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Active v Passive – has the demise of the active manager been exaggerated?

International Institutional Investor Series (IIIS) 2019

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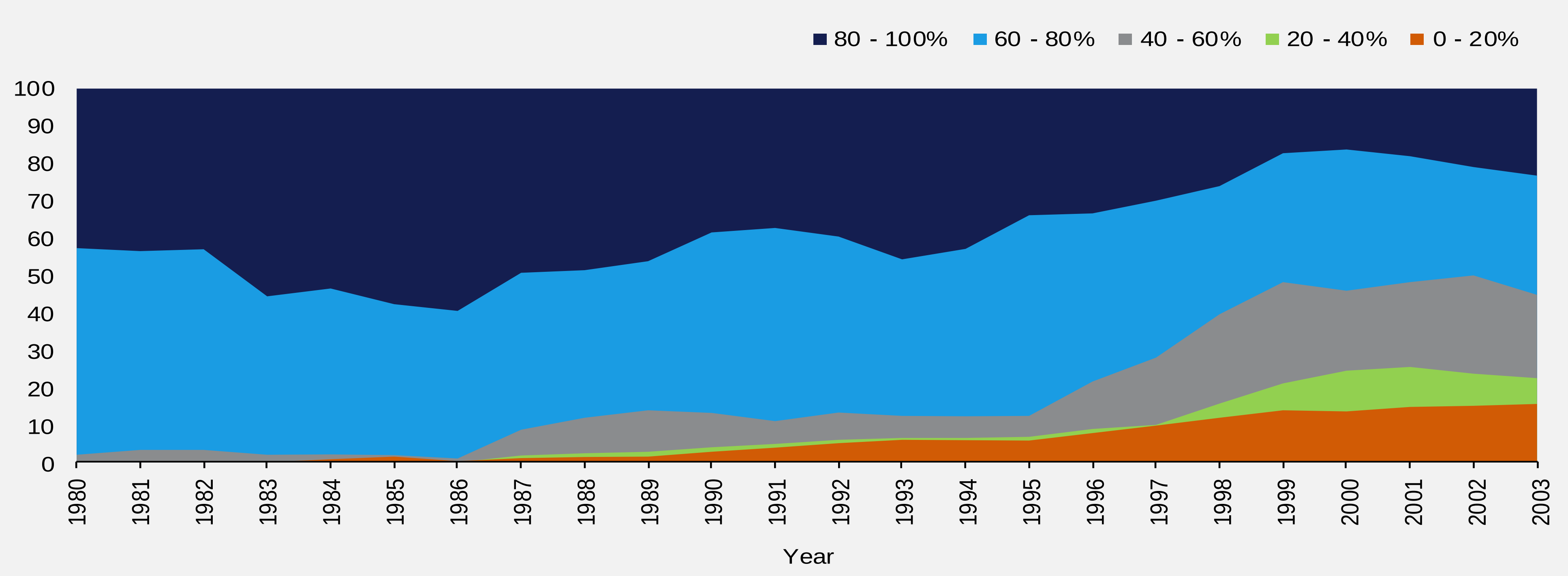
Strict and closet indexing has exploded in last 25 years, at expense of true active investing



- In 1980s, almost all mutual funds had active share of 60% or more
- Strict and closet indexing now accounts for around half of total AUM
- Indexing creates inefficiencies that can be exploited by active managers

Source: 'How Active is your Fund Manager?', Cremers & Petajisto, Mar 09

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In the US, the shift to passive has not slowed down

Flows from active picked up at end of 2018 and worse than 2017

	Large Caps		Mid Caps		Small Caps	
Year	**Active**	**Passive**	**Active**	**Passive**	**Active**	**Passive**
2006	-17.5	19.3	-19.4	2.8	-1.9	5.0
2007	-80.7	65.5	-14.6	3.6	-16.3	-0.2
2008	-116.4	87.2	-38.6	5.0	-13.2	10.6
2009	-73.7	-6.9	-6.0	2.7	-1.3	3.5
2010	-90.4	21.6	-2.3	7.6	-3.6	5.6
2011	-100.2	34.8	-10.3	-1.5	-12.4	-7.8
2012	-119.3	59.9	-19.8	7.9	-21.9	-1.7
2013	-42.9	103.7	9.6	22.2	-1.9	20.5
2014	-94.8	152.2	-17.0	12.4	-39.0	4.6
2015	-181.6	44.1	-40.9	21.0	-33.2	13.8
2016	-223.0	189.2	-59.7	15.8	-22.8	28.2
2017	-218.1	209.5	-45.2	17.6	-23.3	18.9
2018	**-214.7**	**190.3**	**-54.4**	**11.9**	**-25.3**	**23.8**
Total	**-1,573.3**	**1,170.4**	**-318.6**	**129.0**	**-216.1**	**124.8**

Source: EPFR; Jefferies

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And active continues to underperform

Year	2014	2015	2016	2017	2018	Q1 2019
% of outperforming US Funds	26%	47%	29%	51%	37%	54%

Source: FactSet, UBS Quant, May 2019

The average active fund has not added value for a decade. Cause or effect?

