider investment as a long-term process. If you do not have formal finance knowledge or time to manage your own investments, please consider a financial adviser to provide you with an asset allocation strategy. An asset allocation strategy that is based upon your needs and objectives considers tail events (such as the GFC or the technology bubble, or Asian financial crisis etc.). These extraordinary events will continue happening, but if the investors are well prepared for it, these will pass by. An aspect that is extremely important to remember is that human capital must be considered in formulating any investment strategy. I would recommend a financial adviser to everyone, as you can get an unbiased (behavioural aspect) investment advice. **FSM**