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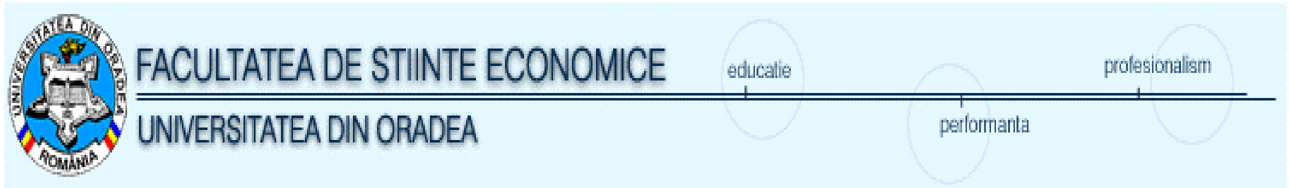

Passive Versus Active Strategy

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Abstract

The paper treats the debate about active management versus passive management, presenting the two extreme views supporters and opponents of EMH theory, the most common used active and passive strategies, with their theoretical grounds and empirical studies.

One of the most controversial and intriguing issue in investments is the market efficiency. The Efficient Market Hypothesis (EMH) asserts that the current price of a security fully reflects all available information and is the fair value. This way, by reflecting the knowledge and expectations of the investors, as new information arrives in an efficient marketplace causing a revision in the estimated economic value of a security, its price adjusts to this information quickly and, on balance, correctly. This makes impossible to consistently beat the market.

An efficient market does not have to be perfectly efficient in order to have a major impact on investors. It is required that the market to be economically efficient. That is, after acting on information to trade securities and subtracting all costs (transaction costs and taxes), the investor would have been as well off with a simply buy-and-hold strategy. If the market is economically efficient, securities could depart somewhat from their economic values, but it would not pay investors to take advantage of these small discrepancies.

A natural outcome of a belief in efficient markets is to employ some type of passive strategy in owning and managing common stocks.

If the market is totally efficient, no active strategy should be able to beat the market on a risk-adjusted basis.

The Efficient Market Hypothesis has implications for fundamental analysis and technical analysis, both of which are active strategies for selecting common stocks.

Passive management, on the other hand, stands on solid theoretical grounds, has enormous empirical support and works very well for investors.

The intellectual origin for the role of free markets and the price system goes back to Adam Smith. He was the first to offer a comprehensive statement that markets work and that a free market is the best way for a social order to allocate the resources. In his Wealth of Nations he shows that countries with such a system prosper, while those without do not. Friedrich Hayek extended the work of Smith and tried to provide insight as to why and how the free market system works. The key idea is that the price system is a mechanism for communicating information. The knowledge that is relevant for producing any good or service is never possessed by a single individual or a single group. Rather, it is dispersed among many market participants. The price system acts to spread this knowledge and coordinate the actions of individuals. As Hayek pointed out in his Nobel laureate lecture, we are only beginning to understand how subtle and efficient is the communication mechanism we call the market. It garners, comprehends and disseminates widely dispersed information better and faster than any system man has deliberately designed.

Passive strategies do not seek to outperform the market, but simply to do as well as the market. The emphasis is on minimizing transaction costs and time spent in managing the portfolio, because any expected benefits from active trading or analysis are likely to be less than the costs. Passive investors act as if the market is efficient and accept the consensus estimates of return and risk, accepting current market price as the best estimate of a security's value.

Passive strategy can be considered the simply buy-and-hold strategy for whatever portfolio of stocks, the investment in a common stocks portfolio adjusted to an index, the buy-and-hold strategy of the ten highest dividend-yielding stocks among the index at the beginning of the year or the investment of important amounts in mutual funds and pension funds.

The buy-and-hold strategy means that an investor buys stocks and basically holds them until some future time in order to meet some objective. The emphasis is on avoiding transaction costs or additional search costs. The investor believes that such a strategy will, over some period of time, produce results as good as alternatives that require active management whereby some securities are deemed not satisfactory, sold, and replaced with other securities. These alternatives generate transaction costs and involve inevitable mistakes.

The buy-and-hold strategy is applicable to the investor's portfolio, whatever its composition, being important the initial selection of the stocks. This strategy implies also some function specific to active management, as: the reinvestment of the income of the generated portfolio in other securities, the increasing or reducing of the portfolio's diversification, when the correlation between one stock and the market is too strong or weak.

A possible alternative of the passive management is to buy-and-hold the ten highest dividend-yielding stocks among the index at the beginning of the year, hold for a year, and replace any stocks if necessary at the beginning of the next year with the newest highest-yielding stocks in the index, This strategy does not require stock selection since it is based only on using the easily calculated dividend yield for the identified stocks, and making substitutions when necessary.

An increasing amount of mutual fund and pension fund assets can be described as passive equity investments.

Using index funds, these asset pools are designed to duplicate as precisely as possible the performance of some market index.

Using passive strategies there are no attempts to forecast the market movements and act accordingly or to select under-or overvalued securities. This way the expenses are kept to a minimum, including research costs, portfolio managers' fees, and brokerage commissions.

Investors who do not accept the EMH, or have serious doubts, pursue active investment strategies, believing that they can identify undervalued securities and that lags exist in the market's adjustment of these securities' prices to new information. These investors generate more search costs, both in time and money, and more transaction costs, but they believe that the marginal benefit outweighs the marginal costs incurred.