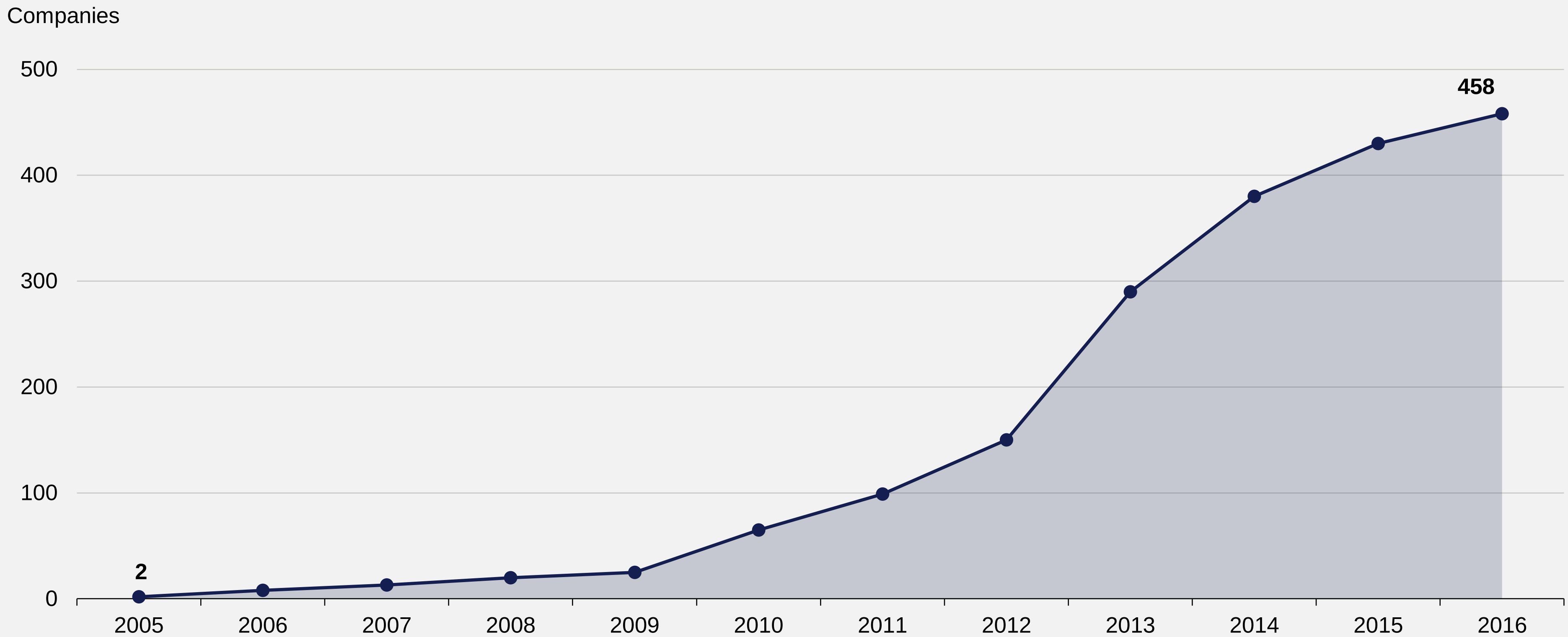
The last time managers outperformed as in 2009

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD
% Beating	45.8	70.8	53.4	48.2	24.2	36.0	47.3	25.1	62.6	49.3	51.8	33.4	36.0	36.5	45.1	23.0	44.0	29.8	43.3	42.0	43.0
Average Alpha	3.7	7.5	0.5	0.1	-3.7	-1.7	0.0	-2.7	2.2	-0.4	1.8	-1.4	-1.3	-1.1	-0.5	-2.6	-0.7	-2.2	-0.6	-0.3	-0.3

Note: 2019 is through Feb 28
Source: Lipper; FactSet; FTSE Russell; Jefferies

Has this shift caused the deterioration of active fund performance?

