VIEWPOINT

In defence of active management

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There is a commonly held, but deeply misguided perception that the average active manager does not represent value for money because they cannot beat a cap-weighted market benchmark.

One aspect of this perception is true – the average active manager cannot beat a cap-weighted market benchmark. But that's where the truth ends.

The reason for that lack of outperformance does not stem from lack of skill, as is widely believed. This perception problem haunting active managers is rooted in a very simple, yet profound, misunderstanding both of market benchmarks and how the market works.

Benchmarks are an output

The belief that active managers do not represent value is fuelled by misguided arguments made by passive managers – including pioneers of index investing who have been known to call active management "a loser's game" and have argued most investors should favor passive investment and avoid active management.

This argument confuses the role of benchmarks in investment.

By definition the average active manager cannot outperform the benchmark because the benchmark is determined by the sum of activity carried out by both active and passive managers. And because passive managers have no impact on the benchmark – they merely follow it - it is, in fact, the sum of all the bets taken by active managers that determine the benchmark.

Thus, it is plainly obvious that it is impossible for the average active manager to outperform (or underperform) the average active manager. The benchmark is, after all, the output of all the activities carried out by active managers.

Active capital, active economy

The role of active managers as a group is to drive the benchmark upwards by allocating capital to companies that add value to the economy. If they instead allocate to companies that destroy value, the benchmark will fall.

Passive management makes no judgement call on whether the companies in a benchmark create or destroy value. They simply track the decisions made by active managers. Taken to its extreme, the absence of active management would lead to the destruction of the economy as we know it, since Capitalism cannot exist without capital allocators.

In this context, long-term investors' decision to opt for passive management strategies means that a critical pool of capital is effectively resigning its role in value creation or generating economic growth in the long-term. Yet, it is the role of investors to ensure wealth generation for the savers whose money they are allocating. If passive management is toxic for the economy and therefore for investment returns, long-term investors deciding to track a cap-weighted benchmark are simply abandoning their responsibilities.

In fact, the main group of people involved in running the process of wealth creation is long term investors allocating to active managers. It is obvious today that that neither governments nor central banks can succeed in fulfilling that role.

The role of active managers

It is vitally important that investors understand benchmarks are an output of the investment management industry, and should never be used as an input. As we have seen, confusing this point is dangerous for both their own investment performance and for the economy as a whole. Yes, the average active manager cannot beat a cap-weighted benchmark, but that does not mean they are useless as a group. Far from it.

The role of active managers as a group is not to outperform the index, but to drive that index and, therefore, the economy. They play a vitally important role in creating wealth and prosperity for savers and should very much sit at the heart of portfolio management strategies.

In turn, long term active managers should recognise their role is not to beat a benchmark – they are the benchmark. They play a much more fundamental role, they run the economy and should focus on doing the best possible job in that role.

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