

active on passive



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Graham Bentley explains why advisers may want to consider elements of both passive and active investments for client portfolios.

"For the ordinary man is passive. Within a narrow circle ... he feels himself master of his fate, but against major events he is as helpless as against the elements. So far from endeavouring to influence the future, he simply lies down and lets things happen to him."

George Orwell 'Inside the Whale', Inside the Whale and Other Essays, 1940.

We've certainly been experiencing some major events lately, haven't we? In the year to 20 February 2009, of the 502 retail IMA funds focused on in UK Equities, 238 failed to beat the (very negative) FTSE All Share Index. In 2007 364 were unable to deliver returns beyond that benchmark, and in 2006 over 200 funds failed the same test. Over the last ten years, the worst performing

fund in that universe would have lost you some 68%. Even worse, had you been careless enough to invest in each year's worst performing fund, you would have successfully turned an initial investment of £10,000 into the princely sum of £318.70 (although the chances of that were over 37,000,000,000,000,000,000,000,000 to 1, so rest easy).

Given that even Absolute Return equity funds have lost money over the last year, it is perhaps unsurprising that many advisers are beginning to question the value of the annual management charges associated with so-called 'active management'. This is a debate whose noise level is inversely proportional to market advances – what's the point in a fund manager if he or she can't make me money?

“ Whatever your persuasion, active or otherwise, access to passive funds is clearly an important option ”

systematic and specific risk

Let's start by revisiting the subject of where returns actually come from. In 1964, Modern Portfolio Theory received a boost when Professor William Sharpe published the Capital Asset Pricing Model (CAPM). CAPM breaks a portfolio's risk down into systematic and specific risk. Systematic risk is the risk of holding the market portfolio, eg every UK share. As the market or 'system' (the FTSE All-Share index, for example) moves, each individual share will rise or fall to varying degrees. So let's say we hear tomorrow that the recession is over. What do you think the system/market will do? Yes – virtually every share will rise as future expectations of profits are revised. To the extent that any asset participates in such general market moves, that asset exhibits systematic risk. On the other hand, suppose we have news that a pharmaceutical company has discovered a cure for AIDS. That company's share price should rise, but the news should have no effect on say, the shares of a telecoms company. This is known as the return to specific risk, being that which is unique to an individual asset. It represents the component of an asset's return which is uncorrelated with general market moves.

Theoretically, the market compensates investors for taking systematic risk, but not for taking specific risk. This is because specific risk can be diversified away. When an investor holds the market portfolio,

each individual asset in that portfolio carries specific risk, but through diversification that is washed away and what is left is just the systematic risk of the market. This systematic risk is measured using beta. Essentially beta describes the sensitivity a security (or fund, for that matter) has to a movement in the market. Any asset that exhibits the market return has a beta of 1.0. By comparison, a portfolio that has a beta of 0.5 will go up, or down, by half as much as the market overall. A portfolio (or instrument) with a beta of 2.0 should benefit or suffer by twice as much as the market overall.

It is possible to construct a chart where a line can be drawn connecting the expected return on a risk-free investment (don't laugh, but cash is risk-free) with a beta of zero, and the market return, ie a beta of 1.0. This is known as the Securities Markets Line (SML). According to the theory, a portfolio might out- or underperform the market randomly from one year to the next, but over time the portfolio's long-term performance will fall on or under the SML.

'holy grail' of active management

But fund managers are paid to produce returns over the market. Now that's relatively easy if you take higher risk, eg to exhibit a beta greater than 1.0 in a bull market, or less than 1.0 in a bear market. But what about higher returns while taking market risk (in other words returns above

the SML)? This is the holy grail of active fund managers. Note this is not about having randomly good or bad years, but about having good years with noticeable consistency. CAPM didn't accommodate this possibility, but in the late 1960s Professor Mike Jensen considered the possibility of a portfolio residing above the SML due to the skill of the portfolio manager. He called this excess return 'alpha', and factored it into CAPM.

His next question was whether anyone actually exhibited it. Collecting annual return data for the S&P 500, which he used as a proxy for the market portfolio, and 115 mutual funds, he performed a regression analysis for each mutual fund to determine its alpha. The vast majority of the funds had negative estimated alphas, with the average fund underperforming the market by over 100 bps a year. The results strengthened support for the idea that markets were efficient, and didn't offer opportunities for managers to exploit mispricing. Further work on 'academic' finance reached the point where many theorists completely discounted the value of active fund management. Professor Eugene Fama rather infamously stated 'I'd compare stock-pickers to astrologers, but I don't want to bad-mouth the astrologers'.

evaluating performance

Active managers, of course, argue that the market is not completely efficient due to behavioural biases, allowing skilled



investment managers to beat the market. And a number of managers clearly do so every year. On the other hand, investors as a group are able to earn no more (or less) than the market return. If one investor outperforms, others must underperform to a balancing degree – in game theory parlance this is known as a ‘zero-sum game’. The average investor will usually earn the market return, because it is difficult for the average manager to consistently outperform. After costs, passive adherents argue, the average portfolio underperforms the market by the amount of its costs. High-cost portfolios must outperform by an amount sufficient to offset their higher costs. And in a zero-sum game, this relatively high degree of outperformance must be offset by a correspondingly high degree of underperformance by other investors.

The academic research concludes that although some managers possess skill, spotting those that will consistently outperform in the future is extremely difficult. For example, many managers favour a ‘value’ approach. When value

stocks outperform the FTSE All-Share Index, it will appear that the manager generated significant alpha. But if year in and year out the manager’s investment strategy consists of simply maintaining a value bias, you could have simply purchased a (cheaper) fund that tracks the FTSE 350 Value Index. Put another way, the manager’s performance should be compared to this index benchmark, rather than to the All-Share Index. On the other hand, if the investment manager’s bias toward value shares was actually a tactical decision, then the FTSE All Share will be the right benchmark to use when evaluating his performance.

utilising beta and alpha

So, whither fund management? Well, the latest trend is to separate beta from alpha investing, grandly described as ‘portable alpha’. A manager can obtain exposure to the beta risk and return of UK equities by buying futures contracts that track the performance of the FTSE 100 Index. Futures contracts are geared, ie the manager can purchase them for less than

the index price, say £25 for £100 value. The remaining £75 is then invested to eliminate exposure to beta, leaving just alpha risk and return. The manager might accomplish this by being long and/or short of a number of uncorrelated stocks. The upshot of this is that pure alpha is theoretically uncorrelated with beta. And that makes it a potentially very valuable addition to a portfolio. Translated into the retail space, it may very well be possible to combine both beta generation through low-cost passive vehicles and the use of investment approaches that focus on target return strategies, for example, to generate alpha.

Whatever your persuasion, active or otherwise, access to passive funds is clearly an important option. Skandia is pursuing a strategy of adding low-TER passive funds alongside active managed opportunities as we continue our journey towards Total Open Architecture, with more funds planned for addition in the coming weeks. Watch this space! ●●

The March edition of Informer also included articles from SWLP, who discuss active management and ZIM who explain why they favour a passive approach for investing. Visit the articles section of www.informerlive.co.uk to view.



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