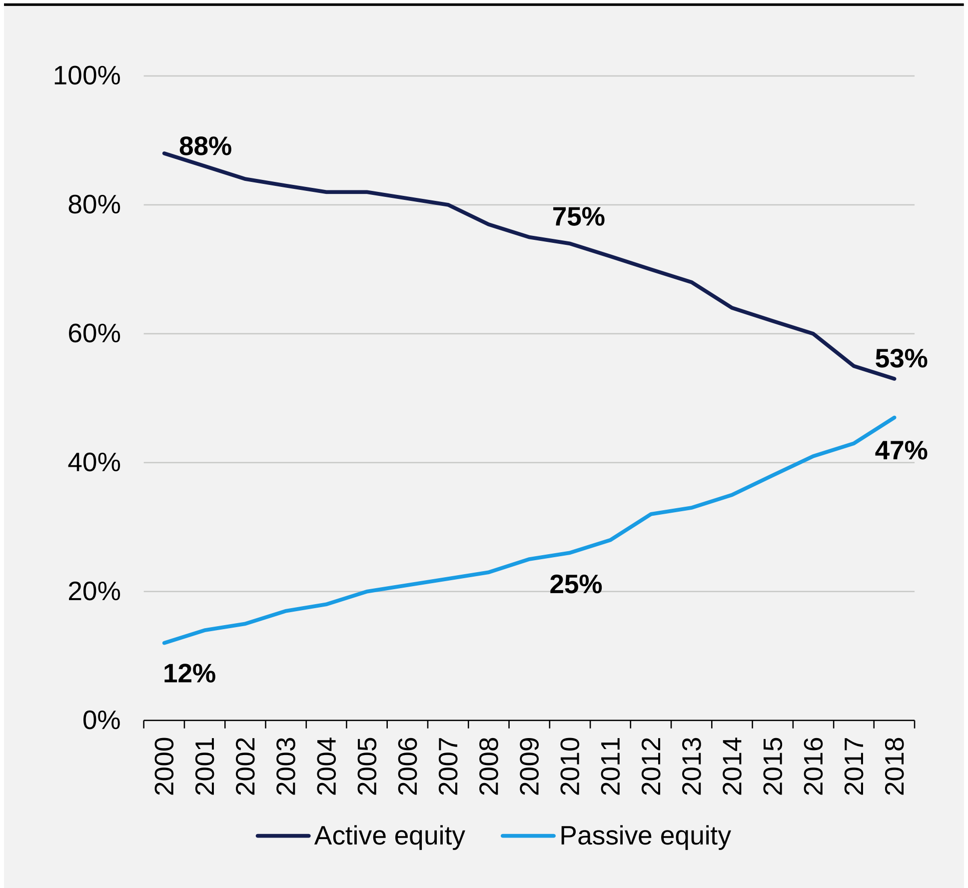
Taking Ownership – The number of S&P 500 companies in which passive mutual funds and ETFs collectively owned at least 10% has soared

