Year of Good Fortune

Clients say they want high returns—but which path leads to riches?

By Alison MacAlpine

Can active managers earn their fees and beat market indices? Are passive strategies more cost-effective and successful over the long term? These are questions that investors—and their advisors—have wrestled with for 50 years, says Pauline Shum, associate professor of finance at York University's Schulich School of Business.

"Academically, the traditional evidence is that the market is fairly efficient and that the majority of managers have not been able to beat the market on a consistent basis—although lately there is some evidence that some professional managers are able to use strategies based on behavioural finance to obtain higher returns," she says. That suggests an argument could be made either way.

Advisor's Edge wanted to measure the temperature of the active versus passive debate in Canada, so we invited two active proponents and two passive proponents to share their perspectives.

ADVISOR'S EDGE: What are the advantages of an active investing approach?

CHRISTOPHER REYNOLDS: An active management philosophy can help investors minimize swings in their portfolios, in other words, minimize risk, and, over the long run, add value to the investment process. Not all managers consistently beat the index, but if you can find the ones who do, and generate that value-added one to two percent over a long period of time, it can make a substantial difference.

Christopher Reynolds is co-founder, vice-chairman and president of Investment Planning Counsel Inc. (IPC), where more than 500 advisors manage over $9.5 billion in client assets. He argues that active investing adds value to investor portfolios.

TOM BRADLEY: I'd add that with active management, decisions are made by the people who should be making decisions—the professionals. As we move to passive products, we also move the decision-making increasingly into the hands of the investor, and in some cases they don't have the capabilities, experience or time to make decisions related to asset allocation, market timing and sector rotation. Another benefit is flexibility, which is important because at times the indices get distorted. We saw that less than a decade ago when Nortel was close to 35% of the TSX, and today you could argue that energy has a disproportionate weighting in the index relative to the overall economy. Active management has the capacity to deal with that and build a more appropriately diversified portfolio.

Tom Bradley launched Steadyhand Investment Funds, Inc. in early 2007. Previously, he was an equity analyst, institutional portfolio manager, chief operating officer and then president and CEO of Phillips, Hager & North Investment Management. He says that as long as certain conditions are met, an active investing approach works best for investors.

AE: If flexibility is an advantage of active management, can't that also lead to style drift?

TB: We think active managers should not be constrained by style and should have the ability to go where they need to go to find value. However, I'm a very strong believer that if you're going to avail yourself of an active product, behind that active product there's got to be a very strong investment philosophy that's been around for awhile

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and that's being executed by an experienced hand. We look for people who are passionate about a particular way of generating returns.

AE: What are the advantages of a passive investing approach?

Howard Atkinson: It's the place to start when you look at assembling a portfolio. It's very simple: Before you can beat the market, you'd better learn to match it. The Schwab Center for Investment Research conducted research in the 1990s, and their conclusion was that investors tend to have higher returns with lower risk if they use a core-and-explore approach.

The core would be an indexing strategy, and the range they continue to recommend is between 30 and 70 percent of a portfolio. If you're very aggressive, you'd only allocate 30% to indexing, and if you're conservative you'd go all the way to the other end, to 70%. The balance would be in active strategies where you're trying to outperform various markets.

Howard Atkinson is president of Horizons BetaPro ETFs, president of the Toronto CFA board of directors and author of The New Investment Frontier III: A Guide to Exchange Traded Funds for Canadians (Insomniac Press, 2005).

Eric Kirzner: I don't think most retail investors have the ability to pick stocks or good active managers on their own, so building a base portfolio with indexed products makes sense. Institutional investors have different mandates. They have to find ways of getting that extra one or two percent over the indexes, and they have the training to do that.

Eric Kirzner holds the John H. Watson Chair in Value Investing at the Rotman School of Management at the University of Toronto. His most recent book, co-written with Richard Croft, is Protect Your Nest Egg (CanWest, 2006). He believes most retail investors can benefit from a passive investing approach.

AE: How can investors recognize an active manager who can beat the index?

TB: We look for managers who are absolute-return oriented. They're not trying to out-benchmark the indexers. In fact, benchmark considerations shouldn't affect the portfolio they put together because that can water down their investment philosophy. Also, they have low turnover. If you have high-turnover active managers, the friction costs make it pretty tough to consistently beat a low-cost index fund.

CR: We favour managers who have a very set investment process. They have a means to analyze companies and buy them at a good price, and they stick to that discipline over the long run. Through diligent research, you can find managers who tend to outperform their respective indices over a long period of time, net of fees.

TB: To be an active manager takes a lot of guts. You have to be willing to be wrong on your own. An experienced hand that's had success and isn't trying to build a career on next year's performance has the credibility to be wrong. That's why, number one, I'd point advisors towards experienced people who have been doing the same thing for a long time. Advisors should also look at how concentrated a portfolio is. If I give an active manager money, I don't want it going into their 150th best idea; I want them to put more money in their top-25 ideas.

