ACTIVE INVESTING: KEYS TO STOCK MARKET SUCCESS

Albin Kistler AG opinion piece
April 2024

ACTIVE INVESTING: KEYS TO STOCK MARKET SUCCESS

Passive investment products are increasingly catching on

Since low-cost exchange-traded funds (ETFs) first emerged around 20 years ago, the importance of passive investing for institutional clients has steadily grown. These exchange-traded funds generally track a benchmark index and are therefore called "passive". This contrasts with "active" investing, where the asset manager is responsible for picking the securities. Passive products are particularly popular for traditional asset classes. They provide direct access to market returns (less product fees). This also eliminates the risk of choosing a below-average asset manager. We therefore think that passive investment solutions add value and can be a useful component of a well-thought-out structured portfolio.

However, it is astounding how rigid some people can be in denying the undisputed benefits of active investing despite the obvious advantages. We firmly believe there are still opportunities for an active asset manager to achieve above-average returns. We also currently consider active investing to be significantly superior to the passive alternative if we are serious about taking client-specific sustainability requirements into consideration. Below, we explore a number of key aspects that favour the potential for achieving an additional return with active managers.

Reasonable costs

Probably the most well-known argument for passive solutions is their cost advantage compared with active investing, along with the notion that active investing may not be fundamentally worthwhile. This is underpinned in part by decades-old studies, which came to the conclusion that the majority of active managers did not manage to beat the market after all the costs had been deducted. The study quoted most often in this context comes from 2010 and looks exclusively at the US market.[1]

[1] Fama, E. F. & French, K. R. (2010). Luck versus Skill in the Cross-Section of Mutual Fund Returns. *The Journal of Finance*.

But many of the claims it makes, need to be relativised from today's perspective. In particular, the differences in fees between active and passive products have narrowed considerably. For example, the average asset management fees of the active products analysed during that period were 2-3% per year. It is therefore hardly surprising that it was only rarely possible to beat the benchmark index after costs. Today, the fees for active investment products from serious providers are significantly lower, which has increased the probability of higher returns.

Furthermore, the arguments often ignore the fact that the average of a random sample says nothing about the distribution or characteristics of outliers on both sides. Given the nature of averages, there were of course active products whose net return was below the benchmark and there were also managers who were able to produce significantly higher returns across the cycle.

Features of a benchmark index

Most benchmark indices have a regional focus and are weighted by market capitalisation. There are both good and less good reasons for this. However, with a broad-based index you generally get balanced access to a representative universe of stocks. This is the case with, for example, the global stock index.

But in times of irrational exuberance, taking an uncritical approach and passively tracking the dominant indices may be dangerous. The stocks and sectors that are bought the most at these times are precisely those that have experienced the greatest exaggerations (e.g. Japan at the end of the 1980s and the dotcom bubble around the year 2000). The mostly capitalisation-weighted logic of passive products then additionally amplifies the trend and further fuels the imbalances. By contrast, active managers can make distinctions and thus avoid unhealthy concentrations. A good asset manager focuses on a company's price and quality and does not determine the composition of the portfolio on the basis of individual companies' market capitalisations.

The Swiss benchmark index SPI is an extreme example when it comes to imbalances in composition. The three index heavyweights – Nestlé, Roche and Novartis – have a weighting totalling around 40%. This is not only a significant cluster risk but also means many attractive companies only have very minor importance within the index – an ideal starting point for an active asset manager.

Potentially inefficient market segments

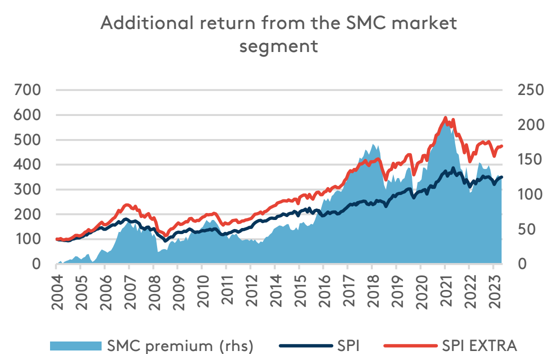
Let us assume you had decided to earn your living by betting on tennis. Which matches would you focus on? Would you mainly bet on the large tournaments with heavy media coverage, where the best-known players appear? Or would you focus more on the lesser-known matches that take place on the less important courts?

If you want to optimise your chances of winning, we think the answer is clear: you would concentrate on a niche where you have specialist knowledge. Your competition there is much less fierce than in the major competitions, where the combined brainpower is pitted against each other and the odds are such that the chances of a major win are correspondingly lower.

The same idea can also be applied to the equity markets. If you exclude the SPI's 20 large-cap stocks, the remaining approximately 190 companies in the small and mid-cap market segment (SPI Extra) have a combined weighting of less than 20%. Global asset managers are often unable to actively operate in this segment due to their investment volume: less competition increases the chances of additional returns.

In addition, these companies often also receive less attention, not least due to the significantly lower analyst coverage. While, for example, each of the 20 large-cap SMI stocks is covered by 25 analysts on average, this number shrinks for the remaining 190 or so companies in the SPI index to an average of five, with more than 80 of these companies being covered by no more than two analysts.[2] The probability of finding an undiscovered pearl is greater.

Ultimately, these less liquid securities often benefit from an "illiquidity premium", which compensates investors for the reduced tradeability. In view of the additional returns that this market segment has demonstrated in the past, this is an attractive source of returns for an investor with a long-term horizon.



Source: Bloomberg, own presentation.

[2] Source: Bloomberg, number of analyst estimates.

Consideration of sustainability criteria

Last but not least, active management means that clients' specific preferences or values can be catered for. Specifically, this may mean the exclusion of certain companies or industries and the consideration of sustainability criteria. Even though a large number of passive ESG products have been launched in the interim, you mostly end up with a non-transparent definition of sustainability here that cannot be influenced and is not necessarily in line with your personal views. In addition, these often only pursue a best-in-class approach. This means that those companies with the best sustainability performance within an industry are taken into account, which may run counter to the desired sustainability approach.

Active asset managers above a certain size often benefit from direct access to the management of the companies in question. This enables them to create a personal picture of the management and assess its quality. Finally, active asset managers have the opportunity to exert a direct influence if undesirable developments occur. This can range from voting at a company's general meeting to selling the whole position.

Conclusion

When deciding whether an equity investment strategy should be implemented by means of an active or passive investment, several criteria need to be considered. In particular, caution is required when uncritically relying on outdated study results. Instead, it is important to take the specific circumstances into account and give appropriately high priority to carefully selecting a serious provider with a long-term successful track record.

In particular, we regard asset managers with a clear and consistent investment philosophy, combined with a fair and transparent pricing structure, as well positioned. Successful active asset managers have sound analytical expertise and concentrate on regional or stylistic focal points. They use imbalances in the composition of the passive benchmark index to their advantage and operate in market segments that may be little followed or remain ignored by large investors due to their limited market size.

Finally, it is important to remember that pure "passive" investing is in any case an illusion. This is because if a passive product is selected to implement an investment strategy, numerous "active" decisions need to be made. These extend from the weighting of the individual asset classes and regional diversification, right through to the selection of the products used or the specific sustainability approach. In view of the complexity and high relevance of all these aspects, we therefore consider it advisable to involve an expert partner in the vast majority of cases.

Simon Subiaz
Deputy Head of Asset Management

Andreas Buner
Banks/Financial Service & Information Technology Analyst
Private Clients Advisor

The periodically published studies are available to download in PDF format on the Albin Kistler website:
www.albinkistler.ch/en/