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Opinion

Restoring Balance, and Accuracy, With a New Narrative on Active Management

January 7, 2019

It's time for a new narrative on active investment management.

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For the past 20 years, actively managed funds have been defined by what they are not — namely, index funds. The narrative seems to be that passively managed funds are cheaper — and therefore better — while active management underperforms, largely because of fees.

This one-sided characterization does a disservice to investors by ignoring the value that active management adds to investment portfolios and financial planning, and overlooking changes in the costs of investing.

On a macro level, active management plays a critical role in the health of the financial markets and is a major contributor to the strength of the economy.

To help create an up-to-date, balanced narrative, the Investment Adviser Association (IAA) in 2017 formed the **Active Managers Council** to provide education and research on the value of active management and to engage on related public policy issues, such as congressional consideration of retirement initiatives. Through research papers, commentary and educational material available through its new Web portal, the council aims to be a resource for investors and policymakers seeking a more comprehensive — and more accurate — perspective on active management.

Active management adds value

Active managers predictably add value on a risk-adjusted basis, as professors Martijn Cremers of the University of Notre Dame, Jon A. Fulkerson of the University of Dayton and Timothy B. Riley of the University of Arkansas explain in the Council's first sponsored paper, "**Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds**." Through their academic literature review, the researchers conclude that "the conventional wisdom is too negative on the value of active management." Active managers, they wrote, "have a variety of skills and tend to make value-added decisions."

Finding skilled managers isn't just a matter of luck, the review suggests. Rather, traditional approaches to selecting active managers — which consider past performance, investment approach and manager characteristics — have validity because they can identify skill in advance.

In other words, it's entirely rational that investors remain committed to active management.

In a recent panel discussion hosted by the Investment Adviser Association, "**The Advantages of Active Management in a Powerful Portfolio**," a range of industry professionals echoed those sentiments and reinforced other key themes, namely:

Active management permeates investing

The reach of active management is broad, because every investment decision involves active management. Simply buying an index fund is an active choice. (Which fund? How much? When?) Creating an index likewise involves significant judgment. In fact, the growth of smart-beta ETFs underscores the conviction of the utility of active management.

Creating a financial plan without active decisions about asset allocation and evaluating how that allocation aligns with an investor's financial objective and risk profile is impossible.

Put simply, buying index funds does not guarantee that investors will meet their financial goals, nor does it guarantee they will avoid risk.

Active and passive work well together

Indeed, index funds work well when combined with active management, and vice versa.

Active management enables investors to navigate complexity, customize portfolios, capitalize on specific skills or profit from market inefficiencies. Passive management helps to reduce costs, especially in more efficient market segments.

Most investors benefit from a combination of the two approaches, with the mix determined by their particular objectives, skills and risk tolerance.

Active management is critical for healthy markets and economies

Not only do investors benefit from active management, but so does the broader economy.

That's because active managers perform the investment research and analysis that make markets efficient, by ensuring that price remains in line with underlying fundamentals. They play an important role in corporate governance, by encouraging strong stewardship at the companies they invest in. Finally, they support capital formation and entrepreneurship by providing a market for IPOs and other forms of capital-raising.

The shift from active management into index funds could have negative consequences in all of these areas, as the SEC Investor Advisory Committee discussed in September. For example, the growth in index funds is leading to greater correlations in stock prices, making it harder for investors to diversify effectively. At the same time, index funds' tendency to trade on the market close has altered intraday trading patterns and led to higher volatility and trading costs.

Toward a balanced narrative

Both active management and index investing play essential — and complementary — roles for investors, the markets and our economy. The Active Managers Council is committed to creating a more balanced narrative that emphasizes the importance of both approaches and encourages regulators to remain neutral in the discussion.