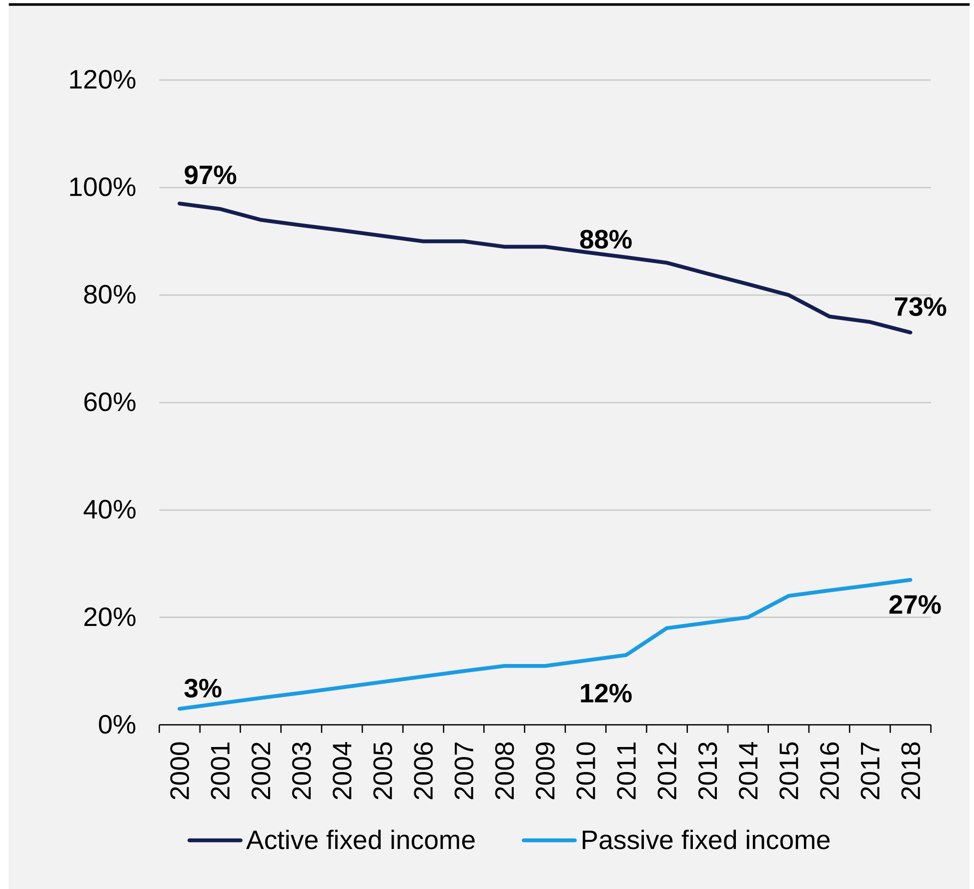


Note: Applies to total market value of share classes included in the S&P 500. All figures are for US based funds, as of year end except for 2016, which is as of Jun 30
Source: Wall Street Journal analysis of data from Morningstar (funds and stock ownership); S&P Global Market Intelligence (S&P 500 constituents, share classes, share counts and market values)

In US, passive funds now outnumber actives

Passive equity AUM nears Parity with active while passive fixed income adoption is accelerating





Note: Includes long-term mutual fund assets + ETF assets
Source: Morningstar

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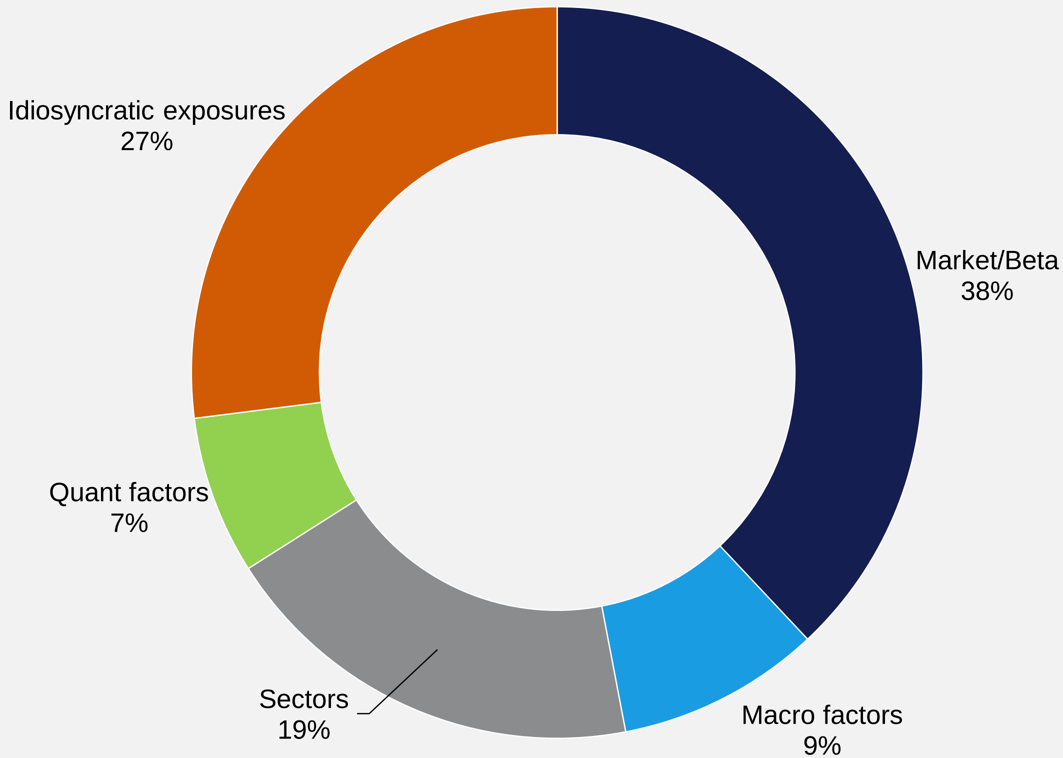
Yet at best, index moves only account for about 38% of returns

Return decomposition for MSCI World



Source: FactSet, UBS Quant. Chart shows proportion of matched PCA factor returns described by each factor group

Loss aversion is now more important than outperformance?

The need to quantify performance has led 'Tracking Error' to be equated with 'Risk'"

- Limiting tracking error is often seen as a way of limiting risk
- Important risk relates to **permanent** loss of capital e.g. bankruptcy
- Tracking error is associated with **temporary** loss of capital (day-to-day share price undulations)
- Limiting tracking error reflects an irrational fear of short-term volatility (short termism) combined with a lack of appreciation of the power of compounding
- Short-term volatility should be viewed as the cost of good long-term performance
- Any constraints should ideally relate to **factors** of investment performance (turnover, concentration, investment criteria) not investment performance itself (tracking error)

Source: "How Active is your Fund Manager?", Cremers & Petajisto, Mar 09

Why do we fear volatility?

