

The Active vs. Passive Investment Debate

Discussion on:

The Rewards and Risks of Active vs. Passive Investment Management

On the One hand.....



..... And on the Other Hand

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Agenda

- Are Markets Efficient?
- Can Managers Add Value?
- Where is Active Management Going?

Definitions

Passive (Index) Management

Two Meanings

- **Security Selection:**
 - Match performance of an asset class index such as the S&P/TSX Composite Index
- **Asset Mix:**
 - Match performance of a policy mix (such as 50% stocks/50% bonds)

Definitions

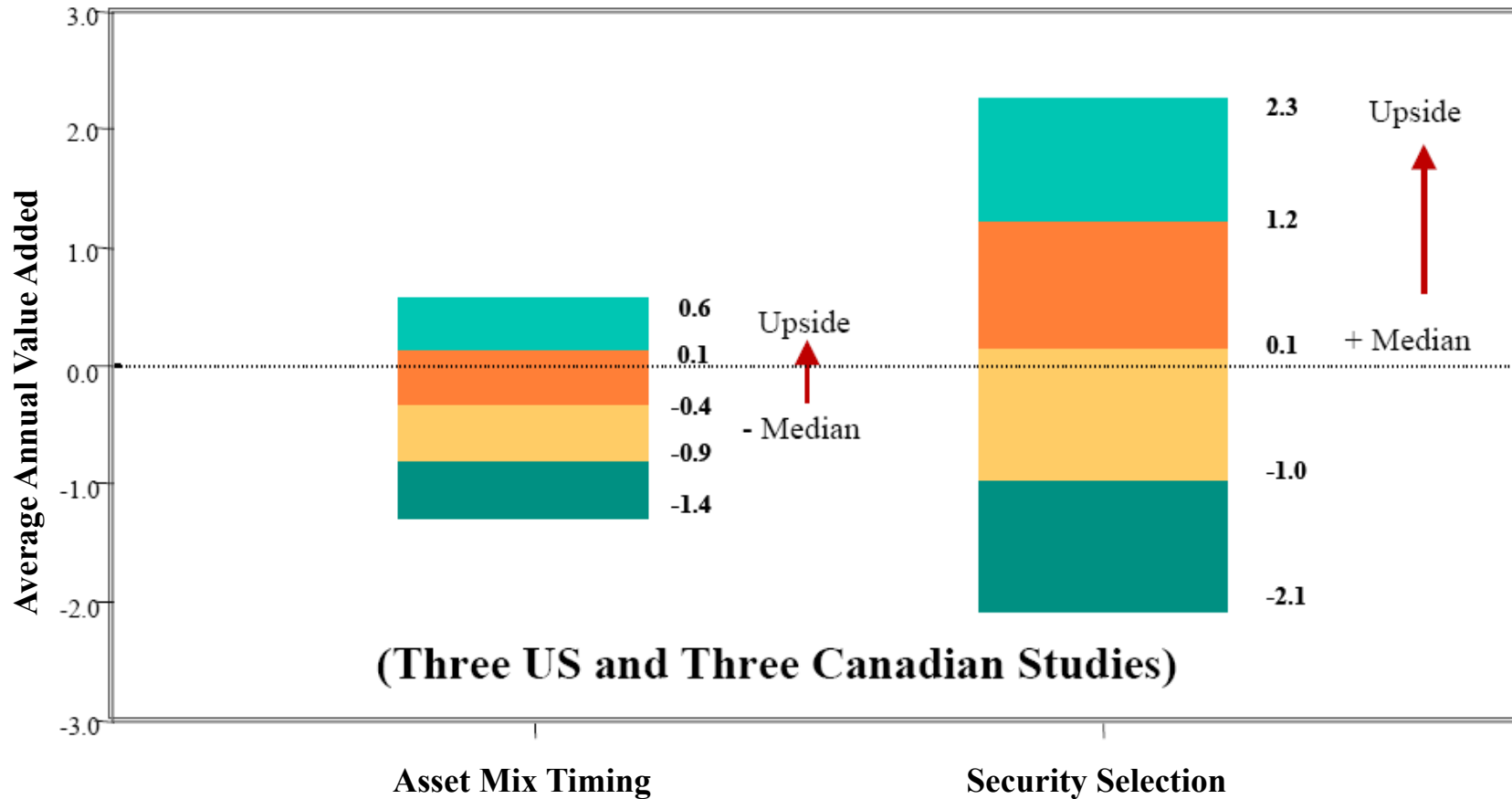
Active Management

Two Strategies

- **Market Timing:**
 - Timing asset class exposure to earn a return that exceeds the return available by maintaining a constant asset mix (for e.g. 50% stocks/50% bonds)
- **Security Selection:**
 - Selecting securities to earn a return that exceeds the return available from investing in an index such as the S&P/TSX Composite Index

Market Timing Track Record – Low Odds Strategy

North American Value Added Experience



5 Source: The Portable Pension Fiduciary: A Handbook for Better Pension Fund Management (Toronto: Benefits Canada, 1997 page 62) , by John Ilkiw

Why Market Timing is Unprofitable?

*“Historical Analysis Indicates You Must Be
Right At Least 2/3 of the Time*”*

- A. Bull markets last longer than Bear markets
- B. Stocks go up more over time than go down
- C. Most upward performance occurs in unpredictable spurts

Active vs. Passive Investment Management

Security Selection

Issues to Consider:

Philosophical



Is the Market Efficient?

Practical



Can Active Managers
“Beat the Market?”

A. Philosophical: Is the Market Efficient?

Eugene Fama (1965)
Efficient Market =
Securities Reflect All Available Information

What Does This Mean?

