The Actives, the Passives, and the Marxists

Few terms grab the collective attention of citizens in a democracy more than "Marxism." Defined loosely as a classless society, it reflects the social, political, and economic theories of its chief architect, Karl Marx, a German philosopher who collaborated with Friedrich Engels to author "The Communist Manifesto" in 1848. Marxism is often used interchangeably with the word "socialism," an economic and political theory advocating collective ownership and administration of the means of production and distribution of goods. In other words, the opposite of capitalism. Despite some bad actors throughout history, capitalism has persisted because it rewards creativity and hard work, key components for the growth, wealth, and productivity of a functioning and thriving society. This is a system that equity investors know well and in which they have the greatest confidence. As far as most equity investors are concerned, socialism is a scourge that impedes progress, not advances it.

And so it came as quite a surprise this past summer when a longstanding investment manager and research company, Sanford Bernstein, published a note titled "The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism," written by the firm's Global Quantitative and European Equity Strategy group. Kudos to the creative minds that came up with that provocative title. They undoubtedly anticipated the challenge of asking people to read something as dense as a 47-page treatise with economic models, Biblical quotes, and semi-pretentious medieval literary declarations (to wit: "One is immediately reminded of the passage in *De lapidibus et metallis* from book 16 of the Etymologies of St Isidore of Seville written in the early 600s recounting the reign of the Emperor Tiberius"). Putting aside for a moment the fact that the piece was published by an organization with a vested interest in seeing active management persist, the authors succeed in provoking readers to view passive investing through a different lens. The piece is less a discourse on the merits of active investing from a performance perspective than it is an examination of the notion that passive investing is quietly altering the structure of resource distribution in our society, a sort of Trojan horse with the potential to undermine the very system it's been created to outperform. Or at least that's the theory.

Active management could certainly use a good punching bag. Over the last number of years, as the US equity market has enjoyed an extended bull run, passive management has owned the limelight that accompanies outperformance. As one would expect for anything that gains popularity, product growth has been substantial, with new offerings across traditional broad market indices, sectorspecific ETFs[1], and factor-adjusted ETFs that invest passively in an index based on specific financial attributes or metrics. In the midst of this product proliferation, there are plenty of questions to tackle. Can a passive approach be compatible with an active approach? (Short answer: Yes.) Does investing passively equate to a denunciation of capitalism? (Short answer: No.) Do the biggest passive investors have too large a role in the US economy by virtue of their potential dominance in issues of corporate governance? (Short answer: Maybe.) Examining the passive vs. active debate in the context of the Bernstein note has the potential to give us a different perspective on these and other issues, and allows us to clarify our position with regard to how we consider passive investing in an institutional portfolio.

The History and Reach of Passive Investing

By now the story is a part of Wall Street lore, a classic little guy versus big guy narrative, the renegade versus the institution, the disrupter versus the conformer. John Bogle started Vanguard in 1974 based on a largely academic idea that a passive index of stocks could beat an actively managed index on a net-of-fees basis over the long term. The industry, constructed on a bedrock of stock-pickers, was predictably skeptical. Ned Johnson, the founder of Fidelity, remarked derisively that an indexing approach guaranteed mediocrity, and that investors should expect better from their managers than the average. Forty years and $3.5 trillion in Vanguard assets later, the criticisms from firms like Fidelity (which now manages index funds itself) have abated, and Bogle's innovative approach has gone full-on mainstream. In 2014 and 2015 combined, the ETF industry attracted north of $600 billion in inflows.[2]

Nobody fears an acorn, but when its seeds give rise to a forest, people take notice. The passive investment industry occupies a greater and greater amount of acreage in the investment landscape each year, with the three biggest players – Vanguard, Black Rock, and State Street – now constituting the largest shareholder in 88% of the S&P 500 firms,[3] a significant corporate governance concern, particularly as it

[1] Exchange-Traded Fund. An ETF is a marketable security that tracks an index, commodity, bonds, or a basket of assets like an index. Any reference to ETFs in this letter refers to passively-managed ETFs, which comprise the overwhelming majority of ETFs offered.

