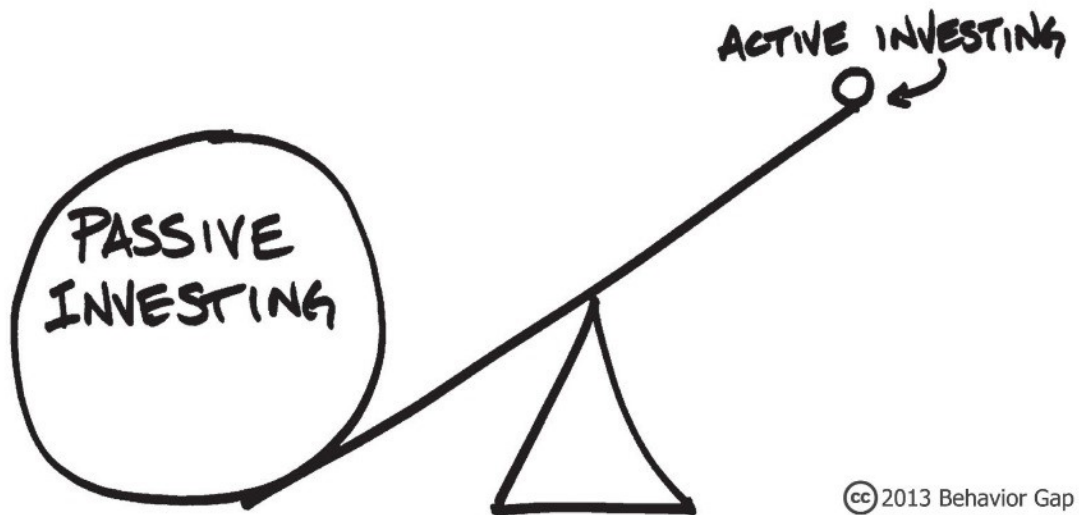


## Active versus passive – the debate is over



At Tailorednz, we believe a growing body of evidence has moved us past the traditional active vs. passive debate. The best evidence comes from the US where the research has been collected and mostly aptly documented. The traditional debate contrasts an index fund, representing the passive camp, and an active equity or hedge fund, representing the active camp.

A widely publicised wager between Warren Buffett and a hedge fund manager called Protégé Partners illustrates the point. Buffett bet that that the Vanguard S&P 500 (a passive index type fund) would beat a selected group of hedge funds over a 10 year time horizon. So far the

Vanguard fund is up 43.8%, compared with the hedge fund's gain of just 12.5% since the bet was made.<sup>1</sup>

Buffett's backing of the S&P 500 was primarily an argument about the significance of cost minimisation not philosophy. In his 2014 Berkshire Hathaway letter to shareholders, Buffett said he had instructed his estate to put 90% of his funds into the Vanguard S&P 500 and 10% in cash. Here's his rationale:



*"Both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal..."*

-Warren Buffett.  
2013 Berkshire Shareholder Letter  
Page 6

This observation, from one of the greatest stock pickers in history, suggests that one does not necessarily need to agree with a passive investment philosophy to observe the weight of the evidence. The evidence shows, overwhelmingly, that investors are not rewarded by the high costs of active investment management.

When Russell Kinnel, director of research at Morningstar, attempted to identify the number one predictor of performance for investment managers, his findings also made a compelling argument in favour of low cost investing.

---

<sup>1</sup> In USD terms as at 06/02/2014, approximately six years into the wager.



“If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds. . . . Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance.”