1. Investors Earn Returns Commensurate with Risk, ie., **No Free Lunch**
2. Various Forms of Theory:
 - Weak
 - Semi-Strong
 - Strong



A. Philosophical: Is the Market Efficient?

Weak Form

A security's price reflects all the information contained in the historic price record. Past prices cannot provide information of any value in helping to determine future prices.

Semi Strong Form

At any given time, all relevant public information is fully reflected in the security's price.

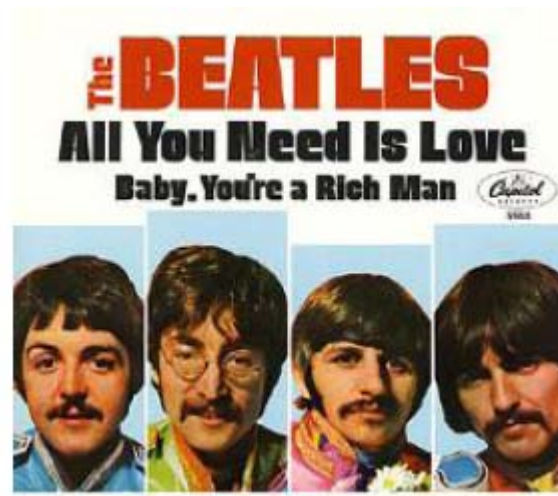
Strong Form

All public and private information is fully reflected in the security's price

A. Philosophical: Is the Market Efficient?

So...What Do Academics Think?

1960 – 1970's



**Markets Are Efficient Except to Some Degree
in the Strong Form**

A. Philosophical: Is the Market Efficient



1980's

Computers & Databases
led us to:

- Small Firm Effect
- Weekend and Monday Effect
- January Effect
- Low P/E Effect
- Low P/Book Effect

A. Philosophical: Is the Market Efficient?



1990's : 3 Views

1. Markets **ARE** Efficient

- Data Mining
- Fees
- Risk

2. Markets are **NOT** Efficient

- Technical Trading Patterns
- Chaos
- A.I., Neural Net
- TAA – Forecast Returns (Fama)

3. Bounded Market Efficiency

- Professional vs. Noise Traders
(ie, Banks, Individuals, the Herd)
- Fads, Bubbles, etc

The Market is Efficient?

Postwar Movements in S&P Index and Their Causes*

	Date	Percentage Change	New York Times Explanation
1	19-Oct-87	-20.47%	Worry over dollar decline and trade deficit; Fear of US not supporting dollar
2	21-Oct-87	9.10%	Interest rates continue to fall; deficit talks in Washington; bargain hunting
3	29-Sep-08	-8.80%	Congress Votes against Wall Street bailout package
4	26-Oct-87	-8.28%	Fear of budget deficits; margin calls; reaction to falling stocks
5	3-Sep-46	-6.73%	".... No basic reason for the assault on prices"
6	28-May-62	-6.68%	Kennedy forces rollback of steel price hike
7	26-Sep-55	-6.62%	Eisenhower suffers heart attack
8	26-Jun-50	-5.38%	Outbreak of Korean War
9	20-Oct-87	5.33%	Investors looking for "quality stocks"
10	9-Sep-46	-5.24%	Labor unrest in maritime and trucking
11	16-Oct-87	-5.16%	Fear of trade deficit; fear of higher interest rates; tension with Iran
12	27-May-70	5.02%	Rumours of change in economic policy. "...the stock surge happened for no fundamental reason"
13	11-Sep-86	-4.81%	Foreign governments refuse to lower interest rates; crackdown on triple watching announced
14	17-Aug-82	4.76%	Interest rate declines
15	29-May-62	4.65%	Optimistic brokerage letters; institutional and corporate buying; suggestions of tax cut
¶	¶	¶	¶
49	30-Nov-82	3.23%	"..analysts were at a loss to explain why the Dow jumped so dramatically in the last two hours.."
50	24-Oct-62	3.22%	Khrushchev promises no rash decisions on Cuban Missile Crisis; calls for US-Soviet summit

**Less than 25% of Major Moves can be Attributed to a Specific World
Political or Economic Event****

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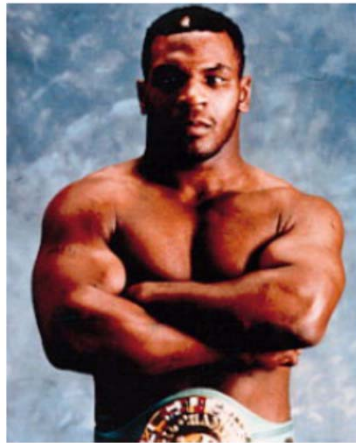
*Source: Hillsdale Investment Management Inc.

**Source: NBER Working Paper No. 2538, "What Moves Stock Prices?", by David Cutler, James Poterba, and Lawrence Summers, March 1988. In "Events That Shook The Market", Roy C. Fair found that "many large stock price changes have no events associated with them", Page 713, Journal of Business 2002

