Active versus passive investing

Finding the perfect balance

Much has been written in recent times about the relative merits and pitfalls of active and passive investing, and comparing one against the other. Numerous studies have documented the alpha opportunity in active management across asset classes, regions and investment styles. However, there has been little discussion on the key factors to frame allocation decisions, such as when and where to include active and passive management strategies in an investment portfolio.

Defining passive investing

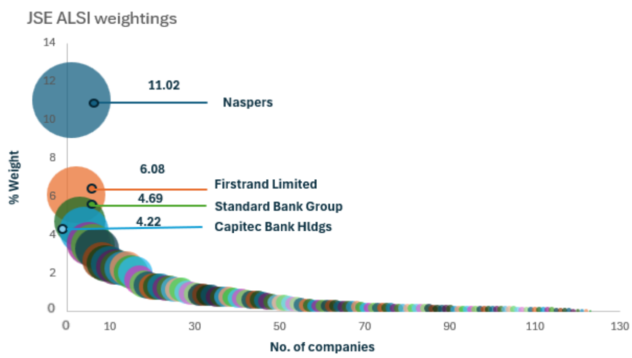
Passive investing is an investment strategy that aims to match the return of an index over time. The essence of the strategy is index-return replication, unlike active management where the strategy considers share fundamentals for mispricing, relative to the market. Therefore, shares are not bought and sold on investment merit, but rather with the aim to match the index. The cost to invest in a passive portfolio is normally lower than that of an active portfolio.

Certain shares on the JSE All Share Index ("JSE ALSI") have a significantly larger market size (share price x number of shares) than others, which may influence the performance of an index that an investor is invested in.

This bias is commonly referred to as index concentration, which is the risk of a few shares dominating the index from a risk-return perspective.

The chart below illustrates the concentration risk of the JSE ALSI as at 31 December 2024. We can see just how dominant some shares can be in the index.

JSE ALSI weightings



Source: Alexander Forbes Investments

Investors in the stock market indices can benefit when markets are moving upwards, or 'rallying', or when stocks that have a high weighting in the index are performing well. However, investing in an index can detract from an investor's performance quite significantly when markets are performing poorly, or when stocks that have a high weighting in the index perform poorly.

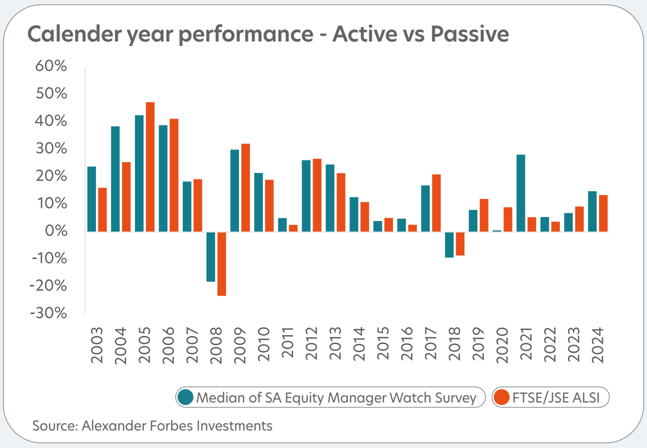
Defining active investing

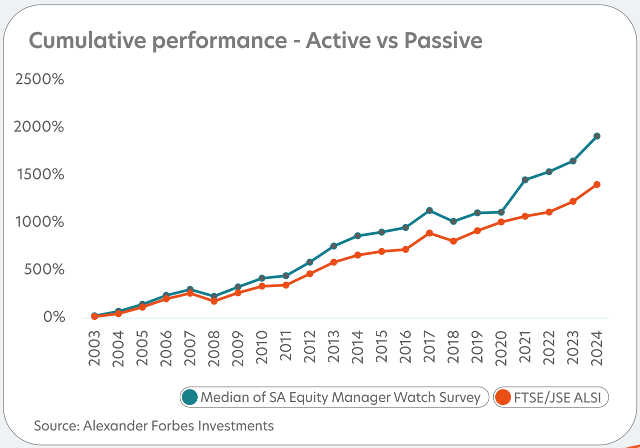
Active investing involves assessing specific company characteristics and considering local and global economic events while 'actively' increasing or decreasing exposure to a stock, deviating from the index weighting. This difference to the index is based on the view, conviction and projections of a stock's forecasted performance. This means that active managers trade more frequently, incurring additional research and trading costs, compared to a passive strategy.

