EFFICIENT GROUP

ECONOMIC COMMENTARY

- Dr. Francois Stofberg, with specialist input from Christiaan van Wyk

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The active versus passive debate

The active versus passive investment strategies debate has been raging for many years, with both sides trying to make the case for their own strategy at the expense of the other. Without pre-empting our own beliefs on this matter, we will start with the words of John C Maxwell: "A great idea is simply the combination of many good ideas".

Before one can start the conversation about active versus passive investment strategies, one must first look at the key characteristics of both. A passively-managed investment strategy is one where the investment manager pools large sums of investor money to buy assets in accordance with the constituents and weightings of a chosen index. The manager will, therefore, make no active decisions regarding which benchmark assets to include in or exclude from the portfolio, nor will the manager change the benchmark weighting assigned to the given asset. In contrast, an active investment manager will decide which benchmark assets to include in the portfolio and will, typically, deviate from the benchmark weightings. An active manager will further, typically, hold fewer assets than the benchmark, making the portfolio more concentrated than the comparable passive portfolio. In doing so, it affords the active manager the opportunity to outperform the benchmark.

Both active and passive investments have strengths and weaknesses. For example, passive strategies are usually cheaper than actively-managed portfolios but are limited to the benchmark they track, whereas active managers have the flexibility to invest in the specific assets that are expected to deliver index-beating returns. Tax is another topic of debate: Passive investors argue that the buy-and-hold strategy gives them the upper hand via pre-tax compounding returns, whereas active managers can manage taxes for the investor – offsetting taxes on gains in a year where the investor has realised other losses.

The decision of whether to use active or passive investment strategies usually comes down to investor preference. But could a "great" investment solution not simply be a combination of two "good" investment strategies? We believe that there is a place for both active and passive investments, and instead of choosing a single strategy, one can combine these two strategies to create a solution that will benefit the individual client. As an example, the investment manager can allocate a portion of a client's portfolio to a passive investment, which will give the client beta/index returns, then use the remainder of the portfolio to make active decisions and only allocate capital to high-conviction ideas. The result is a cost-effective portfolio that can achieve alpha/excess returns over time; this strategy is commonly referred to as a "core-satellite approach" to portfolio construction.

The core-satellite example is but one of many ways that investment managers can utilise both active and passive investment strategies to build and to optimise investment solutions. In closing, we believe that it is, therefore, fruitless to debate which investment strategy is superior: In the end, it all comes down to the needs of the client and the skill of the investment manager to utilise all of the tools at their disposal.