**Source: Page 217, Chapter 13, World Events That Impact Financial Markets, "Stocks for the Long Run", Jeremy J. Siegel,

B. Can Active Managers “Beat the Market”

Active



Passive



The Secret Formula of Active Investment Management

The Fundamental Law of Active Management

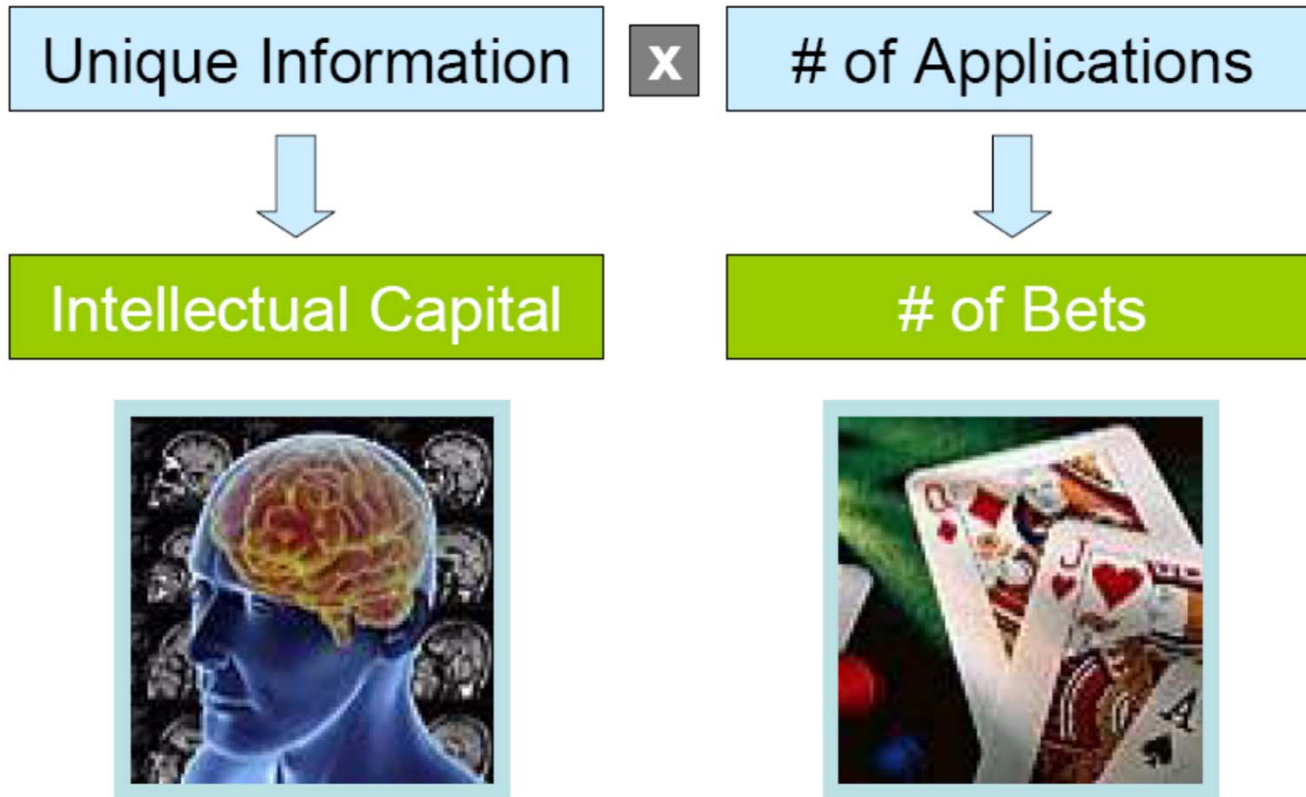
$$\text{Information Ratio} = \text{Manager's Skill} \times \sqrt{\text{Breath}}$$

Relationship Between
Forecasts and Actual
Outcomes

Number of Independent
Forecasts of E (R)

Information Ratio = (Excess Return)/(Tracking Error)
Tracking Error = Standard Deviation of Excess Return

In Other Words, Smart Managers Count Cards

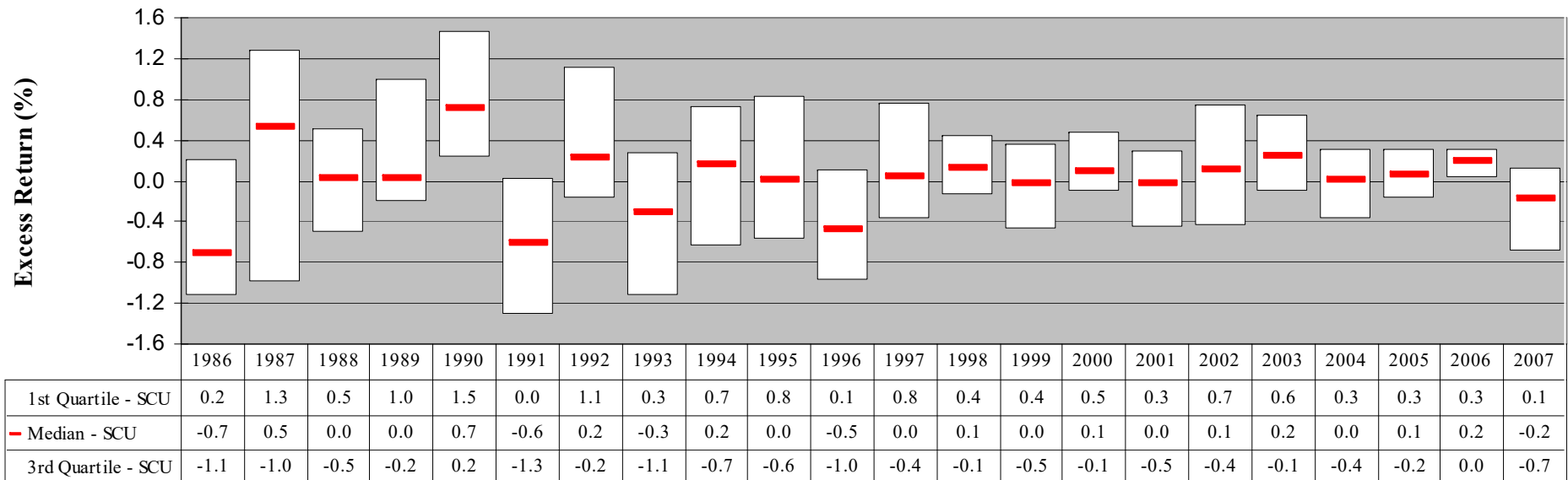


Let's Review If There are Smart Managers and if They Can Count Cards

- Cdn Fixed Income
- Cdn Equity
- U.S. Large Cap
- U.S. Small Cap
- Global Equity