[2] "Record number of companies launch exchange traded funds" Financial Times, Jan 2, 2016

[3] "Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk." Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo. Oct 28, 2016

relates to ESG (environmental, social, and governance) investment factors. This concentration has invited criticism, most notably that "the Big Three utilize coordinated voting strategies and hence follow a centralized corporate governance strategy… (and) generally vote with management, except at director (re-)elections. Moreover, the Big Three may exert 'hidden power' through two channels: First, via private engagements with the management of portfolio companies; and second, because company executives could be prone to internalizing the objectives of the Big Three." Of course, these three institutions downplay their role and impact, but it's impossible to ignore how much potential power they can wield given the sheer size of their ownership stakes in some of the largest companies in the world.

The Market as a Mechanism for Capital Allocation

The gist of the argument put forth by Bernstein is that "active investment decisions form a crucial part of the capital allocation process in an economy," and while a Marxist economy isn't ideal insofar as it is planned centrally and presumably less effectively than a capitalist system, *at least there is a plan*. As passive management becomes the chief form of capital allocation, the argument goes, inefficiency rots the system from the inside. While capitalism forms a system that produces and invests for profit, and Marxism forms a system that produces and invests for utility, passive investing forms a system that does neither. Passive investment allocates resources based on past equity performance, which may or may not be reflective of the industry or company fundamentals. The point that Bernstein is trying to make is that those fundamentals are not considered at all in the resource allocation decision, hardly a hallmark of effective long-term investing. In short, if active investing looks to the real economy for signals, passive investing looks only to the financial economy, which is at best loosely based on the real economy, and only then typically from a rear-view-mirror perspective.

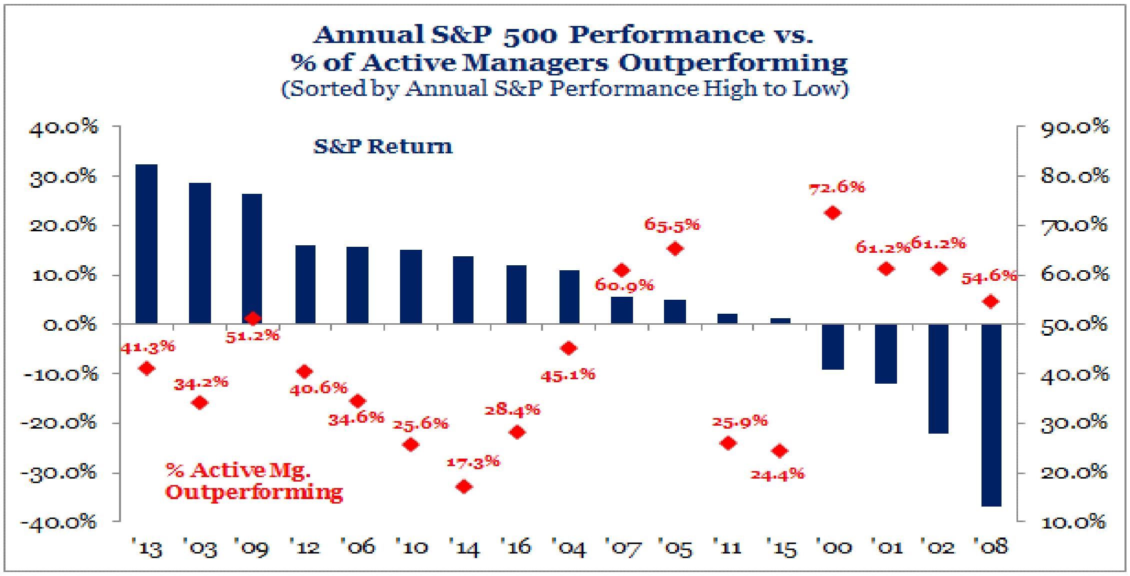
While Bernstein claims that it is not anti-passive ("Let's be clear up front. We are not saying that passive is a bad thing. Far from it. The growth of passive has delivered a major benefit to asset owners in lowering the cost of access to equity market exposure…"), the firm clearly has an ax to grind given the fact that active investing is part and parcel of its business. However, prominent critics of Bernstein's argument have an ax to grind as well. Writing with what we assume is unintentional hyperbole in the Wall Street Journal, Burton Malkiel, author of "A Random Walk Down Wall Street," exaggerates the Bernstein argument in an attempt to buttress the case for passive investing, stating that, "It is now alleged that index funds pose a grave danger to the stock market and overall economy."[4] (It bears mentioning that Malkiel is the chief investment officer of a company called Wealthfront, an online investment manager that only utilizes ETFs in its individualized asset allocations.) Bernstein is not anticipating that passive management will infiltrate 100% of the market, but says that penetration doesn't need to reach that level in order to disrupt the efficient functioning of the market. Unfortunately, the level it does need to reach remains unclear. Even Bernstein recognizes that trying to derive a theoretical level at which point capital allocation breaks down is an impossible exercise, but that's not entirely the point from the firm's perspective.

