Russell Investments

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Title: **The Active Versus Passive Decision for New Zealand Investors**

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Synopsis: Don Ezra and Geoff Warren have constructed a new framework for deciding between active and passive management ("When should you choose an alternative to passive investing?", January 2010). This paper applies their framework to the New Zealand context, drawing broad conclusions on an asset class by asset class basis.

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The Active Versus Passive Decision for New Zealand Investors

By Craig Ansley – Director, Capital Markets Research

In a recent Russell paper ("When should you choose an alternative to passive investing?", January 2010), Don Ezra and Geoff Warren presented a framework for deciding when to choose an alternative to passive investment within any particular asset class. (Passive refers to investment in a capitalisation-weighted index.) Five reasons are identified for seeking an alternative:

1. No readily replicable index is available.
2. The passive index is at odds with the investor's objectives.
3. The standard passive index is inefficiently constructed.
4. The investment environment favours active management in general.
5. Skilled managers can be identified.

The first three of these reflect situations where the passive index is either unavailable or unsuitable, while the other two relate to expectations that active management can outperform.

THE NEW ZEALAND PERSPECTIVE

In this paper, we examine the active-passive decision for the major asset classes used by New Zealand investors within the Ezra-Warren framework. To do this we look at each of the five potential reasons for investing actively and see how it applies to the products available to New Zealand investors.

For some assets, a clear case emerges for active investment. The choice for other assets is more debatable, either because the evidence is unclear, or because the decision relies on the preferences of the investor or their ability to access manager selection skills.

REASON #1: NO READILY REPLICABLE INDEX IS AVAILABLE

For some asset classes, there is no index available that could be replicated by a manager. These include:

- *Direct property;*
- *Direct infrastructure;*
- *Private equity;*
- *Hedge funds; and*
- *New Zealand credit.*

For these asset classes, active management is the only feasible choice.

Moreover, the most commonly used index for *global fixed income*, the Barclays Capital Global Aggregate Bond Index, cannot be replicated exactly, because it includes over 9,000 securities, many of which are not traded regularly, and there is no futures market to allow synthetic replication. Transactions costs to fully replicate the index would be burdensome, and so 'passive' managers use a sampling approach, i.e. they purchase just a representative subset. With a sampling approach, the tracking error is higher than for passive equity investment, and the default risk can be dramatic because of concentration in certain sectors. These issues are discussed in more detail in Ruff (2009). Because of these problems, active management is often a better proposition than passive.

REASON #2: THE PASSIVE INDEX IS AT ODDS WITH THE INVESTOR'S OBJECTIVES

This of course depends on exactly what the purpose is, but there are three common circumstances where the index is at odds with the investor's purpose:

- *Fixed income.* Often, the duration and credit risks in the fixed income index do not align with the investor's liabilities or risk preferences. For example, some investors have very long-dated liabilities, and wish to offset these with longer-dated bonds than the index. Other investors may not wish to accept some types of credit risk in the index, for example asset backed securities, or may set higher credit rating limits than the index.
- *Listed infrastructure*. An investor may wish to invest in infrastructure for specific return patterns, such as predictable cash flows or inflation protection. Because *listed infrastructure* indices typically cover all listed infrastructure, the investor may prefer an active manager that can tailor the portfolio accordingly.
- *Sustainable and ethical investing.* An investor with a sustainable investment objective might well set criteria that are different from the available indices. This is likely to be most relevant for equities.

REASON #3: THE STANDARD PASSIVE INDEX IS INEFFICIENTLY CONSTRUCTED

Assets where doubts arise over the efficiency of available indices include:

- *Fixed income*. Index composition is typically driven by the issuance cycle and debt retirement and is often not a complete reflection of the opportunity set. See Warren (2008) and Ruff (2009) for a discussion and explanation of these shortcomings.
- *Collateralised commodity futures*. The two CCF indices commonly used for passive products, the S&P GSCI and the DJ-AIGCI, are heavily skewed to particular commodity sectors (especially energy, and particularly so for the S&P GSCI). An active approach may allow for a more diversified exposure. In addition, the index calculation method of automatically rolling contracts leaves it vulnerable to short term distortions of supply and demand in the futures market.

REASON #4: THE INVESTMENT ENVIRONMENT FAVOURS ACTIVE MANAGEMENT IN GENERAL

Where an acceptable passive alternative exists - that is, there is a replicable index, efficiently constructed that aligns with the investor's objectives - the case for an active approach rests on the ability of managers to outperform. The first question is whether active managers in general can be expected to generate excess returns. Examining this issue in depth across all asset classes is too large a task for this paper, but we offer some general observations on historical performance and structural features of asset classes.

*(i) **Historical performance***

For the major asset classes that New Zealand funds invest in, Table 1 gives 10 year average excess returns (actual less index returns) for the median manager in the Russell universe. Reported returns implicitly include trading costs for active managers, but exclude management fees.

