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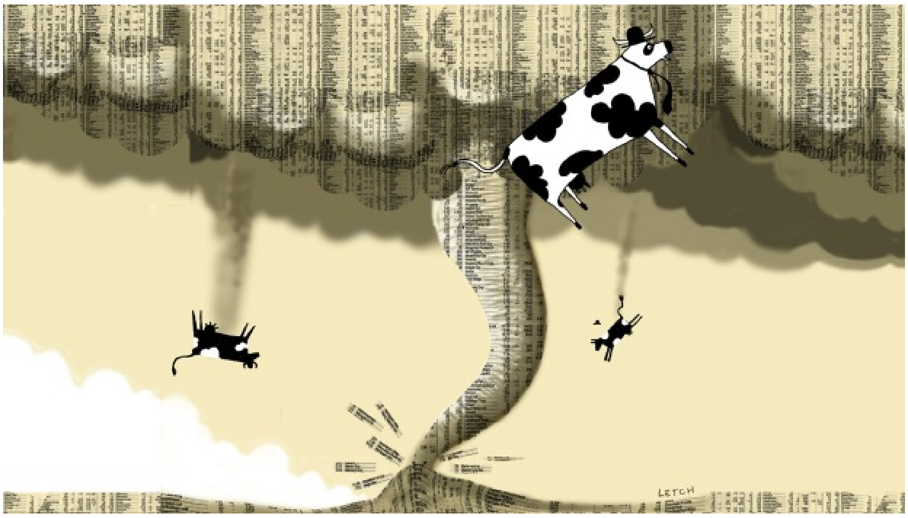
Passive investing is lobotomised investing



You can, of course, always fall back on the less elegant explanation that passive strategies suit because you have neither the time nor the wit to pit yourself day in, day out against the collective might of the great unwashed. **Simon Letch**

by **Christopher Joye**

Buying a "passive" or "indexed" fund is lobotomised investing, predicated on the beliefs that the market is smarter than you are, investors are systematically rational, assets are always properly valued as prices move in an unpredictable "random walk" and, finally, one has no ability to identify those "active" managers that do consistently beat benchmarks. (Yes, they exist.)

The problem is that every single one of these assumptions has at various times and across different sectors proven to be wildly incorrect, save for the question on your relative intellectual quotient and/or financial markets expertise.

For those who never want to engage in analysis and/or are convinced they possess fundamentally inferior faculties, passive strategies may certainly be preferable to an "active" approach. And let's be frank, many folks fall into this category.

Yet let's also bust the utterly misguided myth that passive investing is universally superior to active. By active we mean any strategy that seeks to deliver post-fee returns above those offered by a naïve market capitalisation weighted index, ideally in risk (or volatility) adjusted terms.

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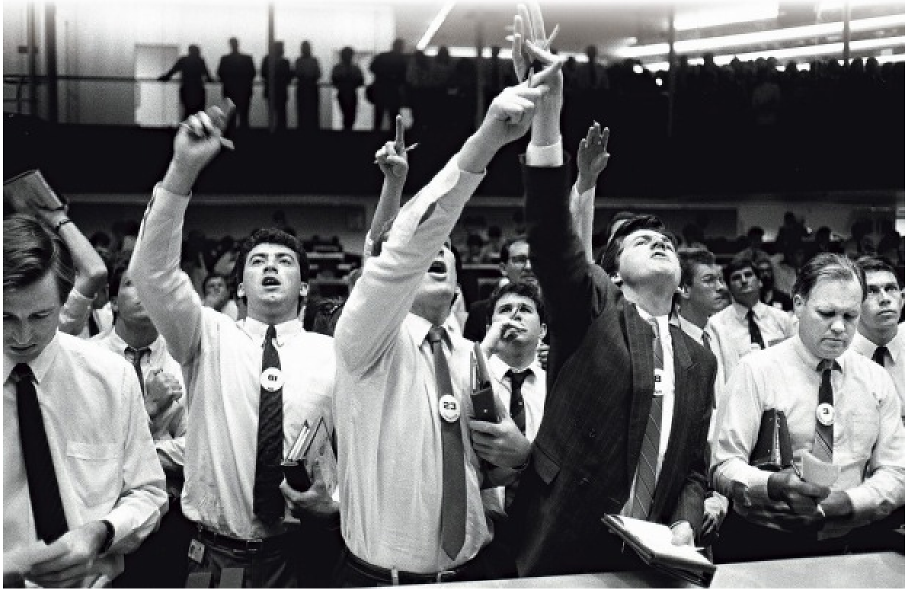

Recall the 1987 crash that followed the leveraged buy-out boom. **Anton Cermak**

Important features

So what are the problems with passive? First, there are many asset classes that are demonstrably inefficient when prices deviate materially from fair value, or intrinsic worth, and in which the average active "asset-selector" will comfortably trump passive indices. Think opaque sectors such as private equity, unlisted credit and residential and commercial property.

These domains share several important features that distinguish them from the price-efficient listed equities market: they are not traded on a transparent and low-cost exchange, public reporting on prices and volumes of all transactions is either non-existent (private equity, credit, commercial property) or delayed many months (residential property) and the participants who predominate are often non-professional investors, motivated by non-financial considerations (eg, owner-occupiers) and/or passive (eg, buy-and-hold) players, all of which furnish the active adversary with an edge.