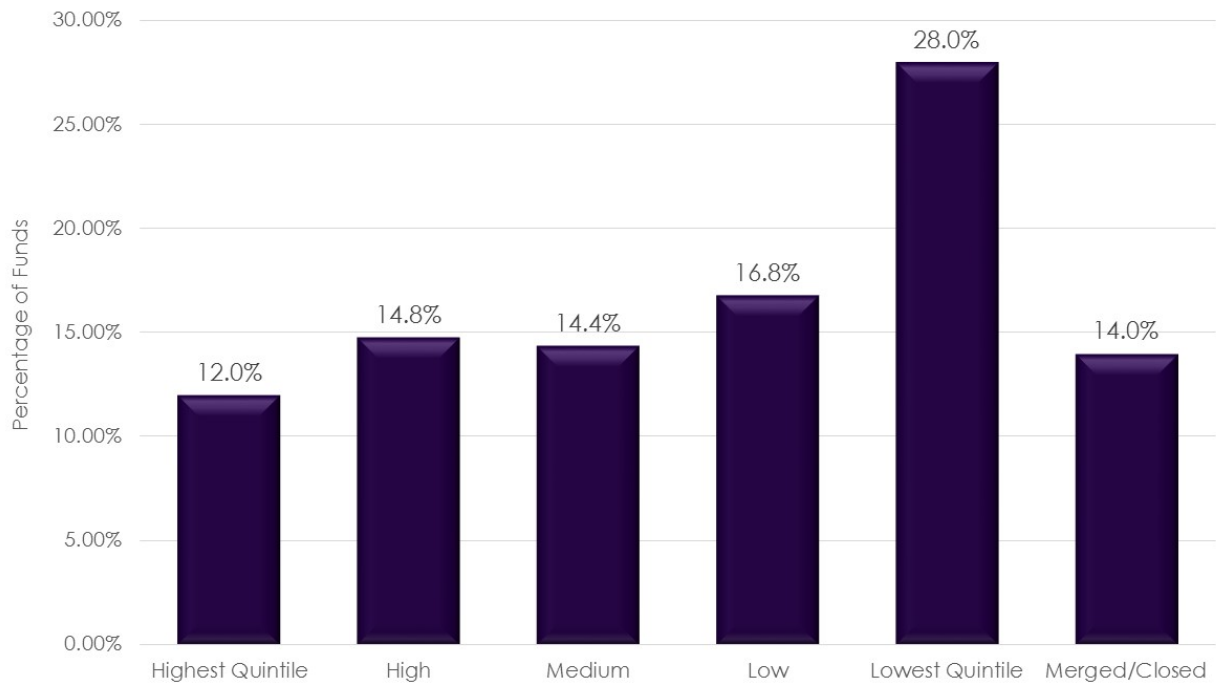
-Russell Kinneil.  
Director of Mutual Fund Research, Morningstar  
Morningstar FundInvestor, vol. 18, no. 12 (August):1-3.

The second part of the debate focuses on persistence in performance. Every study of the persistence of active managers to deliver outperformance (and there have been plenty) shows that, once you control for risk, there is no statistically meaningful performance persistence.

To illustrate simply, Vanguard conducted a study in which they ranked all US equity funds in terms of excess return versus their stated benchmark over the five years ending 2008. They divided the funds into quintiles, separating out the top 20% of funds. They then tracked the performance of those top 20% of funds over the following five years through December 2013 to check for persistence. If the top quintile funds displayed any meaningful performance persistence, we would expect a significant majority to remain in the top 20% five years later. A random outcome would result in about 20% of the funds dispersed evenly across the five quintiles.

The results were close to random. Only 12% of funds repeated a top quintile performance, while 28% moved to the bottom quintile.