In applying active strategy, the investors consider that they possess some advantage relative to other market participants; such advantages could include superior analytical or judgment skills, superior information, etc.

The most traditional and popular form of active stock strategies is the selection of individual stocks identified as offering superior return-risk characteristics. The stocks are selected using fundamental security analysis, but technical analysis is also used, and sometimes a combination of the two. Many investors have always believed, and continue to believe, despite evidence to the contrary from the EMH, that they possess the requisite skill, patience, and ability to identify undervalued stocks.

One of the features of the investments environment is the uncertainty that always surrounds investing decisions. Most investors recognize the spread of this uncertainty and protect themselves accordingly, by selecting the stocks to buy or to sell in order to realize a diversified portfolio.

The central focus of the analysts' work is the attempt to forecast the stock returns. This involves the direct forecast of a specific company's return or the use of valuation models. Investors interested in stock selection use valuation models, and for inputs they can utilize their own estimates or, in some cases, use those provided by analysts.

The major sources of information used by analyst in their work are the financial statements, annual reports and companies' top management presentations established by market authorities.

The variables of major importance in their analysis include expected changes in earnings per share, expected return on equity (ROE) and industry perspective.

The active strategy involves shifting sector weights in the portfolio in order to take advantage of those sectors that are expected to do relatively better, and avoid those sectors that are expected to do relatively worse.

Investors employing this strategy are betting that particular sectors will repeat their price performance relative to the current phase of the business and credit cycle.

A standard active strategy on matured markets is the division of the stocks into four broad sectors: interest-sensitive stocks, consumer durable stocks, capital goods stocks, and defensive stocks. Each of these sectors is expected to perform differently during the various phases of the business and credit cycles. For example, interest-sensitive stocks would be expected to be negatively influenced during periods of high interest rates. As interest rates decline, the earnings of the companies in this sector (banks, finance companies, savings and loans, utilities, and residential construction firms) should improve.

It is clear that effective strategies involving sector rotation depend heavily on an accurate assessment of current economic conditions. A knowledge and understanding of the phases of the business cycle are important, as is an understanding of political environments, international linkages among economies, and credit conditions both domestic and international.

Most investors still favor an active approach to common stock selection and management, despite the accumulating evidence from efficient market studies and the published performance results of institutional investors. The reason for this is obvious - the potential rewards are very large, and many investors feel confident that they can achieve such awards even if other investors cannot.

Market timers attempt to earn excess returns by varying the percentage of portfolio assets in equity securities. The investor has to observe a chart of stock prices over time to appreciate the profit potential of being in the stock market at the right times and being out of the stock market at the bad times.

This way, when equities are expected to increase their value, investors shift from cash equivalents such as money market funds to common stocks and when equities are expected to decrease, the opposite occurs.

Alternatively, investors could increase the Betas[1] of their portfolios when the market is expected to rise and carry most stocks up, or decrease the Betas of their portfolio when the market is expected to go down.

One important factor affecting the success of a market timing strategy is the amount of brokerage commissions and taxes paid with such a strategy as opposed to those paid with a buy-and-hold strategy.

Like many issues in the investing arena, the subject of market timing is controversial. Evidence indicates it is difficult for investors to regularly time the market efficiently enough to provide excess returns on a risk-adjusted basis.

In the first major study of the performance of the United States bond market[2] Blake, Elton and Gruber[3] examined 361 bond funds for the period starting in 1977 and compared the various active funds to simple index strategy alternatives.

The authors found that the active funds, on average, underperform the index strategies by 85 basis points a year. Depending on the benchmark, between 65 and 80 percent of the funds generate excess performance that is negative.

In a study of equity mutual funds[4], Elton, Gruber, Hlavka and Das examined all funds that existed for the period of 1965-1984, 143 funds. These funds were compared to the set of index funds—big stocks, small stocks and fixed income—that most closely correspond to the actual investment choices made by the mutual funds. The result shows that on average these funds underperform the index funds by a 159 basis points a year and not a single fund generated positive performance that was statistically significant.

In another comprehensive study[5], Mark Carhart analyzed a total of 1,892 funds that existed any time between 1961 and 1993. After adjusting for the common factors in returns, an equal-weighted portfolio of the funds underperformed by 1.8% per year.

These studies, along with earlier studies, provide a fifty-year history of professional investment management and the conclusion is quite clear: the beat-the-market efforts of professionals are impressively and overwhelmingly negative. In any asset class, the only consistently superior performer is the market itself.

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[1] Beta is a measure of the systematic risk of a security that cannot be avoided through diversification.

[2] There are more US studies of mutual fund performance than in other countries. They tend to have larger data sets and were among the first to use more sophisticated measurement methods.

[3] Blake C., Elton E. and Gruber M. (1993), The Performance of Bond Mutual Funds, *Journal of Business*, Vol.66, No. 3 [371-403]

[4] Elton E.J., Gruber M.J., Das S. and Hlavka M. (1993), Efficiency with costly information: a reinterpretation of evidence from managed portfolios, *Review of Financial Studies*, Vol. 6, [1-22]

[5] Carhart M. (1997), On Persistence in Mutual Fund Performance, *Journal of Finance*, Vol.52, No. 1 [57-82]

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