Table 1: Median Manager Gross Excess Returns 2000-2009

Asset class	Index	Excess Return[1]	Data Availability
NZ equities	NZSE40/NZX 50 Gross	2.6% p.a.	Q1-00 – Q3-09
Global equities	MSCI	0.6% p.a.	Q1-00 – Q4-09
NZ fixed interest	ANZ NZ Govt Stock Index	0.6% p.a.	Q1-00 – Q4-07
Global fixed interest	Barclays Cap Global Agg Bond Index	-0.3% p.a.	Q1-02 – Q4-09
Global listed property	FTSE EPRA/NAREIT Global Real Estate Index	0.9% p.a.	Q3-06 – Q4-09

[1]Excess return relative to benchmark of median manager in Russell universe.

The median manager has outperformed the index since inception in all asset classes examined except global fixed interest. For NZ fixed interest and global listed property, the excess return margin is small but still large enough to give a positive after-fee margin. For global equities, the position is not as clear.

Excess return data always need to be viewed with circumspection, of course: past performance is an unreliable guide to future performance.

(ii) ***Structural features***

As a general rule, excess returns might be expected to be less available in the core developed markets, which tend to be relatively efficient, populated with well-informed investors, and where many managers are competing for opportunities. The case for active management should be much stronger in markets that are somewhat secondary and less efficient, where competition between managers is limited, or where there is significant opportunity to participate in attractive new issues. Examples include global listed property, emerging markets and small cap equity markets.

REASON #5: SKILLED MANAGERS CAN BE IDENTIFIED

As we have seen, a case for considering active management can be made for most asset classes based on Reasons 1 through 4. For asset classes where the case is weak, manager selection skill is crucial to successful implementation of active management. For the asset classes in Table 1 where the median active manager excess return is small, Table 2 gives 10-year average benchmark excess returns for the average of Russell hire-ranked managers. The figures are based on the same benchmarks as Table 1, and are computed before fees.

Table 2: Russell Hire-Ranked Manager Excess Returns 2000-2009

Asset class	Excess Return over Benchmark[1]	Margin over Universe Median[2]	Data Availability
Global equities	1.8% p.a.	1.2% p.a.	Q1-00 – Q4-09
NZ fixed interest	0.6% p.a.	0.0% p.a.	Q1-00 – Q4-07
Global fixed interest	1.1% p.a.	1.4% p.a.	Q1-02 – Q4-09
Global listed property	3.2% p.a.	2.3% p.a.	Q3-06 – Q4-09

[1]Excess return relative to benchmark of Russell hire ranked manager average.

[2]Excess of Russell hire ranked manager average over Russell universe median.

Except for NZ fixed interest, the average of Russell hired-ranked managers comfortably exceeds both the benchmark and the universe median.

Once again, one must remember that past performance is an unreliable guide to future performance.

BRINGING IT ALL TOGETHER

Table 3 summarises initial views with respect to the major asset classes considered by NZ investors. It is notable that reasons such as the absence of an acceptable index can often all but rule out passive management in many asset classes: most alternative assets, fixed income and probably commodities. In other assets, an active approach seems preferable because of reasonable prospects for active returns, as evidenced by either historical experience and/or certain market features. NZ equities, emerging markets, and global listed property fit into this category. Nevertheless, in all these instances there will be a degree of reliance on manager selection skill. Global equities is the only asset class where the case for active management seems to rest almost entirely on manager selection skill.

Table 2: Active or Passive – Summary of Asset-by-Asset Views

Asset class	Factors affecting case for active management	Verdict
Equities		
New Zealand	– Active has historically added value.	Active
Global	– Average active outperformance small – Efficient and competitive markets	Case for active management depends on manager selection skill
Emerging markets	– Possibility that index and market are inefficient – Scope to exploit cross-market mis-pricing	Active
Fixed Income		
New Zealand	– Credit market is small and illiquid – Tailored approach may be preferred by some investors to capture specific exposures – Active added value small	Active, mainly to overcome index shortcomings
Global	– Fixed Interest indices are incomplete, inefficient, and difficult to replicate – Tailored approach may be preferred by some investors to capture specific exposures – Active added value historically mixed-to-poor	Active, mainly to overcome index shortcomings. Case improved by manager selection skill
Property		
Global, listed	– Active added value is mixed through time, but history is short and dominated by results during the recent global financial crisis – Evolving and less efficient markets should give rise to opportunities for active managers – Scope to exploit cross-market mis-pricing	Active
Direct	– Index is not replicable	Active (no choice)
Infrastructure		
Listed	– Active managers can tailor portfolio to ensure that desired characteristics are achieved	Active
Direct	– No replicable index is available	Active (no choice)
Other Alternatives		
Private equity	– No replicable index is available	Active (no choice)
Hedge funds	– No replicable index – Pursuit of alpha the justification for existence – Attempts are being made to replicate betas	Active (no choice)
Commodities	– Questions over efficiency of indices – Active offers scope to construct more efficient portfolios	Active, tailored to access a more efficient portfolio

RELATED READING

Warren, G. and Ezra, D. (2010), “When should you choose an alternative to passive?” *Russell Research* (January*)*

Ruff, M. (2009), “Complexities of Passive Management in Fixed Income”, *Russell Research Report* (May)

Warren, G. (2008), “Future of Fixed Income: An Alternative for Structuring Investments”, *Russell Research Report*, (May)

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