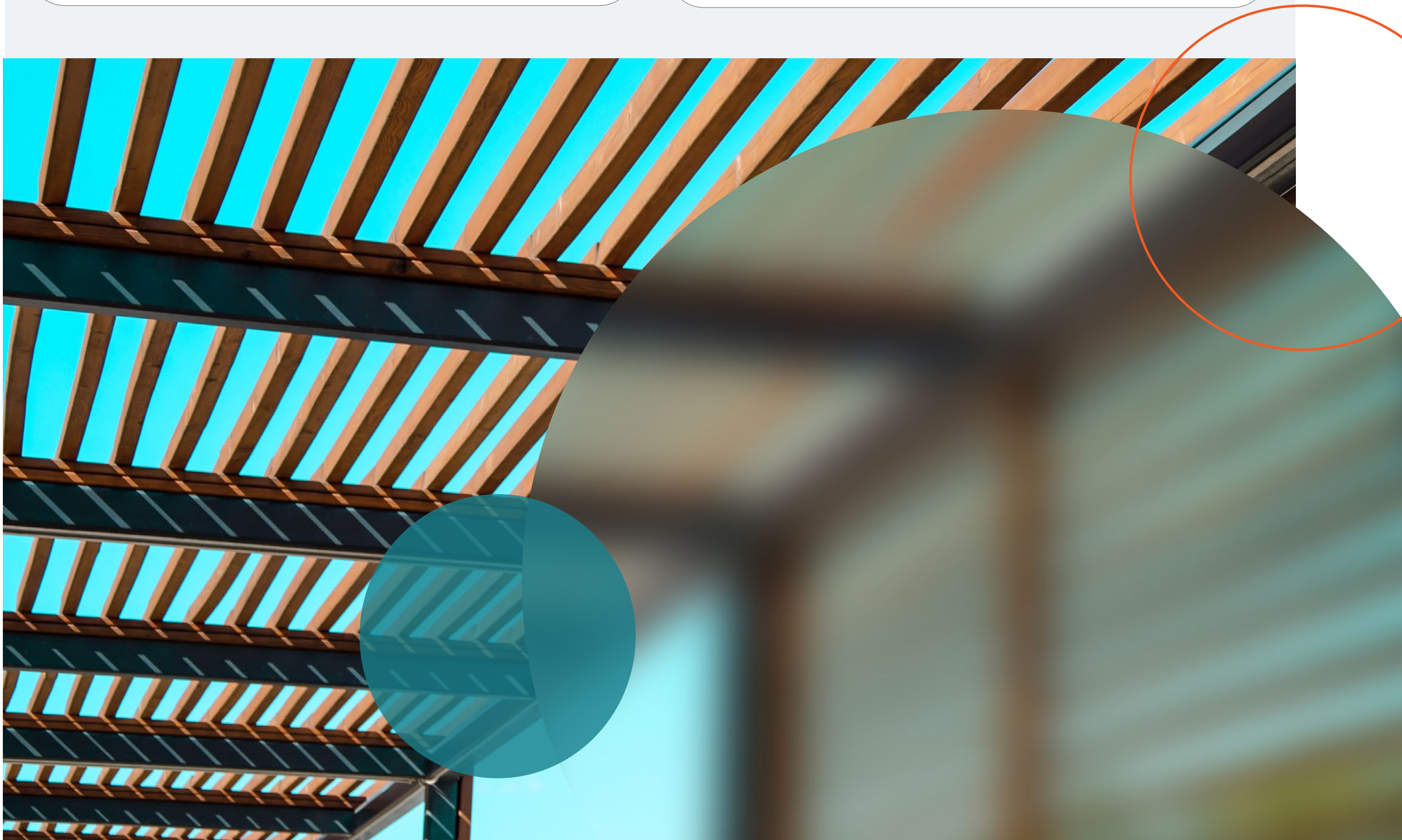
For example, the graphs below show the calendar year and cumulative performance of active asset managers (measured as the median of the Alexforbes SA Equity Manager Watch™ Survey) and the ALSI (passive strategy) in bull and bear markets from 1 January 2003 to 31 December 2024.

Looking at the cumulative performance returns of active asset managers versus the ALSI shows that active asset managers have generated greater performance on a gross-of-fees basis. Given that a passive strategy would generally have a substantially lower fee than an active strategy, the outperformance on a net-of-fee basis would be narrower.

The point for investors to take away is that both purely passive and active strategies have merit, with each potentially doing better during different market environments and cycles. Given the psychology of investing, these market cycles determine which strategy is likely to be popular with investors at a given point in time.







Considerations in choosing an investment strategy

While there is no one-size-fits-all approach to which strategy to employ, we believe that there are a few critical considerations to make when deciding between active and passive funds:

- **Governance:** the ability to appropriately govern the process and understand that the active management component requires appropriate knowledge of when to hire and fire managers. Decisions on where to invest and what types of managers to hire will also have a greater impact on total results than any individual manager. Governance is the broad term we use to capture holistic decision-making at the asset-owner level.
- **Investment complexity:** investments can be structured from plain vanilla (listed securities and cash) to the more complex types (private markets, hedge funds and other alternatives).