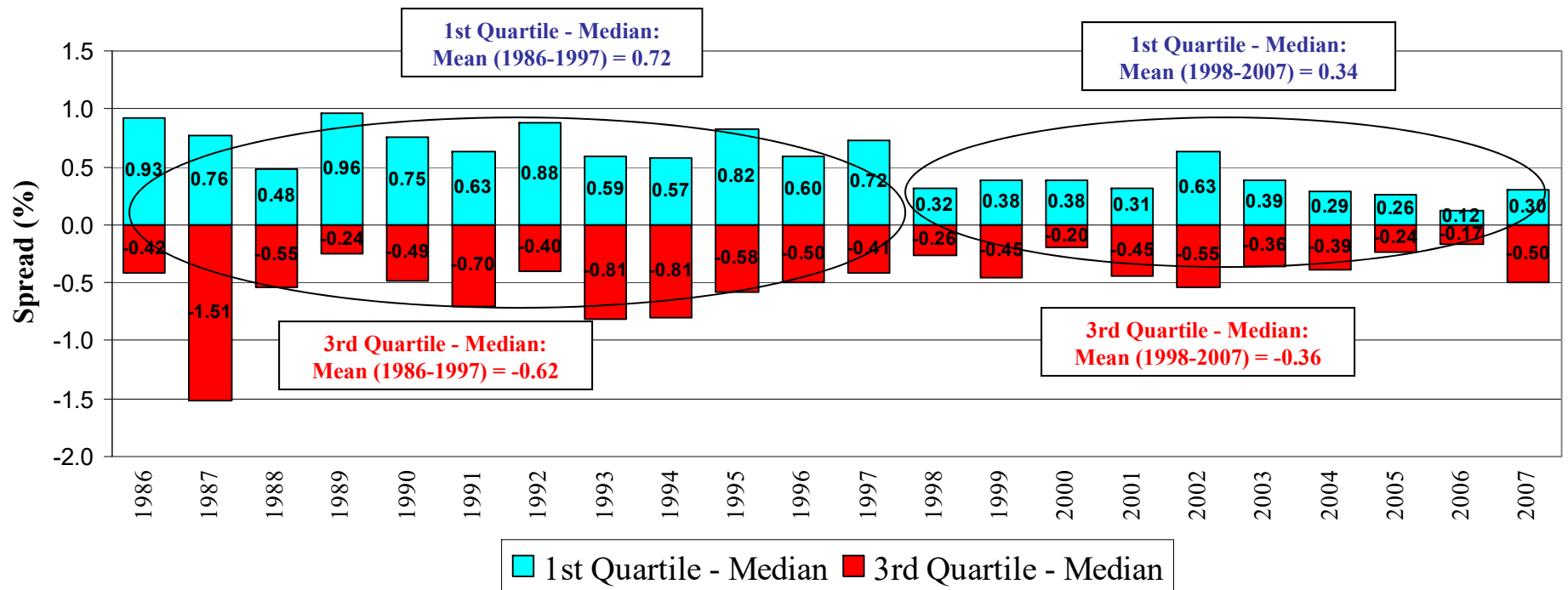
How Have Active Canadian Bond Managers Faired?

Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. Scotia Capital Universe



Tough to Sell Active Canadian Fixed Income

**Annual Spread (%) Between Canadian Fixed Income Managers:
1st Quartile vs. Median and 3rd Quartile vs. Median**

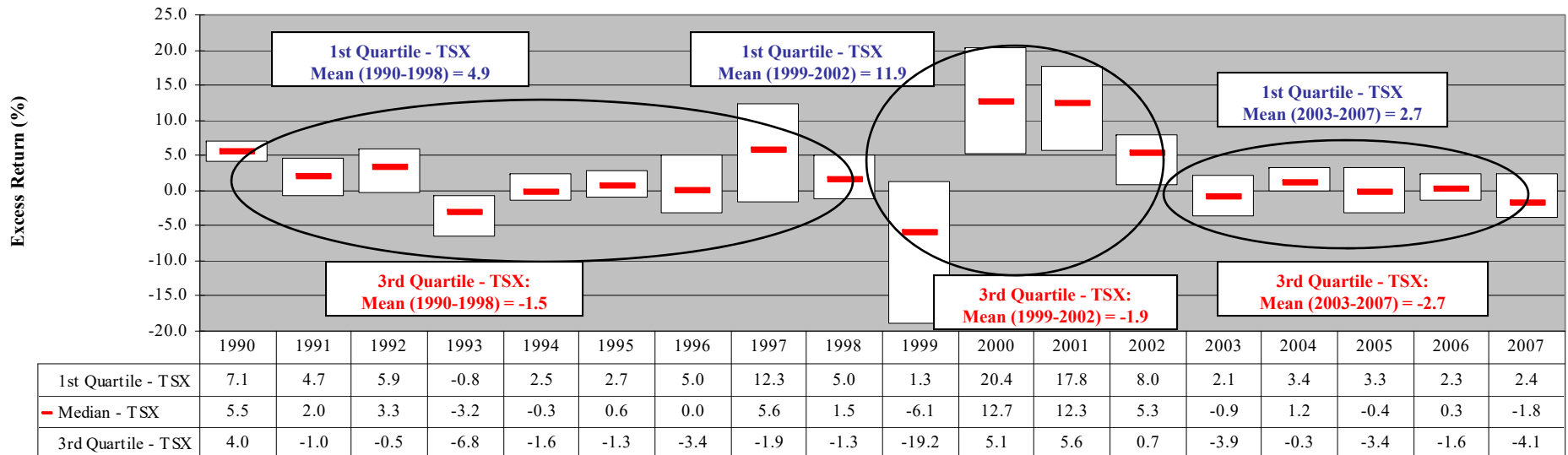


Why is the Canadian Bond Market so Tough to Beat?