- Asymmetric sensitivity to losses and gains
- We should welcome volatility as shares do not go up without it
- Important risk is about sudden lurches in volatility, not volatility itself (permanent capital loss versus temporary capital loss)

Source: Shutterstock Images

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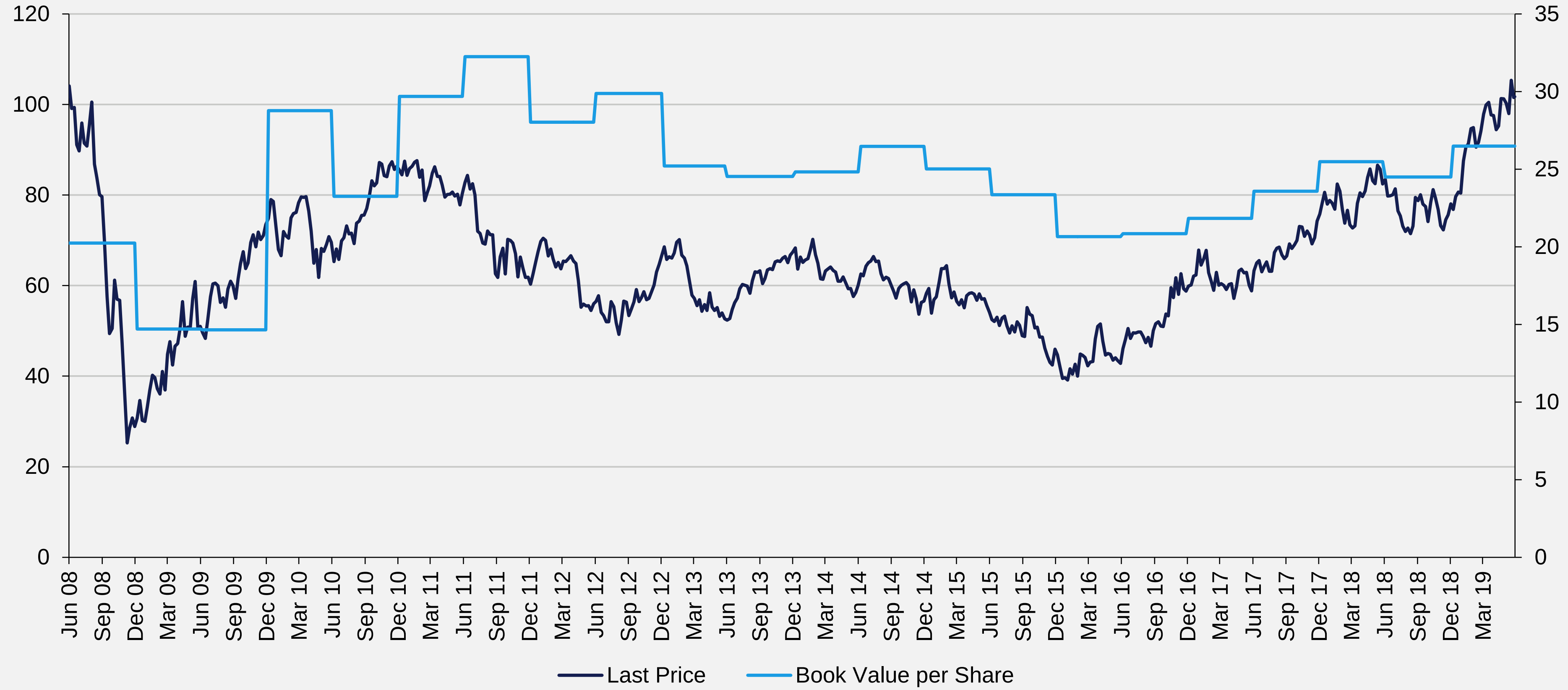
(i) What explains share prices?

