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The vital role of active managers in value creation

By YVES CHOUEIFATY

During the last 100 years, not once has the average racer beaten the average speed.

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 capitalization-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 fueled 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 asset owners 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 upward 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 judgment 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, because capitalism cannot exist without capital allocators.

The role of active managers as a group is not to outperform the index, but to drive that index and, therefore, the economy.

In this context, long-term asset owners' 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 asset owners 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 asset owners 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 asset owners 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 asset owners 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 recognize 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.

Yves Choueifaty is CEO and founder of TOBAM S.A.S., a Paris-based investment management firm.

Passive managers take to shareholder activism

Influencing companies by engagement, proxy voting

By RONALD P. O'HANLEY

More than $413 billion flowed into U.S.-based passive funds in 2015, according to Morningstar Inc., raising questions as to whether those passive investors can have sufficient influence on the companies receiving their capital based simply on their inclusion in an index.

Three academics — one from Boston College and two from the Wharton School, University of Pennsylvania in their 2014 research paper "Passive Investors, Not Passive Owners"— show how investors' interests are unquestionably being represented aggressively by passive fund managers.

I agree, and say the influence gap can be bridged as long as passive managers get active on behalf of their investors and in the interests of long-term value creation.

Unlike active managers who can sell companies when they disagree with management, passive managers represent near permanent capital that cannot vote with its feet — as long as a company is included in the index it remains in the portfolio. But that long-term ownership requirement actually enhances influence and perspective.

As passive flows grow, managers have a distinct responsibility to become long-term asset stewards and actively engage with companies in the index across a range of important governance and sustainability issues that are key to generating value over the long run.

But how can passive managers make a difference when they are required to own every stock in the index? The most effective way to create meaningful change is to build a thoughtful engagement program with a focus on sector, thematic or market-specific issues that can scale across multiple companies. Managers can identify companies for active engagement based upon criteria such as the size of holdings; poor long-term financial performance within a sector; lagging market and industry standards; or priority themes and sectors according to emerging environmental, social or governance risks. However, they must also be prepared to use their voting power to reinforce value priorities with clearly articulated rationales if engagement falls short.

Active stewardship

There are several areas where passive managers can get active with their asset stewardship to influence corporate governance and sustainability issues. Ensuring strong independent board leadership is increasingly important for providing a counterweight to management and achieving an appropriate balance between a company's short- and long-term objectives, as concerns grow over corporate short-termism. It provides an effective mechanism for assessing the performance and compensation incentives for management in the context of a company's long-term strategy.

Engagement on sustainability issues can take a variety of forms across environmental and social issues.

One recent sector project focused on oil and gas companies across our global holdings and led to discussions around how companies are navigating the challenges of falling crude oil prices, geopolitical risks emerging from Russia, Africa and the Middle East, as well as the ongoing debate around climate change, stranded assets and emission reductions. Talks with a Taiwanese packaged food company centered on monitoring food safety within its supply chain. Meetings with a garment sector company brought up how supply chain labor and fire safety standards can be improved. And after a multiyear engagement effort with various companies on environmental standards, we saw significant improvements in the quality and transparency of reporting around hydraulic fracturing processes as well as water and waste management practices. In addition to company-specific dialogue, we also engage with local regulators and government agencies to address systemic, marketwide concerns.

Voting power

By consolidating voting decisions and engagement, managers can harness the full power of their company holdings and exert greater influence with management and boards. Proxy advisers are a useful source for data and analytics, but we believe managers should not outsource their votes to them. Unfortunately, far too many managers continue to do so. In a 2014 study, "Are Mutual Funds Active Voters?," two academics from Pennsylvania State University found that more than 25% of mutual funds indiscriminately voted with the recommendations of a proxy adviser across all companies in their portfolios over a five-year sample period. We also believe stewardship should extend beyond proxy voting and engagement to include promoting investor protection for minority shareholders in global markets through partnerships with local investors and regulators.

Rising passive flows are raising the ownership stakes and influence of passive managers in companies around the world. With great influence, however, comes great responsibility. In a global economy struggling with structural and technological disruptions, passive managers need to get active. Long-term active stewardship can make a lasting and positive difference across the corporate universe.

Ronald P. O'Hanley is president and CEO of State Street Global Advisors, Boston.

Excerpt

Confronting exchanges' declining listing standards

***Rick A. Fleming**, investor advocate, Securities and Exchange Commission, in a Feb. 19 address to The SEC Speaks, a program of the Practicing Law Institute, Washington:*

I would argue that the (New York Stock Exchange) listing standards, and especially their quantitative standards, have tended to drift downward like a leaf in autumn. ... Occasionally, there is a scandal or a statutory mandate that comes along and acts as an upward draft, and the listing standards are pushed higher in response. But, when the wind stills, the leaf begins its gradual downward drift, pulled by the relentless force of gravity or, in the case of the exchanges, profits. And over time, small incremental changes can add up to a significant deterioration of the listing standards. ...

Even more important, I believe the exchanges should resist the temptation to engage in a race to the bottom. ... It is concerning, then, to see the NYSE justify so many changes in its rules by pointing to its competitors who traditionally have catered to different types of companies.

More broadly, in an age of for-profit exchanges, where exchanges have an inherent conflict between the interests of investors and their own bottom lines, it may be time again for the commission to confront the larger question of whether it makes sense for a for-profit business to be entrusted with the regulatory responsibilities of (a self regulatory organization). Based upon the evidence I've seen so far, I believe investors have cause for concern.