- What Unique Information do Managers Have on Interest Rates?
- How Many Times Can They Apply These Forecasts?
- How Do You Beat The Bond Market?
 - “Call” on Interest Rates
 - Spreads

How Have Canadian Equity Managers Faired?

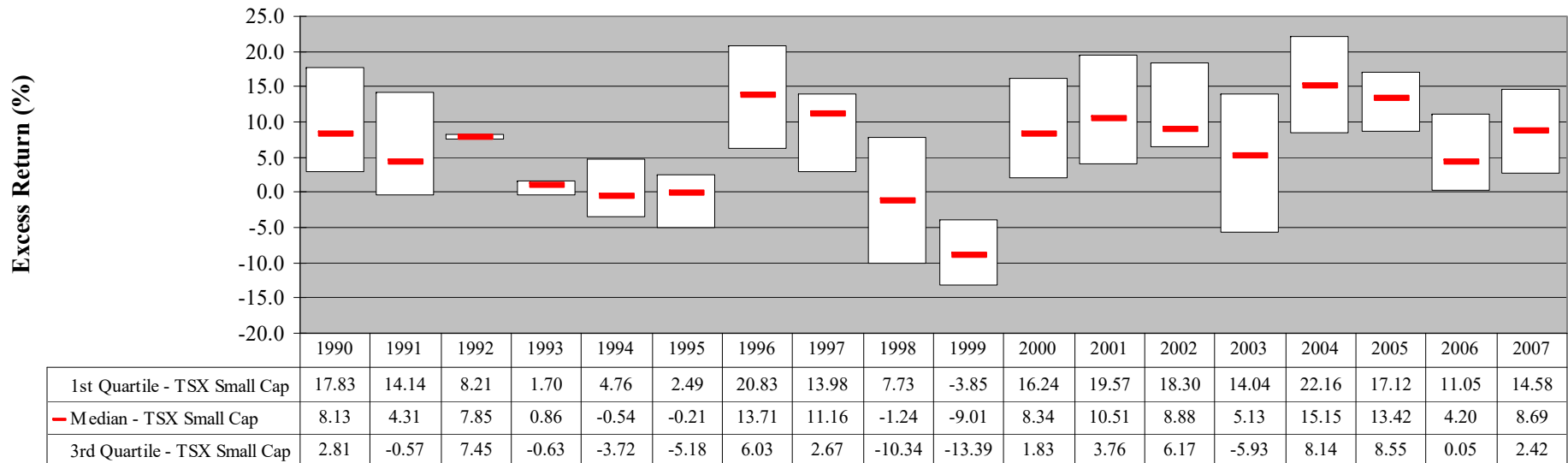
Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. S&P/TSX Composite



Statistics			
	1st Quartile – S&P/TSX Composite	Median – S&P/TSX Composite	3rd Quartile – S&P/TSX Composite
Mean	5.9	2.1	-1.9
Median	4.0	0.9	-1.5
Stdev	5.7	4.8	5.4
High	20.4	12.7	5.6
Low	-0.8	-6.1	-19.2

How Have Canadian Small Cap Equity Managers Faired?

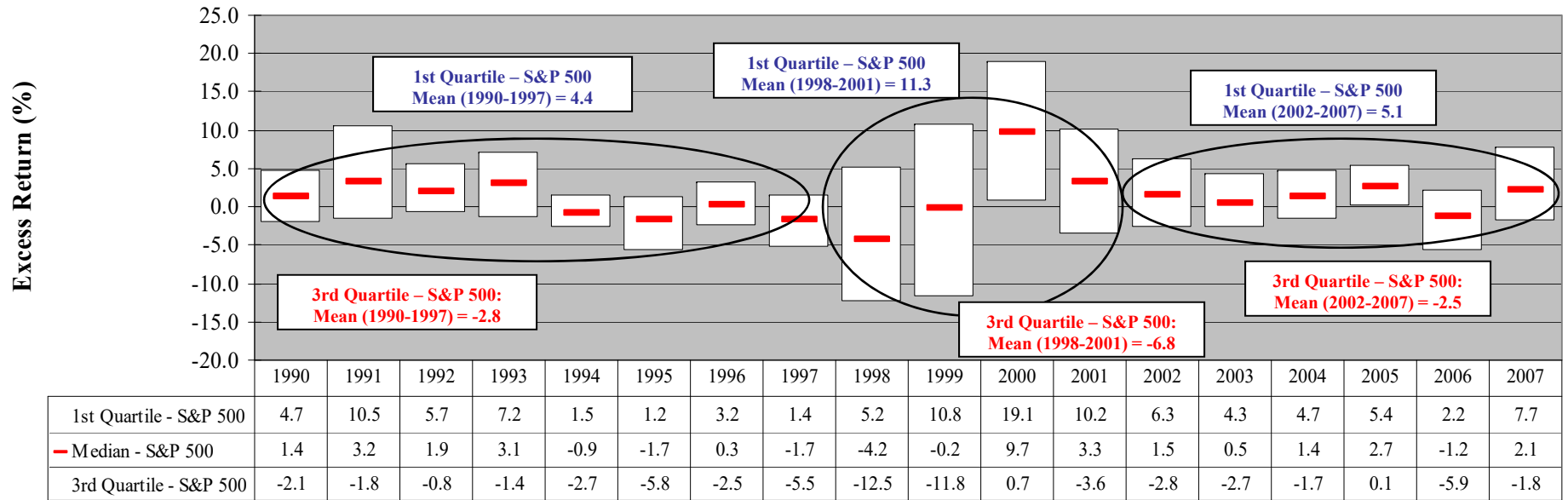
Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. S&P/TSX Small Cap Index



Statistics			
	1st Quartile – S&P/TSX Small Cap	Median – S&P/TSX Small Cap	3rd Quartile – S&P/TSX Small Cap
Mean	12.3	6.1	0.6
Median	14.1	8.0	2.1
Stdev	7.3	6.3	6.3
High	22.2	15.2	8.5
Low	-3.8	-9.0	-13.4

How Have U.S. Equity Managers Faired?