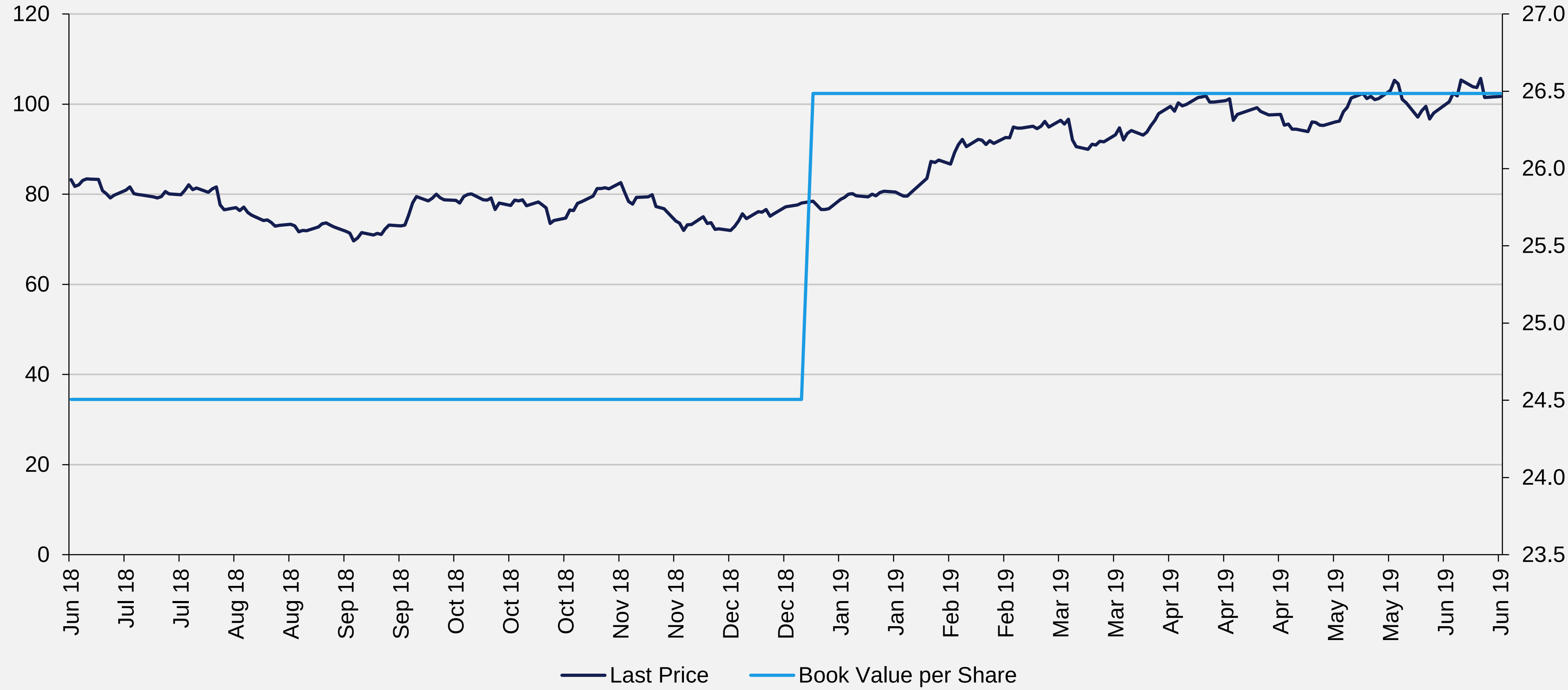
Rio Tinto over eleven years (Share price versus book value per share)



Source: Bloomberg, 24 Jun 19

(ii) What explains share prices?

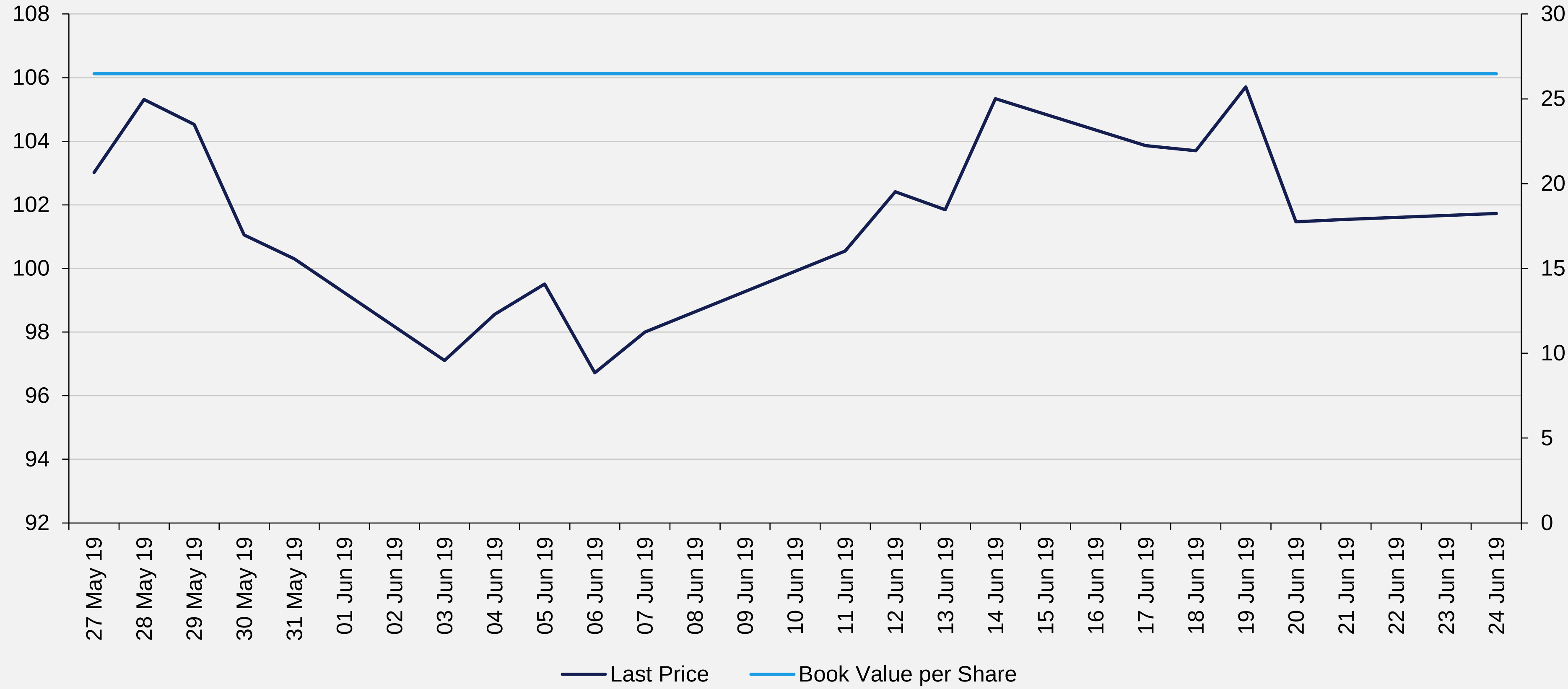
Rio Tinto over one year (Share price versus book value per share)