## How the top 20% of US Funds from 2004 - 2008 ranked in the subsequent five years 2009 to 2013.

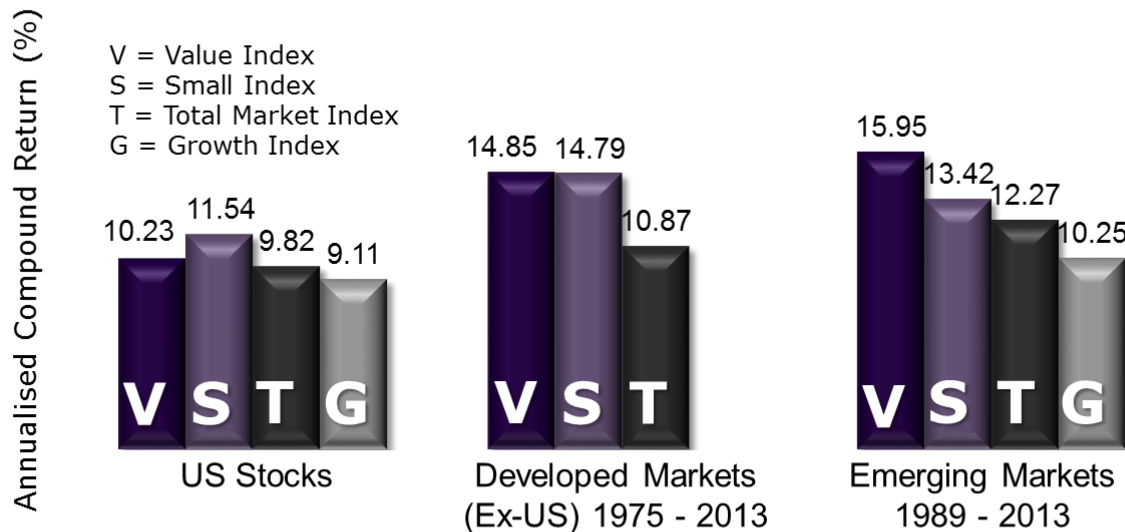


Source: Figure 7. "The case for index-fund investing" Vanguard

[https://pressroom.vanguard.com/content/nonindexed/Updated\\_The\\_Case\\_for\\_Index\\_Fund\\_Investing\\_4.9.2014.pdf](https://pressroom.vanguard.com/content/nonindexed/Updated_The_Case_for_Index_Fund_Investing_4.9.2014.pdf)

If costs really matter and performance persistence by active managers cannot be counted on, is there a reliable way outperform markets?

This is where we depart from the traditional passive vs. active discussion. Considerable research shows that low cost shares (based on a combination of fundamental ratios), small company shares and profitable company shares exhibit higher returns than the market over long periods of time. The figure below compares long term value, small cap, growth and total market indices for various markets.



Annual Returns are from January to December. US large, US small, non-US developed, and emerging markets stocks in US Dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. US value and growth index data (ex utilities) provided by Fama/French. The S&P data are provided by Standard & Poor's Index Services Group. CRSP data provided by the Center for Research in Security Prices, University of Chicago. International data provided by Fama/French from Bloomberg and MSCI securities data. MSCI EAFE Index is gross of foreign withholding taxes on dividends; copyright MSCI 2013, all rights reserved. Emerging Markets index data simulated by Fama/French from countries in the IFC Investable Universe; simulations are free-float weighted both within each country and across all countries.

Both value and small cap segments of the market outperform total market and growth. The implications of this are that not every share has the same expected return. This is probably because shares incorporate unique systematic risks, for which prices and market capitalisation are merely a proxy. And there are other proxies beyond just these two. The question is how to invest in shares with a higher expected return. Do we pay a manager to pick what he believes are the best of the bunch? Two problems arise with this approach - the manager's fee (evidence shows this is not money well spent) and also that we lose some of the virtually costless benefits of diversification.

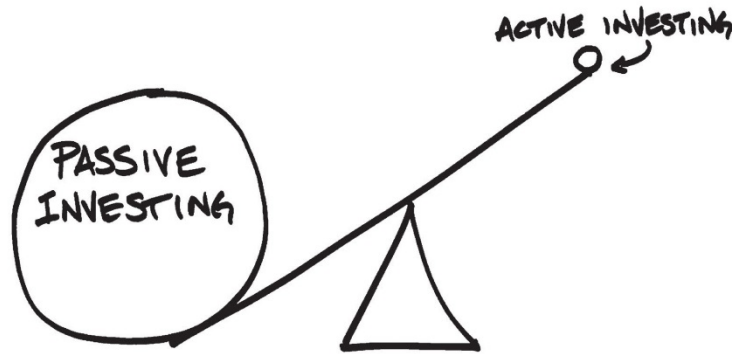
Passive investors can defeat both of these problems. They can use very low cost and highly diversified funds to access these sources of higher expected returns in a way that adds long term value over broad market benchmarks and peers.