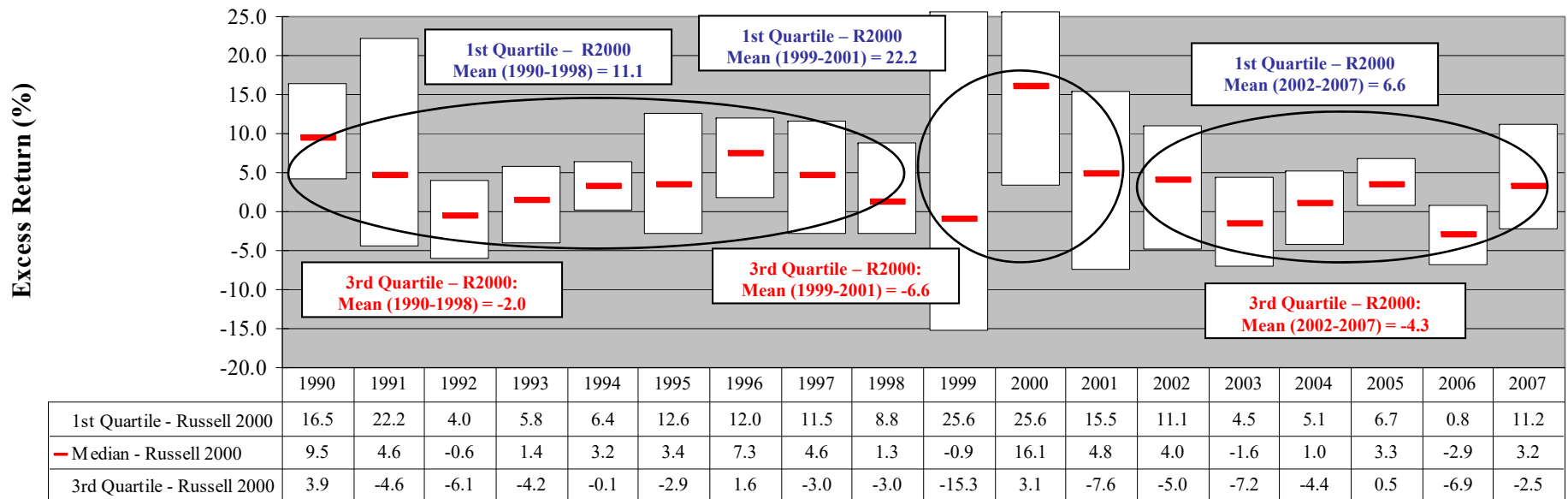
Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. S&P 500 Index



Statistics			
	1st Quartile – S&P 500	Median – S&P 500	3rd Quartile – S&P 500
Mean	6.2	1.2	-3.6
Median	5.3	1.4	-2.6
Stdev	4.4	2.9	3.6
High	19.1	9.7	0.7
Low	1.2	-4.2	-12.5

How Have U.S. Small Cap Equity Managers Faired?

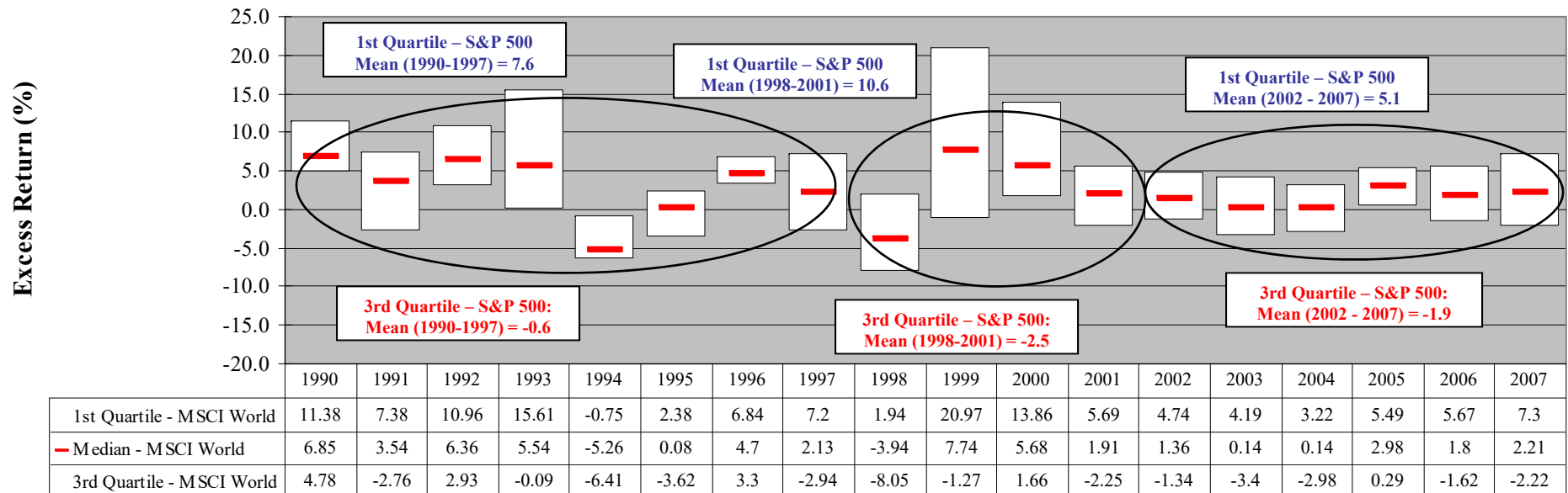
Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. Russell 2000 Index



Statistics			
	1st Quartile - Russell 2000	Median - Russell 2000	3rd Quartile - Russell 2000
Mean	11.4	3.4	-3.5
Median	11.1	3.3	-3.6
Stdev	7.3	4.4	4.5
High	25.6	16.1	3.9
Low	0.8	-2.9	-15.3

How Have Global Equity Managers Faired?

