A Bird's Eye View
Sparrows Newsletter
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Evidence based portfolio design

Can passive become the new active?

The rise of the ETF has been heralded as the triumph of passive investing over active, as the harbinger of the demise of the traditional asset manager and as the augur of the ascendance of the robo-adviser.

Whilst there are undoubtedly many merits to a rules-based, disciplined, systematic approach to investment, there are also arguments to suggest that active strategies still have a role to play.

Can these apparently incompatible disciplines co-exist in a single portfolio, and if so, how should they be combined?

The role and value of active management

When planning for a retirement nest egg there are many elements to take into consideration, such as expected earnings and liabilities, desired lifestyle, and investment risk. From a risk perspective it is vital not to place too many eggs into any one basket; in fact the closest an investor can get to a "free lunch" is by following the concept of diversification.

Diversification is not a new concept. The Talmud, an ancient script written many hundreds of years ago, tells us that a wealthy man should have one third of his capital in his business, one third in his property and one third he should keep in cash. Today, we can translate this ancient wisdom into an "asset allocation": split your capital equally between private equity, real assets and liquid investments. With hindsight, we know that this asset allocation would have stood the test of time.

However, this simple historical formula cannot, at least for now, be implemented via passive strategies alone. For a passive approach to track a market efficiently, prerequisites include: transparency (identifying the market's constituents), liquidity (the ability to trade them when necessary at minimal cost) and a market place to facilitate transactions. Private equity is neither liquid nor transparent; real assets are also illiquid. Attempts to transform liquidity tend to fail, as recently experienced by investors when open ended UK real estate funds suspended redemptions after the Brexit vote.

For the time being, it appears, exposure to certain asset classes is best achieved via active strategies.

The role and value of passive management

The capital markets have evolved substantially in recent decades, providing increased liquidity and efficiency. The evolution of passive investment allows investors to capture global market returns in a highly cost effective fashion, while benefitting at the same time from broad diversification. Here, passive has an edge over active, since the costs of running active strategies in highly efficient markets tend to erode any benefit over the long term.

This is why Warren Buffett recommended, in his latest annual letter, that all investors, small or large, adopt index strategies and avoid paying high fees to active managers.

Enhanced portfolio design

A concept applied by institutional investors for many years, now gaining momentum with individual investors, is the 'Core / Satellite' approach. Under this methodology, the core portfolio component invests in developed, liquid, markets with the intention of capturing market returns, in a manner consistent with the investor's risk profile, while minimizing costs. This core element therefore follows a long term, systematic approach, expressed via ETFs and index funds. Costs associated with managing and executing the core are carefully examined and rationalised.

The objective of the core portfolio is to harvest - as efficiently and effectively as possible - market returns across economic cycles, without any attempt to outsmart the aggregated wisdom contained within that market.

With the base portfolio return safely harnessed, attention can then turn to the more complicated process of surrounding this core with selected satellite investments intended to add value via specific tactical or thematic strategies. These may include illiquid holdings (real estate, private equity, and infrastructure) and specialist products, which attempt to exploit pricing anomalies in specialist sectors of the liquid markets. In the latter case, such products should always be suitably benchmarked to allow manager performance to be monitored and challenged.

We all know that nobody can predict the future. Most of us know that the time-tested advice of our elders is priceless. Adapting rules written many generations ago to the modern environment enables us to nurture our nest egg, to avoid pitfalls, and to enjoy the best of both worlds.

Yariv Haim
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