  There are a few key differences among these structures that can help determine potential allocations to passive strategies:
  - Complex investment structures tend to have higher return expectations than simpler structures, typically driven by the higher return expectations from private market allocations.
  - The use of alternatives significantly increases resource requirements to select and monitor the investments, manage distributions, and so on. For this reason, investors with significant allocations to alternatives may want to simplify other compenents of their investment structures through the use of passive strategies.
  - Fees for alternatives are higher than those for traditional listed securities. If there is a desire to reduce fees, passive strategies may be easier to achieve this.
- **Time horizon:** the longer the time horizon, the more likely it is that investors will achieve success with active managers. All investment managers go through periods of underperformance. Investors that are overly concerned with poor performance during a quarter, one- or three-year periods will find it more difficult to stick with underperforming managers and will be more prone to selecting managers based on performance, which is often counterproductive.
- **Tracking error sensitivity:** passive funds aim to have little to no tracking error (this is the difference between the performance of the passive fund and its benchmark). High-tracking-error managers may deliver substantial alpha but also tend to underperform their benchmarks by large amounts, sometimes over sustained periods. Low-tracking-error managers perform closer to the benchmark, whether they underperform or outperform. The greater an investor's sensitivity to the tracking error, the more they should be allocated to passive- or low-tracking error strategies.
- **Fee sensitivity:** as mentioned throughout this note, the more sensitive investors are to fees, the more they should allocate to low-cost passive strategies. However, this requires acknowledging the limitations this places on generating outperformance potential.

The figure below summarises the decision tree:

More active management	Decision factor	More passive management
High	Governance	Low
Low	Investment complexity	High
Long	Time horizon	Short
Low	Tracking error sensitivity	High
Low	Fee sensitivity	High

Source: Mercer

Common misconceptions

Stock markets go through cycles, and have recently experienced devastating shocks leading to cycles of unprecedented market drawdowns and relative underperformance by active managers. When active management underperforms, investors tend to consider passive management as an alternative investment strategy. This stance is underpinned by the following common market misconceptions:

1. Passive strategies do not require active management

We believe investing is an active process, whether the strategy of choice simply tracks the performance of a market index or whether desired outcomes are achieved via active or passive management strategies. Passive management, like any other investment process, still requires investors to understand their investment goals and objectives, leading to decisions on which asset class to invest in, which index to track, and conducting subsequent index provider due diligence.

2. Passive management will always outperform active management

Markets move in cycles and no one knows how long a market cycle will last. The reality is that both active and passive management styles are impacted by current and future market cycles. However, unlike passive management which relies purely on market movement, active management employs manager skills to buy shares that look attractive and sell those that have reached their peak.

Seeking the perfect balance that offers value

It is clear that investment opportunities with higher potential performance returns tend to be more expensive to manage, which adds to the ongoing cost of a portfolio. Ongoing charges have an adverse impact on a solution's ability to reach its objectives, so cost containment is an important component to the long-term success of any investment strategy.

At Alexforbes, it's important for us to deliver value for money. We achieve this by making intelligent use of a range of investments available to us, to achieve better risk-adjusted, net-of-fee performance returns over the long term, for our clients. An efficient means of achieving this is to consider a blend of active and passive (tracker or smart beta) strategies in our solutions.

Where optimal (and appropriate) active management skills cannot be found, passive strategies that track various indices are deployed. This means investors only pay for the active management that is likely to add value to their investments.

Our passive offering

We continually search and monitor the local and global asset manager landscape to find the best asset managers that are able to offer competitive fees on sound operational platforms. We apply a robust manager-research process across the global investment landscape. This puts managers through a stringent operational due-diligence process to understand any risks embedded in their investment strategies as well as in their operational model.

What we offer

- Risk-profiled portfolios ranging from aggressive to more conservative passive offerings.
- Exposure to a number of well-diversified asset classes, which improves risk characteristics.
- Portfolios, which may include an actively managed cash component, offering some performance upside to a mostly passive construct.
- Portfolios that are suited to a LifeStage approach and comply with Regulation 28 of the Pension Funds Act.
- Single asset class portfolios with a purely passive approach.

Connect with us

For any queries, please email us: Info@investmentsolutions.co.za

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Note: The value of a portfolio can go down, as well as up, as a result of changes in the value of the underlying investments, or of currency movement. An investor may not recoup the full amount invested. All policies issued or underwritten by us are linked policies under which no guarantees are issued. The policy benefits are determined solely on the value of the assets, or categories of assets, to which the policies are linked. Past performance is not necessarily an indication of future performance. Forecasts and examples are for illustrative purposes only and are not guaranteed to occur. Any projections contained in the information are estimates only. Such projections are subject to market influences and contingent upon matters outside our control, so may not be realised in the future. Please be advised that there may be supervised representatives.

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