AE: How do managers add value in a passive investing environment?

HA: Matching the index sounds easy, but there's a definite skill set. The large players are very competitive, and they're scrutinized down to a basis point. Passive managers add value for the things they don't do. They're good at controlling costs—the fees they charge and transaction costs. They don't turn the portfolio over a lot, so realized capital gains and taxes are kept to a minimum. And they're good at conducting efficient trading mechanisms, so they can trade the index without signalling trades ahead of time and costing the portfolio in returns.

AE: Are there particular sectors where active management is better positioned to add value?

TB: It's tough to beat the S&P 500, so yes, I think you want to pick your sandbox. Canadian equities are an area where the average or median active manager has added value in the past. With small cap, I'd much rather have my money in the hands of an active manager.

And I'm a real believer that corporate credit in the bond area should be actively managed. But fees have to be reasonable, too. Fees that are 2.5% or more make it a lot tougher for an active manager to beat an ETF with a fee that may be under 20 basis points.

AE: One of the appeals of active management is that it gives investors a perception of control over investment returns. What's the passive investing counter-argument to that?

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HA: There's famous research from 1986—a Brinson, Hood and Beebower study of pension funds. What they found was that a little over 90% of the variability of returns was driven by asset allocation. There's no mention of active or passive. It's the asset classes themselves. If you want to control your portfolio, focus on asset allocation and put together asset classes with low correlations so you get the benefit of risk reduction. Then, hopefully, over the long haul the returns take care of themselves. For this purpose, indexing vehicles are superior to active managers because they're pure—you know exactly what's in there—and you can construct asset classes down to the decimal point of percentages.

CR: I agree with Howard that asset allocation is one of the most important areas to focus on. But if you can focus on the proper asset allocation with great managers, I think that's what adds value to the portfolio methodology over the long run.

AE: It may also take some convincing to persuade advisors that producing "average performance" for their clients is a good thing. What would you say to advisors who are anxious to outperform?

EK: It's not glamorous and it's not as recognizable to the client, but advisors can provide a lot of value by getting clients focused on asset allocation. However, it depends on what promises advisors have made to their clients. If the promise is, "We're going to build you a nice portfolio and beat the indices," then they're going to have to find ways to do it. That isn't easy if you've got two layers of fees built in. Overall, the best approach is to focus on portfolios, have a core portion that is passively managed, and check the actively managed portion against a suitable benchmark—such as the Croft Financial Group's FPX Indexes—to make sure active managers are adding value. I am not opposed to active investing for retail investors as long as the results are there.

HA: No one wants to be average, but indexing is actually above average when you look at the statistics. Most investors treat investing like second marriages, on the basis of hope over experience. In the case of investing, it's the hope of outperforming over the experience that most active managers just don't, period. If you look at the institutional space, and here we've got stewards [with] trillions in investment assets, historically they've indexed portfolios in the range of 20% to 25%. In the U.S. retail landscape, indexing represents about 10%.

Here in Canada, it's less than 5%, although that share is rising. We are far more likely to use an advisor than not, so I think it's advisors who will drive this increase in the use of indexing.

And I think that as advisors move towards an open-architecture, fee-based type of portfolio, and adopt a total portfolio management approach that focuses not only on return but also on risk, cost and taxes, you're going to see the share of indexing in portfolios continue to rise.

AE: Another challenge with passive investing is that it doesn't protect investors when markets are down—how would you respond to that?

EK: Indexing doesn't protect you against the downside, but that's only part of the story. Investors who had a solid mix in their portfolios in 2000, 2001 and 2002—for example, some safety, some fixed income, some alternative investments and some equities—would have weathered that storm.

That's not hindsight; it's just good financial planning and portfolio building. So the fact that indexed products don't protect you on the downside begs the question: How is your portfolio structured?

AE: Any final thoughts?

HA: The passive/active discussion is no longer a debate. The validity of passive investing has been proven over the past 40 years. I just happen to feel it's underrepresented in most portfolios of Canadian investors.

My advice to advisors is that they should focus on the intelligent combination of indexing and active strategies, or a beta and alpha separation. Don't pay alpha fees for beta performance or market performance. Use index-based strategies as a foundation and then build in active mandates and strategies where justified.

CR: The statistics are what they are, but I think this is where the importance of a good financial advisor comes in. Whether it's active or passive, the role of the advisor is to figure out what that client is looking for, what they're most comfortable with, and whether it's a balance of the two or whether they favour one side.

It's the process, the research and the ability to put managers together that make the difference—and that comes down to the quality of the advisor. AE

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