Source: Bloomberg, 24 Jun 19

(iii) What explains share prices?

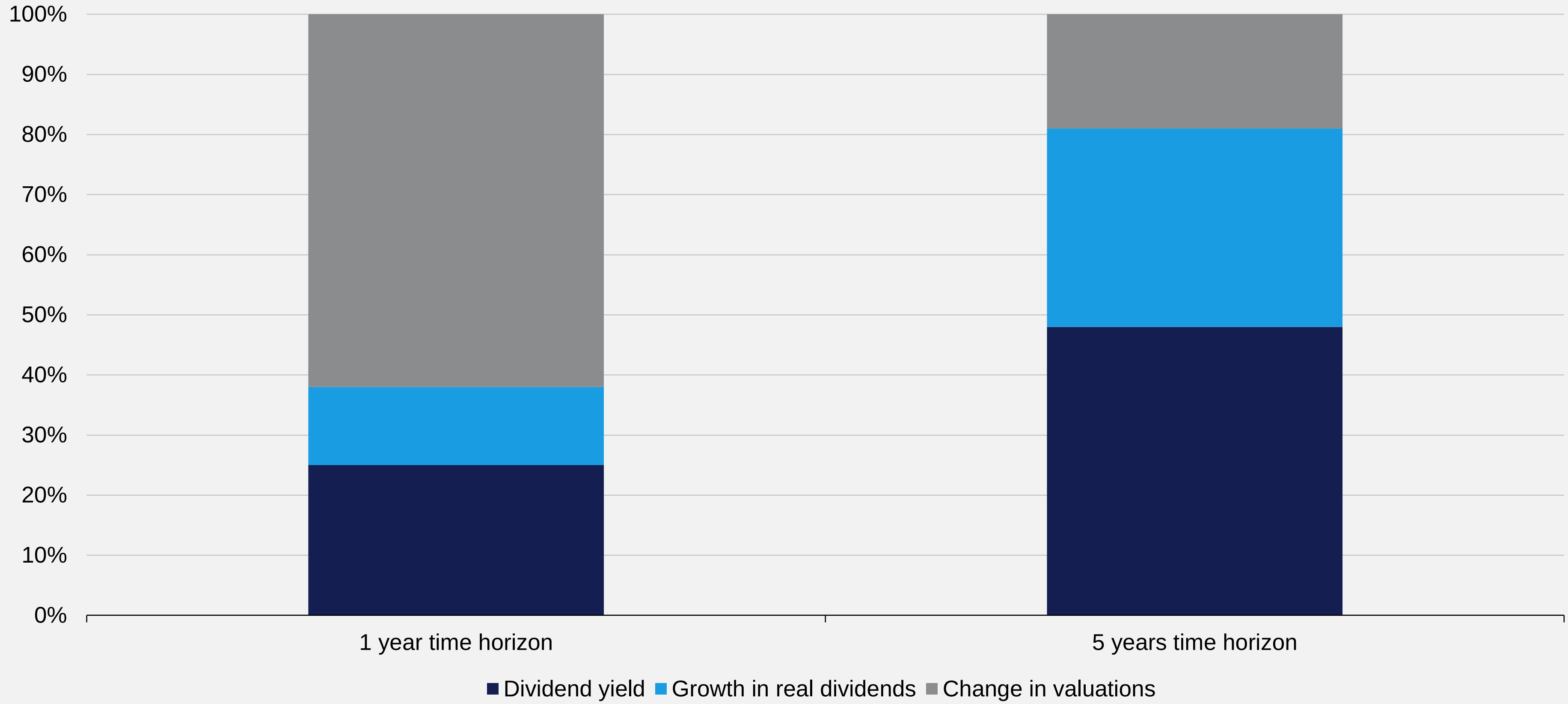
Rio Tinto over one month (Share price versus book value per share)