Annual Excess Returns (%) of 1st Quartile, Median and 3rd Quartile Managers vs. MSCI World Index



Statistics			
	1st Quartile – MSCI World	Median – MSCI World	3rd Quartile – MSCI World
Mean	7.4	2.4	-1.4
Median	6.3	2.2	-1.9
Stdev	5.4	3.5	3.2
High	21.0	7.7	4.8
Low	-0.8	-5.3	-8.1

So.....Can Active Managers “Beat the Market?”

Asset Class	Breadth	Skill	Odds of Success
Cdn. Fixed Income	Low	Low	Low
Cdn. Equity	Low	Avg.	Avg.
Cdn. Small Cap	Avg.	High	High
U.S. Equity	High	Avg.	Avg.
U.S. Small Cap	High	High	High
Global Equity	High	High	High

Long Term Observations.....

Active vs. Passive Management

- Average Manager Return = Market Return
i.e., Market Return = Passive Portfolios + Active Portfolios
- The Market Rewards Different Factors over Time
- Successful Active Managers Need Both Skill and Breadth
- Active Management Pay Off For Managers in The Top Third of the Universe

“Properly measured, the average actively managed dollar must under-perform the average passively managed dollar net of costs.
Active management is indeed a zero-sum game”
– Bill Sharpe, Noble Prize Winner in Economics

So Why Can Active Management Sometimes Be Frustrating From a Client Perspective?

- Over Emphasis on Short Term Past Performance
- Under Emphasis of Manager “Style” and Process
- Change vs Shift in Investment Process
- Organizational Uncertainty Challenges
- Success Can Lead to Mediocrity

Success Can Lead to Mediocrity

Why?

“Bets” Diminish Over Time Due To:

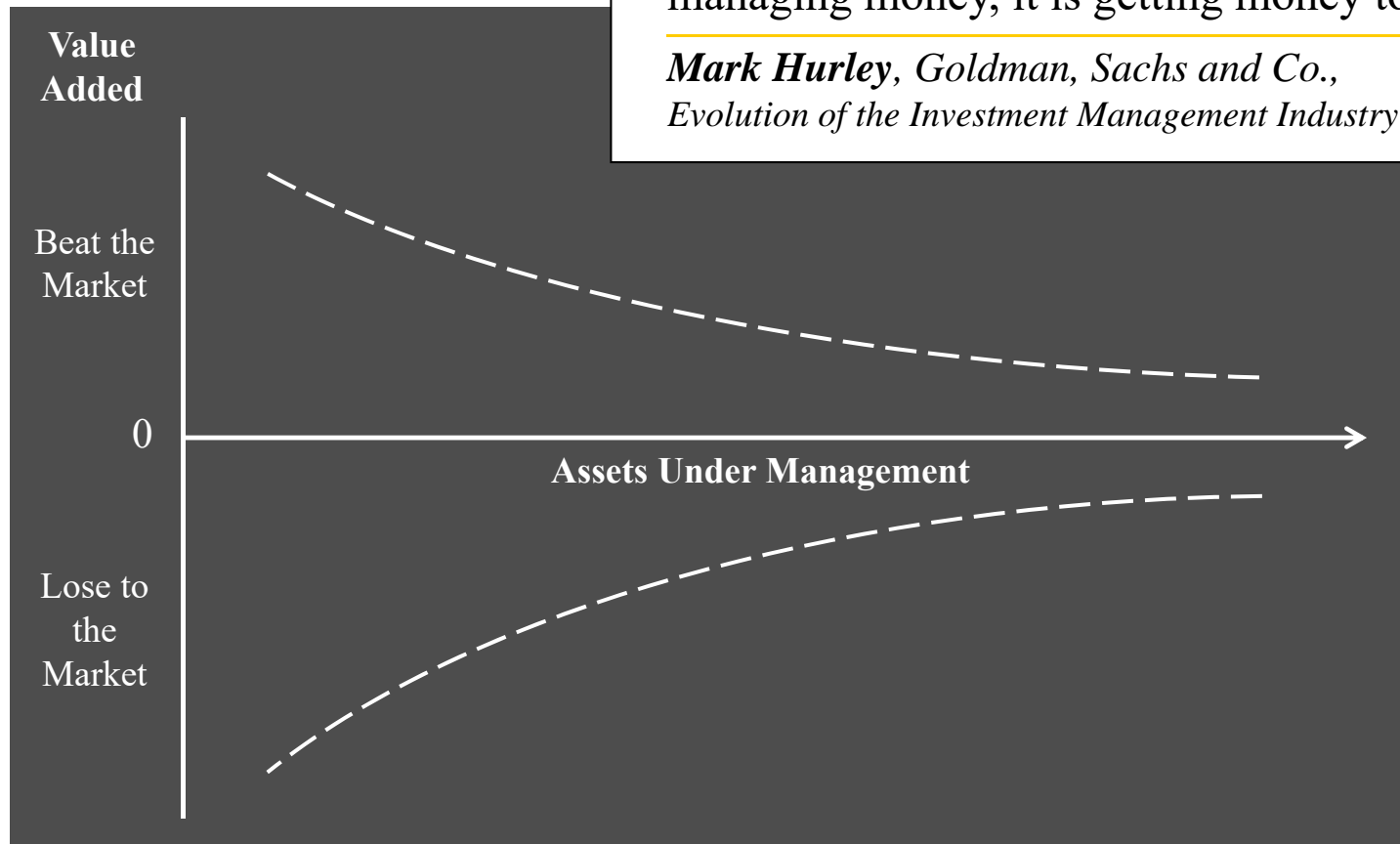
1. Increase in AUM
2. Increase in Transaction Costs
3. Increase in “Qualified” (CFA Charterholder) Employees
4. Business Decision
 - No Skill
 - Protective Mode

