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Busting common passive investing myths

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The debate over active versus passive management has seen many myths and misconceptions around which is best — passive strategies which track indices such as the ASX, or active strategies where managers aim to outperform via astute stock picking.

Investment is a long-term game, and investors must evaluate each manager on their merits: performance, philosophy, fee structure and ability to protect capital.

Most importantly, investors need to ensure they are getting genuine active management if they are paying active fees.

Many managers claim to be active but are essentially index trackers.

Some common myths and misconceptions about passive investing include:

Myth 1: Passive strategies are cheap

Passive strategies have low fees, but these don't reliably indicate value for money. Passive seems cheap because when tracking an index, there is less need for manager skill and research.

It's a bit like a smorgasbord where, for a relatively low cost, you can pile masses of foodstuffs on your plate. You're paying for quantity over quality.

Many investors see the value in paying for an active manager's skill, including the ability to select stocks and protect capital.

Sometimes the value will become clear during difficult markets; if a passive strategy cannot protect capital, it may be costly in the long run.

Many active managers use performance fees, which means the bulk of active fees are only paid when the manager is outperforming.

Provided the performance fee is pegged to a reasonable benchmark, it's a win-win for both investor and manager. (Investors should always seek performance numbers net of fees.)

Myth 2. Passive strategies outperform active over time

This sentiment has become fashionable but deserves greater scrutiny. Performance fluctuates, and each active manager has their own style and benchmarks.

Saying one strategy outperforms the other is a massive generalisation.

Investors can benefit by digging deeper, considering each active manager on their merits and ensuring they are genuinely active and not just hugging an index. There are good and bad managers.

Consider the long term, and consider how your capital is protected during downturns.

Myth 3. Passive strategies are low-risk

Tracking an index is not low-risk. Passive investing may not protect investors against market downturns.

Investors wondering how severe an index can fall need only consider the ASX 200 almost halving in value during the GFC — yet many active managers did not experience falls nearly this severe.

Active managers have many ways to limit the downside, including stock selection, portfolio construction and the ability to increase their cash allocation.

Some active managers may even be able to allocate 100 per cent to cash during major downturns as a safety net for tough times.

Investors must remember that long-term outperformance is not just about picking good stocks; it's also about managing the tough times.

Myth 4. The market is always right

To assume active managers cannot beat the market over time is to assume an efficiently priced market. Yet there is a wealth of evidence, including the GFC, the tech-wreck and various market crashes, which show that markets remain inefficient.

Markets produce boom-and-bust scenarios as they are driven by two strong human emotions: fear and greed.

This manifests in herd-like behaviour: to track the index is to run with the herd.

Good active managers will consistently find good long-term investments at good prices, by exploiting market inefficiencies in pricing. Good active managers are forward-looking, on the hunt for quality and growth.

Indexes are backward-looking. Passive strategies over-allocate to stocks and sectors which have experienced price increases, and will shed stocks whose price has fallen (therefore missing good buying opportunities).

Running with the herd may work for a little while, but history shows the benefits in being agile, locating quality over quantity and protecting capital.

Myth 5. The smart money is going passive

What are the consequences of more money going to passive investing? The more passive a market becomes, the greater potential to push certain stocks and sectors higher as the herd becomes bigger.

The more passive a market, the more inefficient the market will become.

Ironically, this will provide more opportunities to the active managers, as they can exploit the inevitable mispricing that will occur.

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