Source: Bloomberg, 24 Jun 19

It’s business performance that matters in the long run

Contributions to total real returns



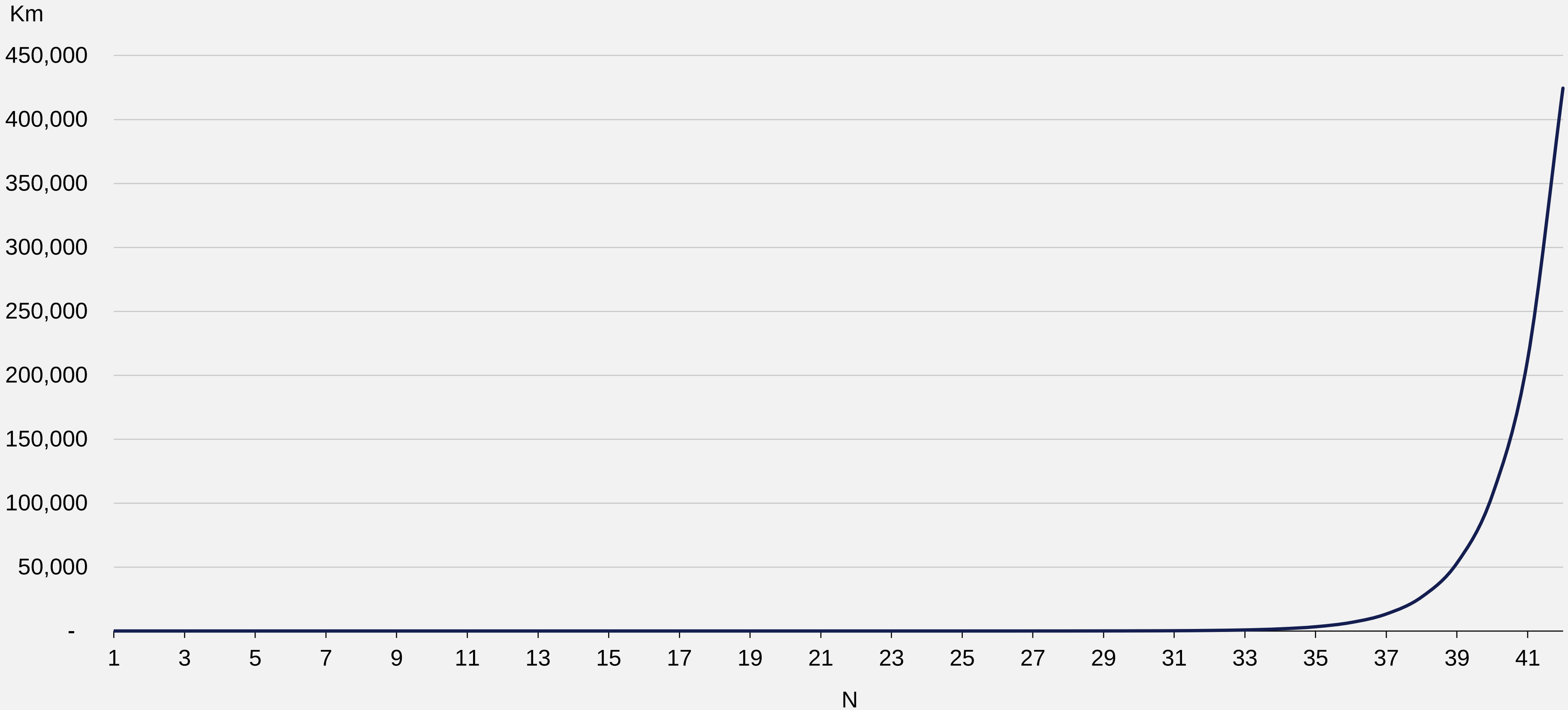
Source: SG Equity Research, 15 Jan 08

- **Question**: if you folded (compound rate of 100%) a piece of standard copy paper (0.1mm thick) 42 times how thick would resulting stack of paper be?
- **Answer**: 424,499km (distance from earth to the moon)

Source: Aberdeen Standard Investments

The most powerful force in the universe

Thickness of paper on Nth fold



Source: Aberdeen Standard Investments

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