S&P BSE INDICES

Exposing the Myths and Realities of Passive Investing

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Indexing is certainly not a myth, and while active investing is a popular reality in Indian markets, we are seeing the slow and steady rise of index-based products. In a recent article, John C. Bogle, the founder of Vanguard Group, said, "We are in the middle of a revolution led by indexing." John C. Bogle's first index fund was launched in 1976, and Vanguard is among today's top global ETF providers.

A revolution indeed; when we see the global ETF assets at over USD 3 trillion, there is no doubt that this space has seen exponential growth. However, there is no argument against the fact that active management can be successful. Advocates of active management argue the ability to outperform benchmarks is what supports their claim on the supremacy of the active play.

However, the question is not whether active management is successful, but rather for how long it is persistently successful. So first, let's review the outperformance of benchmarks. To do this, we must review whether the appropriate benchmark is being followed. "Appropriate" is an important qualifier—among other things, it means that the benchmark should be consistent with the manager's portfolio selection style. To explain this further, a thematic investment portfolio (e.g., for a dividend fund) should ideally be compared to a dividend index rather than a generic market benchmark like the S&P BSE SENSEX or the S&P BSE 200. This ensures that there is an apples-to-apples comparison. This also ensures that market participants are comparing similar universes; hence the "appropriate" comparison.

In the passive world, since index-based products invest in a proportionate slice of the index, market participants are essentially earning the index's returns less fees and expenses. In other words, the investment and its objective are aligned directly with the index. There should be no subjectivity or doubt as to how the index and its benchmark are aligned.

Hence, the first step to ensure that we are measuring active performance appropriately is to check if the investment strategy or product is appropriately benchmarked. That then provides us with the "real" picture.

Active management: Is it always successful?

The success of active management is directly related to its outperformance of the benchmark it tracks. In order to ensure consistency, active managers tend to be reluctant to deviate from standards that include this comparison. This leads them into situations where they may have to hold a position that may not necessarily be attractive to them, or there may be excessive movement of positions in the portfolio, resulting in additional costs and turnover. Hence, a fund manager's choice and conviction play a part in active strategy. However, this being an individual choice brings in bias, which may work in certain market conditions and may not in others.

Another aspect to consistency is fund manager continuity. Market participants get accustomed to a certain level of expertise provided to an active product by an expert fund manager. However, change being the only constant results in varied fund manager capabilities. This may also disrupt the consistency of the investment product in following particular return patterns.

For those looking for a certain return trajectory, passive investing may be the preferred solution. This also applies to those who are not vigilant about the consistency of fund manager or product continuity, or who are not able to track the market conditions on a day-to-day basis.

For example, a market participant who wants to invest in the manufacturing sector can easily buy into a product based on a manufacturing index. This enables consistent and relatively cheap access to the sector. Furthermore, there is a wide range of choices beyond sectors. Factors offer the option to invest in stocks via the preferred index attributes. Passive investments offer a host of factors, such as growth, value, dividend, low volatility, momentum, etc.

In this evolving paradigm, with market participants growing savvier and passive investments offering a host of options, the opportunities this space offers are definitely growing.

A famous quote by Mark Twain stated, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." So can we state for sure that active management is superior? Maybe we should give it a bit of thought!

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