INVESTMENT BRIEF

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Strategic Investment Group®

Active Management Prospects

Persistent flows from active to passive management have altered the very structure of U.S. financial markets and raised a number of essential questions, including: What is driving these flows? Do they make active management easier or harder? What are the implications for portfolio management? By analyzing a proprietary database of securities holdings in the U.S. equity market, we address these questions in this quarter's Special Topic.

Harsh Logic of Macro Consistency

The brutally simple logic of macro consistency underscores the challenge of active management. If passive and active investors together own the entire market, and passive investors replicate the market by holding all securities in proportion to their market capitalization, it must follow that active managers in aggregate also hold all securities in proportion to their market capitalization. Since both active and passive investors hold the market, their respective returns prior to fees and costs must be equal to the market's returns. After fees and costs, passive investors will lag the market slightly, while active investors in aggregate will lag significantly. Active management is, therefore, inherently a negative sum game in aggregate: value added by skilled active investors must come at the expense of value lost by unskilled active investors.

Drivers of Flows from Active to Passive Vehicles

We used a comprehensive set of regulatory disclosures to create a unique database of U.S. equity ownership through time. Our analysis across different investor types shows a marked shift in favor of passive vehicles over the past decade. A major driver of these flows is the secular transition from defined benefit (DB) to defined contribution (DC) pension plans, and the increasing trend within DC plans to favor passive vehicles. Cyclical forces are also apparent. Disenchantment with active managers following a particularly poor showing in the first half of 2016, when at one point fully 90% of active mutual fund managers were falling short of the market, has given further impetus to these flows.

Active Management in a Passive World

The restructuring of the U.S. equity market in favor of passive vehicles is transforming market dynamics in fundamental ways. The rise of passive asset management reduces trading volume and liquidity. Passive fees are falling as economies of scale and increasing competition drive consolidation. In the case of active managers, pressure from ever-cheaper passive vehicles as well as competition among active managers for the dwindling pool of active assets are forcing fees down. The shift to passive management is also amplifying the co-movement of securities in dominant indexes, as stocks in these benchmarks are buffeted by the supply and demand shocks of passive flows.

How the increasing adoption of passive solutions affects the ability of active investors to add value hinges critically on whether the active managers losing assets through flows to passive strategies are skilled or unskilled. Since the logic of macro consistency ensures that active management is a negative sum game, skilled active investors must wrest value added from the unskilled. If both skilled and unskilled investors leave the market proportionately, the pro rata share of alpha available remains unchanged and the challenge facing active managers is no more difficult. If, however, skilled investors are leaving the field and unskilled investors remain in higher proportion, the competition among skilled managers for added value is reduced and their prospects improve. This is the ideal scenario that allows skilled managers more opportunities to succeed. Alternatively, if unskilled active investors are squeezed out by the move to passive, competition among the proportionately growing share of skilled managers in the market increases, as does the challenge of adding value.

Our holdings-based analysis of the U.S. equity market suggests that relatively skilled institutional investors are leaving the field, while the unskilled active retail investor has increased its share of the market. This key finding signals an improving environment for active management.

Implications for Portfolio Management

The secular shift to passive and the relentless logic of macro consistency make it imperative to avoid average active managers. While the current environment increases business risk for active managers and will likely prompt industry consolidation, we believe that the opportunity set for truly skilled active managers is likely improving as passive flows create a less efficient market landscape. In addition, the improved ability to negotiate lower fees is a welcome development for investors. Finally, we believe that more frequent dislocations caused by flows among passive vehicles are creating new opportunities for active investors to take attractive tactical positions in both individual securities and broad market segments. The future of active management appears bright.

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