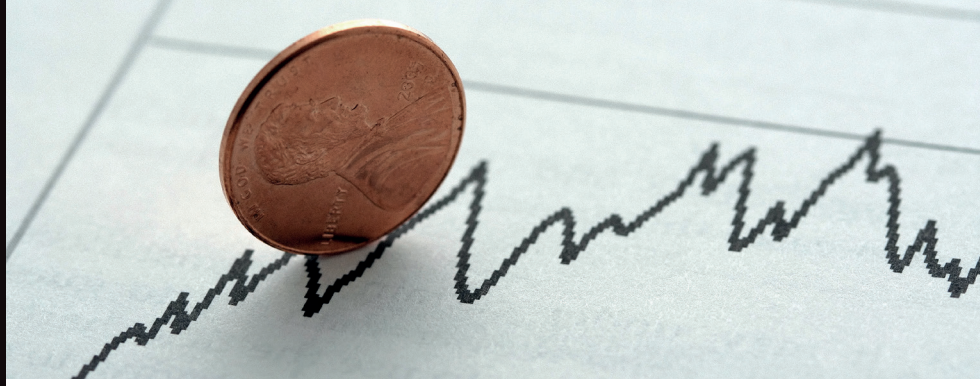
WORLDWIDE
ASSET MANAGEMENT



INSIGHT

Active Fund Management vs. Index-linked Funds

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Are investors becoming "closet communists"?

More and more often, you hear people criticise the concept of actively managed funds. The criticism is rooted in research indicating that actively managed funds underperform the market. However, you cannot expect the average fund to outperform the market, just like you cannot expect the average football club to do better than average. Certain so-called "experts" are given lots of space in the papers when they campaign for dumping managed funds trying to beat the market and moving to index-linked funds, whose raison d'etre is to provide a market return. The idea is to save on the costs of active fund management, which they claim fails to provide a better return.

However, embedded in the concept of index-linked asset management is the seed of its own demise: to a small extent, index-linked management can be a cheap way to achieve the attractive long-term returns available in a healthy market system, but this can only happen if active managers play absolutely dominant roles and make investment allocations expecting to maximise their future risk-adjusted return. In this case, the market sets the "right" price of shares and bonds through trading between informed counterparties. In such a world, an index-linked manager can act as a parasite on the back of active fund managers in a world of optimal capital allocation.

This is a world we should safeguard and make sure we do not lose. Asset management should be the domain of entrepreneurs and investors and should not be managed passively by administrators who do not consider the price of the product they are buying or selling. Otherwise, the consequences will be investment strategies based on minimising risk for the investing organisation rather than on maximising the risk-adjusted client return. There is already a distinct trend towards defining risk as deviation from the market return – the technical term is Tracking Error – and not as the risk of losing money. This potentially has several negative consequences.

1. The market allocates capital relative to size and not to the expected return on invested capital. The biggest stocks in an index receive the highest allocation, not because they have better prospects, but because the company has done well historically. In the world of bonds, the situation is quite grotesque: countries like the US, France and Italy are weighted higher in the index because they overconsume and therefore need to issue more and more sovereign bonds, which investors then must buy because they follow the index. At the same time, countries with prudent budget policies are weighted lower and lower, and investors buy less and less of their better-quality credit. The consequence is that indexation controls capital allocation. We previously saw such a system, one that in true communist fashion allocates according to size and not returns or skills, in the Soviet Union and, last time I checked, that did not end too well.

2. Environmental, Governance and Social issues (ESG) in investments is a rapidly growing trend, and something that ETF's and passive investors are not capable of addressing. Since index managers are passive owners they have little incentive to devote resources to monitoring companies; after all, they tend to compete on fees and their primary objective is to match the performance of indexes. The indexers have no choice in the stocks they hold, so why should they care what the companies do?

3. Index-linked fund management is the ultimate type of momentum investment. The more expensive a stock becomes, the more of the stock passive investors will have to buy. This means that index-linked management helps make the financial system even more unstable.

In other words, what certain "experts" are advocating when they recommend index-linked fund management could, at the end of the day, result in more misallocation of capital. This would lead to lower returns on invested capital, which in turn would lead to lower growth and a destabilisation of our financial system. The road to hell is paved with good intentions, as the saying goes. Index-linking could pose a major threat to our financial system and the capitalist market system, if passive investment becomes the dominant approach. Conversely, it should give the unrestricted active fund manager good opportunities to exploit the misallocation of capital. At one point or another, the momentum will cease, as we saw in 2000 and in 2007, and investors will be reminded that risk is the risk of losing money and not the risk of deviating from a benchmark. Index-linked investing is no free lunch.

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