Alpha Shrinkage As Assets Multiply

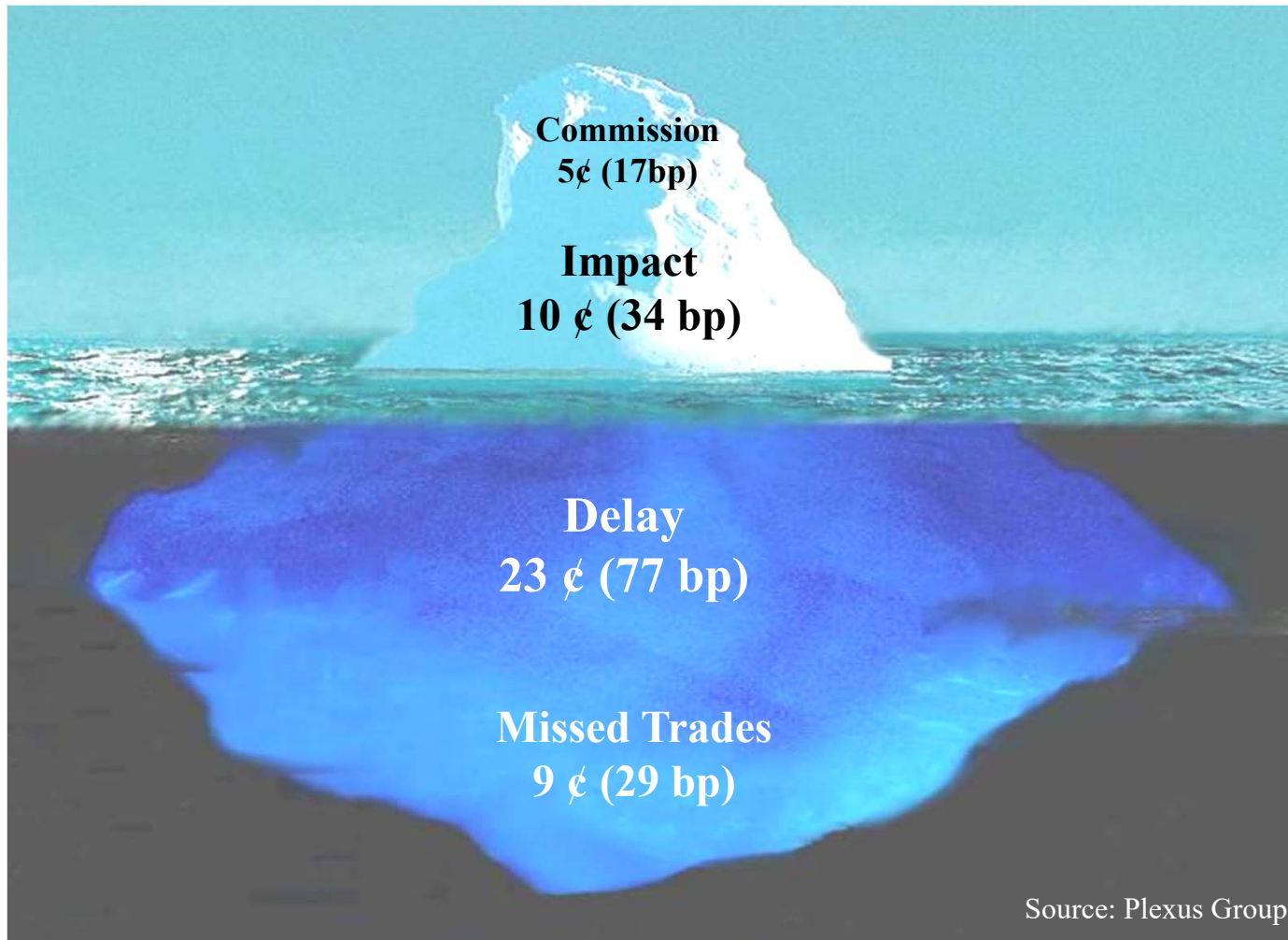
“

The real business of money management is not managing money, it is getting money to manage.”

*Mark Hurley, Goldman, Sachs and Co.,
Evolution of the Investment Management Industry*



Do We Really Understand Execution?



The Elephant In The Room

“

Imagine a business in which other people hand you their money to look after and pay you handsomely for doing so. Even better, your fees go up every year, even if you are hopeless at the job. It sounds perfect.

”

The Economist

March 1, 2008, Special Report on Asset Management

Meeting the Success Challenge In The Investment Management Industry

- Investors Will Pay More Attention to Firm's Business model
- Questions of Capacity will Come up More Frequently
- Capacity Serious Investors Will Employ Performance Based Fees
- This Will Lead More Managers to Focus on Maximizing Alpha as Opposed to Maximizing Assets

The Active vs. Passive Management Debate

- Most “Traditional” Strategies Still Work
- Index or LDI Canadian Bonds and “Port Alpha on Top” or Accept Less
- “Extension” Strategies Increase the Odds of Success
- Small Cap Can be Big
- Always Consider the Fundamental Law of Active Management