In everything we do, the core of the argument is always evidence. We want to see evidence - evidence that has some statistical relevance; evidence that is persistent across time periods,

pervasive across markets and has a sound economic rationale to it. We want to see evidence that ideas don't work merely in theory or on paper, but can produce results after considering the costs of management, transactions and taxes. The problem with active management as it's traditionally described is that the evidence simply doesn't stack up.

As for the debate about active vs. passive... If it's purely an argument based on conjecture and opinion, it will probably never end. However, if evidence counts for anything, we think this debate was settled a long time ago.

# THE WEIGHT OF EVIDENCE <sup>(1)</sup>



(1) A SMALL SAMPLE OF ACADEMIC PAPERS THAT SUPPORT PASSIVE INVESTING - MARKOWITZ, HARRY | *Portfolio selection* | Journal of Finance, 1952 - FAMA, E. | *Efficient capital markets: a review of theory and empirical work* | Journal of Finance, 1970 - SHARPE, WILLIAM | *Capital asset prices: a theory of market equilibrium under conditions of risk* | Journal of Finance, 1964 - CARHART, MARK | *On persistence in mutual fund performance* | Journal of Finance, 1997 - FAMA, E.; FRENCH, K. | *Multifactor explanations of asset pricing anomalies* | Journal of Finance, 1996 - LO, ANDREW | *Reconciling efficient markets with behavioral finance: the adaptive markets hypothesis* | Journal of Investment Consulting, 2005 - MALKIEL, BURTON | *Returns from investing in equity mutual funds 1971-1991* | Journal of Finance, 1995 - MERTON, ROBERT | *Theory of rational option pricing* | Bell Journal of Economics and Management Science, 1973 - SAMUELSON, PAUL | *Proof that properly anticipated prices fluctuate randomly* | Industrial Management Review, 1965 - BLACK, F.; SCHOLES, MYRON | *The pricing of options and corporate liabilities* | Journal of Political Economy, 1973 - CAMPBELL, JOHN; VUOLTEENAHO, TUOMO | *Bad beta, good beta* | Working Paper, 2002 - FAMA, E.; FISHER, L.; JENSEN, M.; ROLL, R. | *The adjustment of stock prices to new information* | International Economic Review, 1969 - MERTON, ROBERT | *An intertemporal capital asset pricing model* | Econometrica, 1973 - SHARPE, WILLIAM | *The arithmetic of active management* | The Financial Analysts' Journal, 1991 - FAMA, E.; FRENCH, K. | *The cross-section of expected stock returns* | Journal of Finance, 1992 - FAMA, EUGENE; BLISS, ROBERT | *The information in long-maturity forward rates* | The American Economic Review, 1987 - ANAND, VINEETA | *Exxon Mobil goes passive in a big way* | Pensions & Investments, 2002 - ARNOTT, ROBERT; BERKIN, ANDREW; YE, JIA | *How well have taxable investors been served in the 1980s and 1990s?* | Journal of Portfolio Management, 2000 - ARRINGTON, GEORGE | *Chasing performance through style drift* | Journal of Investing, 2000 - ARSHANAPALLI, BALA; COGGIN, DANIEL; DOUKAS, JOHN | *Multifactor asset pricing analysis of international value investment strategies* | Journal of Portfolio Management, 1998 - BARBER, BRAD; ODEAN, TERRANCE | *Trading is hazardous to your wealth: the common stock investment performance of individual investors* | Journal of Finance, 2000 - BARR, PAUL | *Washington system goes to indexing* | Pensions & Investments, 1997 - BAUMAN, SCOTT; CONOVER, MITCHELL; COX, DON | *Are the best small companies the best investments?