The point is to recognize that a sort of social contract needs to be acknowledged, and active investing, along with its inherent virtue of information discovery, is an important signatory to that contract. "There is a clear and distinct task that active management (and, by extension, sell side research) performs," Bernstein says. "This is in the allocation of capital either directly through the raising of capital in primary markets or else indirectly in the information discovery process." Of course, for a social contract to be valid, both sides must adhere to its terms, and the sell side's track record isn't exactly spotless. The two great bubbles of the last 20 years – the internet bubble that resulted in a crash in 2000, and the real estate bubble that culminated in the global financial crisis in 2007 – were cheered on by sell-side analysts, many of whom were anything but skeptical of the rise in valuations driving the market. In many cases, research groups within investment banks were proven to be cheerleaders for companies with which the banks had relationships, not quite adhering to the social contract that Bernstein extols.

A Difficult Period for Active Managers

To what degree should investors, especially endowments and foundations with missions that can't be properly executed without earning a certain level of returns, recognize this perceived social contract if it results in weaker returns? This question becomes a crucial part of the equation, especially as these investors consider the implied social contract they have with their own constituencies. As the chart on the next page shows, for the average large-cap investor committed to active management over the ten years through 2016, it hasn't been a particularly strong period. However, it's important to note that active management has shown great fortitude in down markets, an especially relevant point to emphasize as the bull market in US equities stretches into its ninth year.

[4] "Is Indexing Worse Than Marxism?" Wall Street Journal, Nov 24, 2016



Source: Strategas Research Partners

Looking more broadly across asset classes over the ten years through 2016, we can observe that challenges for active managers have extended to other areas as well:

10 Year History as of December 31, 2016			
Asset Class	% of Managers Underperforming Benchmark	Outperformance of Top Quartile Managers	Outperformance of Top 5% of Managers
Large Cap Value	53%	83 bps	177 bps
Large Cap Core	76%	0 bps	127 bps
Large Cap Growth	83%	-35 bps	102 bps
Mid Cap Value	71%	47 bps	208 bps
Mid Cap Core	67%	74 bps	127 bps
Mid Cap Growth	72%	29 bps	197 bps
Small Cap Value	33%	161 bps	283 bps
Small Cap Core	54%	104 bps	305 bps
Small Cap Growth	60%	50 bps	183 bps
International Value	26%	159 bps	350 bps
International Core	53%	78 bps	301 bps
International Growth	46%	98 bps	166 bps
Emerging Markets	56%	106 bps	234 bps
Aggregate Fixed Income	43%	64 bps	138 bps
High Yield	89%	-37 bps	50 bps

Finding Strong Active Managers

We are still strong believers in active management, not because we think the data should be ignored, but because we have observed the impact that capable active managers can have on a portfolio, even after accounting for the fees that often level the playing field. For investors intent on understanding the process behind uncovering these types of managers, there is no secret sauce, although a body of research has developed that attempts to extract some of the ingredients. Much of this work revolves around the concept of 'active share,' a measurement of how much a manager's portfolio deviates from a comparable benchmark. An active share of 100% would mean that none of a manager's holdings can be found in a comparable index, while an active share of 0% would mean that all of the names in a manager's portfolio can be found in a comparable index. The simplified version of the theory states that if an investor is intent on hiring an active manager, that manager should look as different from the benchmark as possible. This should not, however, imply that just because a particular company appears in a benchmark, it is unsuitable for investment.

