Laurus
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"People who have information about an individual case rarely feel the need to know the statistics of the class to which the case belongs."
Daniel Kahneman, "Thinking Fast and Slow"

In our last comment, we focused on looking ahead towards future flattening market returns and the necessity of having long-term goals rather than a short-term performance horizon. We contend that active management is built less on rising markets, and more on protecting capital when markets invert, thereby having more residual capital to grow when Mr. Market eventually turns positive.

As active managers, another concept we are faced with is "skew" – the idea that just a handful of stocks often drive the entire market's performance. For example, in the three-year period ending December 31, 2017 the SP500 Index rose 11.4% whereas just owning the top ten stocks equally would have generated performance over 12% for the period (all in USD).

A recent article by Arizona State University finance professor Hendrik Bessembinder entitled "Do Stocks Outperform Treasury Bills?" noted the following: "When stated in terms of lifetime dollar wealth creation, the entire gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed companies."

The skew effect does not mean active management is futile. While these academic contentions may be somewhat correct over specific point-to-point periods, there are few investors willing to suffer the volatility of a highly concentrated portfolio of ten stocks over the same period. Over the same three-year period above, 310 stocks (62% of the index holdings) outperformed the SP500 index; broader diversification will provide less volatility.

The skew is exacerbated by passive investing. As the latter has become a predominate method for retail investing, markets have begun to act differently than they have in the past. Stocks are indexed by market capitalization and therefore, as the amount of passive investing increases, fund flows will be skewed to the largest firms whether these companies are performing or not.

One could argue that the passive trade more resembles momentum-style investing given there are no valuation or other parameters around the investment other than size. These effects are currently counteracted by active investors – those looking for inefficiencies caused by passive investing – but as the dominance of passive increases, the less effective the counteraction will be.

Comparatively, a good active investment manager will try to understand the investment objectives and risk tolerance of their investors. This will translate into an investment policy with risk and return goals that lead to the selection of specific securities to populate portfolios which, in turn, will respond to results and the changing circumstances of the investor. The action of security selection is only a small part of the set of decisions that affect investment outcomes.

Investors typically underperform their investment potential by not marrying the investment risk of their portfolio to their capacity, by not diversifying sufficiently, by being driven by emotional decisions ("buy high, sell low") and other common mistakes. Passive investing does not address most of these pitfalls

The contribution of active management is substantial. Active managers seek relevant information, analyse it to determine value and select securities accordingly. In the process, they help to set prices and reflect the expected risk of investment. The efficient allocation of capital in our market-based economy relies on this mechanism. Further, the search for superior performance results in the application of discipline to corporate management, both through the corporate control and shareholder engagement.

Equity markets look to be moving in a direction that could favour active management. After an extended period of time when stocks, sectors, and even asset classes tended to rise and fall in tandem, the trend is weakening with correlations declining over the past year or so. A flat market could mean greater dispersion in the performance of individual stocks (as noted above), which creates the opportunity to find investments to capture value.

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