The Death of Active Management has been Greatly Exaggerated: “To Unmask Falsehood and Bring Truth to Light”

By Edward Aw

Over the past decade, the asset management industry witnessed a significant migration of capital from active investment strategies into passive investment strategies. Undoubtedly, the structural change is shaking the active management dominated mutual fund industry to its core. Some in the industry duly sounded the alarm on a possible inefficient allocation of capital resulting from massive capital-flows into passive strategies. Nevertheless, this is a narrow view of the market that believe active investors set prices and trade securities while passive investors hold securities at market weights. The scarcity of active investors and their trades would therefore ultimately spur an inefficient market as passive investors hold securities at market weights reducing liquidity and amplifying market volatility. Such references on the state of industry arguably represent an element of fear mongering in the marketplace. Any lingering concerns around the shifting of capital towards passive strategies and its consequences offer research opportunities to better understand the role of passive versus active management. Thus, I considered the following research questions. First, how do we define active and passive management? Second, are factor premia, the characteristics that explain an asset’s expected variation and return over a longer time horizon identifiable? Third, can we ascertain other variables that limit implementation of a successful active management strategy? Finally, can a repeatable investment process lead to consistent outperformance over a longer time horizon? On the definition of active and passive management, the Nobel Laureate William Sharpe describes a passive investor as one who holds every security from the market, each security represented in the same manner as the market portfolio. As for factor premia, there is a wide breadth of literature covering, but not limited to,
size, yield, value, low volatility, quality, and momentum. Consistent with prior literature, I provide
evidence on factor premia. My findings also suggest utilizing alternative portfolio weighing
methods improves active managers’ relative performance versus a benchmark index. Furthermore,
investors’ time horizon, taxes, and investment management fee further impact relative
performance. Hence the findings contribute to a better understanding of the on-going active versus
passive investing debate. Lastly, the evidence of improved relative performance versus a
benchmark index is not a rejection of the semi-strong form market efficiency that has been at the
heart of academic research in financial economics for over five decades. The role of investment
professionals has nevertheless always been to exploit possible frictions and inefficiencies. One
could therefore contend that the active management industry would not exist without such
frictions, however I leave this greater debate to future work.