In a study conducted back in 2007 that attempted to determine the impact of active share on investment performance[5], Martijn Cremers and Antti Petajisto analyzed the performance of active managers and concluded that a) funds with the highest active share significantly outperform their benchmarks, both before and after expenses, and they exhibit strong performance persistence; b) non-index funds with the lowest active share underperform their benchmarks; c) concentrated stock pickers (high active share, high tracking error) tend to perform the best, followed by diversified stock pickers (high active share, low tracking error); and d) even after fees and transaction costs, both of these groups beat their benchmarks.

There is additional academic evidence to indicate the active share is persistent, meaning that a manager in a particular active share decile was likely to stay in that decile over time. In a follow-up report[6], Petajisto updated his earlier study with Cremers through 2013 and again confirmed that the most active stock pickers were more likely to outperform their benchmarks, even after fees. His study showed that active mutual funds with high active share/lower tracking error outperformed their benchmarks by an average of 1.26 percentage points per year after fees and expenses. Managers with more investment conviction beat "closet indexers" (those with an active share below 60%), who consistently

[5] "How Active Is Your Fund Manager? A New Measure That Predicts Performance" Jan 2007

[6] "Active Share and Mutual Fund Performance" July 2013

underperformed. These patterns held true both during the 2008-2009 financial crisis and within market-cap styles.

Low turnover is another attribute of the most successful managers. Just as low fees and expenses help managers outperform by reducing drag on gross performance, low turnover does the same. Research led by Roger Edelen[7] and co-authored by others found a strong negative relationship between aggregate trading costs and fund returns. According to the authors, "Sorting funds on the basis of their aggregate trading-cost estimate yields a clear monotonic pattern of decreasing risk-adjusted performance as fund trading costs increase." In other words, buy and hold is a better strategy than buy and sell. Mutual funds in the lowest quintile of aggregate trading costs in Edelen's study had average annual returns 1.78 percentage points higher than those of the highest quintile, highlighting the detrimental effect trading costs can have on performance.

In practice, we wholeheartedly endorse the practice of seeking low-turnover managers, and also recognize the importance of finding managers that aren't closet indexers. However, we don't believe that a company's inclusion in a benchmark automatically makes it a less suitable candidate for investment, and so while we recognize the concept of active share as a means for finding less-trafficked names, we don't necessarily prioritize it when seeking strong active managers.

Nothing is Perfect

Capitalism has passed the test of time because, despite its flaws, the incentives that it offers have the ability to create wealth, increase productivity, and lead to advancement in a way that no other system can. Are passive investors implicitly anti-capitalist? Of course not. Passive investing has introduced a different standard for investing – one based on the financial economy and not the real economy – but it has benefited millions that have chosen to embrace its simplicity and cost advantages. The financial economy has certainly become quite formidable, and its acceleration shows no signs of abating. The sheer proliferation of index, ETF, and smart-beta products available proves that Wall Street understands this opportunity and is geared to exploit it as best it can, a dynamic, it should be noted, that historically has never seemed to end particularly well for investors.

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[7] "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance" Jan 2013

As these products continue to proliferate, it's interesting to study the potential impact, which Bernstein's piece theorizes in a fairly thought-provoking way. The point at which any growth in the passive space could possibly cause a detrimental effect to capital allocation in the economy could be a long way off, but it's a curious proposition to consider. One impact that Bernstein explores is the equity volatility that could result from higher correlations as passive investment continues to grow, which, ironically, could provide more opportunities for active investors.

At Colonial, while we heavily utilize active managers in client portfolios, we also use passive indices, generally in core-satellite equity portfolio constructs or in areas where the differential between top quartile returns and median returns is fairly tight due to the availability of exceptional managers that are accepting capital. We believe the return considerations remain more important than the social considerations, but it's worth remembering that investing is part of a system, and that system is only as stable as its components and participants.

Colonial Consulting, LLC

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