Second, the foundation assumptions upon which Eugene Fama's heroically simplistic "efficient markets hypothesis" rests have been comprehensively invalidated in even the most "semi-strong-form" or price-accurate asset-classes.

Time and again, collective investor behaviour has been subject to bouts of persistent irrationality precipitated by innumerable behavioural biases that make a sham of Fama's idealised "homo economicus" (AKA the always accurate and objective human calculator).

Phil Lowe earned his intellectual bones in 2002 when warning that "financial imbalances can build up in a low-inflation environment". **Patrick Hamilton**

Vagaries of the human condition

This has led to huge mispricings or bubbles that have burst via savage and sudden 40 per cent plus drawdowns in global sharemarkets.

Recall the 1987 crash that followed the leveraged buy-out boom, the 2001 "tech wreck" that succeeded the internet-enabled "productivity miracle" in the late 1990s or the 2007 global financial crisis that emerged after we had convinced ourselves that house prices never fall?

Go back further through history and you will find that the ever-fragile vagaries of the human condition, polarised by the extremes of fear and greed, reassert themselves via hyperbolic asset price booms and busts over and again.

On every single measure, Australian house prices today are more expensive than their US counterparts were before the financial crisis. **Louise Kennerley**

Indeed, it requires the University of Chicago's entirely irrational hubris to contend otherwise. (You can, of course, always fall back on the less elegant explanation that passive strategies suit because you have neither the time nor the wit to pit yourself day in, day out against the collective might of the great unwashed.)

Even the conservative Reserve Bank of Australia has concluded that the "efficient markets hypothesis ... cannot explain some important and worrying features of asset market behaviour" with "financial market prices appear[ing] at times to be subject to substantial misalignments, which can persist for extended periods of time".

Wealth of empirical evidence

A third fact is that, in markets where the average active manager does underperform the index, you need not invest with him or her. There is a wealth of empirical evidence showing that dogs remain dogs and those with "hot hands" can consistently beat bourses over long periods.

Consider the US quant hedge fund Renaissance Technologies, which has on average returned 40.6 per cent annually after fees since 1987 (more than 2.4 times Warren Buffett's returns) with only one negative year since inception and one year in which its net return was less than 21 per cent.

This is not explained by insane luck: Renaissance's strategies are "systematic" positions implemented by computer algorithms exploiting non-random anomalies in pricing patterns that have been unearthed by years of rigorous research.

The final inconvenient truth for passive promoters is that the more successful they become, and the more money that is indexed, the greater the probability they will fail to beat the average active alternative.

This is because a passive strategy is completely price or valuation agnostic investing: it simply holds a basket of stocks that track the index – actually less than the index after fees – irrespective of whether those companies are cheap or expensive.

Profit from valuation errors

As more capital is passively allocated there are, by definition, fewer active managers (in a relative sense) working to correct mispricings.

The more passive a market is, the more inefficient the pricing process becomes, and hence the more likely it is that active investors will be able to identify and profit from valuation errors.

The ascendancy of the price-ignorant passive crowd can only, in the final analysis, propagate its demise as active managers inevitably provide superior performance.

Now this is not to say active guys are perfect. Active funds have done no favours for themselves by becoming closet "index huggers" that have no faith in their ability to exploit mispricings and that unavoidably underperform after fees.

They also give the industry a bad name when they adopt absurdly generous remuneration models (eg, performance fees for returns above 0 per cent).

One pervasive argument in favour of indexing is that it's uber cheap. Yet this idea that choosing the cheapest possible product always yields the best results is incredibly stupid. Would you apply this lowest common denominator logic when engaging a doctor, lawyer, accountant or new employee? No way.

There is normally an inviolable relationship between the price you pay for something and the quality of the good or service you receive in exchange.

When you buy food for your children, do you opt for imported Chinese milk powder or the organic local produce?

Most implicitly understand that there is a trade-off between cost and quality: you cannot buy a Mercedes Benz for the price of a Mini. And the same principle applies in finance: pay peanuts and you have a good chance of getting monkeys.

Talk's cheap

"Talk's cheap, money buys houses, and you can't smoke glory," was an aphorism my father favoured when I used to blather incessantly as a child, much as my own son does today. Reserve Bank governor Philip Lowe would have benefited from similar advice.

Patrick Commins's story during the week illuminated a criticism first tendered here. Lowe earned his intellectual bones in 2002 when warning that "financial imbalances can build up in a low-inflation environment", which was accompanied by the solution that "a monetary response (ie, interest rate increases) to credit and asset markets might be appropriate to preserve both financial and monetary stability".

"Monetary policy rules that do not take these imbalances into account may unwittingly accommodate their further build up," Lowe counselled.

After the global financial crisis hit, Lowe and his boss Glenn Stevens were fond of criticising the US Federal Reserve for keeping rates too low for too long, which they maintained contributed to the US housing bubble.

On every single measure, Australian house prices today are more expensive than their US counterparts were before the financial crisis.

All sensible experts agree that the post-2013 boom has been fuelled by the RBA's never-ending rate cuts.

Even the major banks have been privately calling on the RBA to raise rates. So it appears that Lowe's 2002 talk and the recent rhetoric blaming higher prices on (surging!) supply, is nothing more than hot air.

This time-series inconsistency in human behaviour is precisely why history tends to repeat itself.

The author is a portfolio manager/director of Coolabah Capital Investments and Smarter Money Investments, which invest in fixed-income securities.

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