

# DEAD OR Alive?



Have passive strategies prevailed? CIR's online poll investigates whether the death of active management was greatly exaggerated.

BY JENNIFER HUGHEY

**Caution** might be the watchword for most investors following the financial crisis, but many still have faith in an active approach, despite rumours of its demise. *Canadian Investment Review's* latest online debate examines what separates the believers and the non-believers, and questions the benefits of active strategies in a post-crisis investment environment with the help of several industry players: Leona Fields, manager of York University's pension fund, moderated the debate, with Eric Kirzner, the John H. Watson chair in value investing at the Rotman School of Management, arguing for passive strategies, and Zev Frishman, vice president of Global Equity Strategies for the Ontario Teachers' Pension Plan (OTPP), taking the opposite view.

The debate—sponsored by Morneau Sobeco—revisits a popular question, mulling over the long-term value of active strategies and gauging whether there's life left in them.

questioning whether it could ever really be settled—the best answer was probably “it depends” she said, noting that asset class, fees, measurement and the type of active strategy are all key factors in determining which side investors ultimately take—Kirzner stepped into the ring dismissing the potential for middle ground, stating, “the average indexed dollar can't help but outperform the average actively managed dollar after costs.”

Turning to “finance theory and logic”—along with a nod to a Nobel Prize winner—to make his case for passive management, Kirzner cited the Efficient Market Hypothesis (EMH) as the basis for his belief in passive strategies, saying, “if you believe in the EMH, you would believe that the cost of outperforming markets would offset any benefits. The logical extension of the belief is to engage in passive investing or indexing.”

After revisiting William Sharpe's rationale for indexing and the Grossman Stiglitz Paradox—in which competition equalizes performance—he set forth that “active investment analysis quickly becomes a self-defeating process, leaving indexing [passive strategies] as the optimum strategy.”

Though he acknowledged that certain assumptions underlying EMH are unrealistic, noting that “investors

## THE DEBATE

### A PRO-PASSIVE STANCE

Although Fields opened the active vs. passive debate

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often act in emotional and sometimes irrational manner[s] in making their decisions,” Kirzner debunked the notion that such assumptions destabilize a passive approach, stressing that “the assumption does not determine the validity of the model.” He also pointed out that market efficiency tests are empirical, based on data and pricing, not assumptions.

And while Kirzner gave a nod to the other side, noting that it’s possible for an active manager to beat the market, he cautioned that such feats can be elusive and unpredictable, adding that the touted advantages of institutional investors—entrepreneurial culture, long horizons and strong governance—don’t necessarily add up to outperformance.

“A strong management team, good governance and a strong, possibly socially responsible culture make for a healthy organization that has a good chance of meeting its goals,” he said. “But that does not necessarily translate into creating alpha. The proof has to be in the pudding—and I haven’t seen the proof.”

### THE CON

Frishman began his argument for active strategies by revealing a past allegiance to passive management and the “elegant and intuitively appealing” Efficient Market Hypothesis (EMH). But since then, he said, “I have also learned that the major assumptions underlying EMH are quite unrealistic.” Unrealistic, and at times, not truly rational, he explained, noting that “real world” behaviour and worry over legal, regulatory or even job risks can get in the way of maximizing long-term returns.

Adding value through active management isn’t easy, or even attainable for everyone, he acknowledged—“It is hard to dispute the pro side that the combined performance of all investors, retail or institutional, has to be, by definition, equal to the market as a whole and therefore after transaction and other costs, the average investor is going to underperform the market”—but “sophisticated institutional investors can ‘beat the market’ if certain conditions are met,” Frishman stressed. Those conditions: good governance, long-term investment horizons and a culture of entrepreneurial spirit among

company employees.

“These requirements are paramount, as active management has to produce incremental value added that is large enough to outweigh the significantly higher fees often associated with an active approach,” he said, pointing out that institutional investors have advantages over the public investor in the form of information and cost advantages that “increase their odds of outperforming the markets.”

**“IS A KNIFE A USEFUL TOOL OR IS IT A DANGEROUS WEAPON? THE SAME QUESTION CAN BE ASKED OF ACTIVE MANAGEMENT. IT DEPENDS ON WHO’S USING IT, THEIR SKILL AND INTENT, HOW IT’S BEING USED AND HOW SHARP IT IS.”**

— LEONA FIELDS, MANAGER, YORK UNIVERSITY PENSION FUND

Frishman used the OTPP as an example of one such institution that has successfully beat the market, noting that it has outperformed its policy benchmark by over 2% per year.

And while certain asset classes, such as private equity, real estate or infrastructure, might be more challenging, they offer more opportunity for successful “alpha” generation than others, especially for sophisticated investors with the right infrastructure, he said.

Overall, “active management is alive and well,” he said. “It is not easy to apply and achieve a significant value added but doable with the right organizational structure and culture.”

### THE VERDICT

In closing, Fields noted that the participants seemed to agree on several key points of the debate, and finished the debate with a question of her own: “Is a knife a useful tool or is it a dangerous weapon?” The same question can be asked of active management. “It depends on who’s using it, their skill and intent, how it’s being used and how sharp it is,” she said, adding, “all participants seem to agree that the arithmetic of active management shows it is generally a blunt instrument, but that sharp, successful active managers do exist.” Those casting online votes seemed to agree, with 62% voting against a passive approach. ■