* | Journal of Financial Research, 2002 - BAXI, NEERAJ | *Paying up: the hidden cost of portfolio management, commission recapture* | Journal of Investing, 2003 - BAXTER, MARIANNE; JERMANN, URBAN | *The international diversification puzzle is worse than you think* | The American Economic Review, 1997 - BLAKE, CHRISTOPHER; ELTON, EDWIN; GRUBER, MARTIN | *The performance of bond mutual funds* | Journal of Business, 1993 - BLAKE, CHRISTOPHER; MOREY, MATTHEW | *Morningstar ratings and mutual fund performance* | Journal of Financial & Quantitative Analysis, 2000 - BUSSE, JEFFREY; GREEN, T. CLIFTON | *Market efficiency in real time* | Journal of Financial Economics, 2000 - CARHART, MARK | *On persistence in mutual fund performance* | Journal of Finance, 1997 - CARTY, MICHAEL; NOVAK, EDWARD | *Doing it with style* | Financial Planning, 1997 - CHEN, NAI-FU; ZHANG, FENG | *Risk and return of value stocks* | Journal of Business, 1998 - COCHRANE, JOHN | *Portfolio advice for a multifactor world* | Fed Reserve Bank of Chicago, 1999 - COCHRANE, JOHN | *New facts in finance* | Fed Reserve Bank of Chicago, 1999 - COCHRANE, JOHN | *The risk and return of venture capital* | Journal of Financial Economics, 2005 - CONSTANTINIDES, GEORGE | *Rational asset prices* | Journal of Finance, 2002 - COSTA, BRUCE; PORTER, GARY | *Mutual fund managers: does longevity imply expertise?* | Journal of Economics and Finance, 2003 - DAVIS, JAMES; FAMA, EUGENE; FRENCH, KEN | *Characteristics, covariances, and average returns 1929-1997* | Journal of Finance, 2000 - DEL GUERICO, DIANE; TKAC, PAULA | *Star power: the effect of Morningstar ratings on mutual fund flows* | Fed Reserve Bank of Atlanta, 2001 - DIETHER, KARL; MALLOY, CHRISTOPHER; SCHERBINA, ANNA | *Differences of opinion and the cross section of stock returns* | Journal of Finance, 2002 - DIMSON, ELROY; NAGEL, STEFAN; QUIGLEY, GARRETT | *Capturing the value premium in the United Kingdom* | Financial Analysts Journal, 2003 - DROBETZ, WOLFGANG; KOHLER, FRIEDERIKE | *The contribution of asset allocation policy to portfolio performance* | Financial Markets and Portfolio Management, 2002 - ELTON, EDWIN; GRUBER, MARTIN; BLAKE, CHRISTOPHER | *The persistence of risk-adjusted mutual fund performance* | Journal of Business, 1996 - ELTON, EDWIN; GRUBER, MARTIN; MANN, CHRISTOPHER; AGRAWAL, DEEPAK | *Explaining the rate spread on corporate bonds* | Journal of Finance, 2001 - EVANS, JOHN; ARCHER, STEPHEN | *Diversification and the reduction of dispersion: an empirical analysis* | Journal of Finance, 1968 - FORTIN, RICH; MICHELSON, STUART; JORDAN-WAGNER, JAMES | *Does mutual fund manager tenure matter?* | Journal of Financial Planning, 1999 - GREER, ROBERT | *The nature of commodity index returns* | Journal of Alt Investments, 2000 - HARRIS, RICHARD | *The accuracy, bias and efficiency of analysts' long run earnings growth forecasts* | Journal of Business Finance and Accounting, 1999 - IBBOTSON, ROGER; KAPLAN, PAUL | *Does asset allocation policy explain 40%, 90%, or 100% of performance?* | Working Paper, 1999 - KEIM, DONALD B. | *An analysis of mutual fund design: the case of investing in small-cap stocks* | Journal of Financial Economics, 1997 - KORN, DONALD JAY | *Make indexing less taxing* | Financial Planning, 2000 - KOZLOWSKI, ROB | *Indexed assets pass \$3 trillion mark for first time* | Pensions & Investments, 2004 - MCGUIGAN, THOMAS | *The difficulty of selecting superior mutual fund performance* | FPA Journal, 2006

A BEHAVIOR GAP PROJECT

© 2013 Behavior Gap