An expensive folly

Retirement investing should not be about chasing the illusions

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NATIONAL Treasury’s discussion paper, Charges in South African Retirement Funds, has caused waves in the retirement-fund management industry. One of the statements that seems to have touched a raw nerve reads: “Over the long term, in efficient markets, passive management is not demonstrably inferior to active management, and it is significantly cheaper.”

This statement has rekindled the active versus passive investment debate. However, it is rather a shouting match, because there can be no debate around a mathematical certainty.

The bottom line is: investing is a zero-sum game. The total excess (above average) market return (alpha) available to all investors is exactly zero. That holds true for every asset class in every market. It does not matter how efficient those markets are, or how small, or how concentrated, the aggregate alpha available to all investors is always zero.

Investors pay billions of rand each year to fund managers, who in aggregate can deliver zero return.

While some investors do earn an above-average return, they do this only at the expense of others earning a below-average return. Collectively, they all pursue something that does not exist.

It is an expensive folly as both winners and losers forfeit their stake, paid by way of high(er) active management fees. As a group, these investors go home with less than zero.

So do the passive investors, of course. However, because they have abandoned the quest for alpha and simply pursued the market return at low cost, their forfeit is lower. They pocket a higher average return. In the words of Charles Ellis, they win the losers’ game. That said, it is a game worth winning: every one percent per annum fee saving over a 40-year savings term improves the real savings outcome by 30%.

“Yes, but who wants to be average?” protests the industry, suggesting that paying the higher fees begets a higher return. In hindsight, most investors would gladly settle for “average.”

Empirically, the majority of fund managers underperform their benchmarks, after adjusting for fees and survivorship. In addition, it is impossible to predict who will outperform.

Certainly, no fund manager has yet guaranteed to do so. Index funds produce superior returns against most active funds, after fees.

Treasury has done itself a disservice by referring to “efficient markets” in its endorsement of passive investing. It gives active managers an angle to discredit it.

Recently, a large industry player cautioned against passive investing, highlighting that National Treasury puts great store on the validity of the efficient-market hypothesis, in spite of it being largely discredited during the recent financial crises.

“An is a thrilling irony in this view. Of course, it sounds compelling, that financial markets have price flaws and that active managers can exploit these. It implies that the market is a separate, sometimes irrational being, apart from investors.

However, active investors are the market. It is they who trade against each other and who “discover” prices, sometimes at irrational high or low levels.

So who runs the dumb money?

Fund managers trade among themselves, including their own colleagues, who run competing funds for the same investment manager, and the factors driving outperformance — skill and luck — tend to be quite evenly distributed across the industry.

Many market bubbles have burst over the past 10 years, making it the ideal time for active managers to prove their stock-picking and market-timing skills.

Yet the majority lagged their index peers. This failure was inevitable because the zero-sum rule applies at all times. Securities do not materialise in and out of cash. Every trade has a counterparty: for every investor selling at the top, another buys at the top. With hindsight, perhaps the biggest bubble to burst was the idea that active managers protect investors from bad markets.

A common message that active managers try to instill in the minds of investors is that passive managers believe that the market is efficient, and therefore one cannot beat the market. Passive managers believe nothing of the sort. Of course some managers will beat the market, even over the long term. For them, the critical question is not whether markets are efficient or not, but whether investors should expect to exploit any inefficiency. Every independent study says “no”.

If you can’t beat them, scare them.

The industry insiders know this, which is why their arguments don’t appeal to logic or results, but to fear. Arguing that markets are inefficient already, active managers will shamelessly claim it is passive investing that would make markets (more) inefficient.

This fear-mongering helps to deflect attention from the real issue, which is to assist South Africans in getting the best possible value for their retirement savings. Retirement investing should give investors the optimal return at the lowest risk. It should not be about chasing the (low) possibility of earning an above-average return. It should be about avoiding the (high) probability of earning a below-average return.

If passive management delivers similar, if not superior, returns to active management, it makes sense to follow this route, simply to avoid the downside risk. The fact that passive is then also much cheaper, turns a persuasive argument into a scientific one.

Yes, active management does have a place, but not in retirement investing.

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