Active and passive investing – stronger together

By Jonathan Armitage, Chief Investment Officer, MLC

Too often, the investment industry is guilty of presenting issues in black and white ways. Shares versus bonds. Large cap versus small cap. Fundamental investing versus quantitative investing. Listed versus unlisted investments, and on it goes.

"I'm right, you're wrong" arguments are shallow, at best.

The never-ending active investing versus passive investing debate is probably the best known and, like the others, is wildly overblown.

Most experienced investors recognise that no single investment idea is successful, all the time. That's why well-constructed portfolios are made up of different elements across asset classes, country allocations, sizes, investment styles and approaches. Diversification, in other words.

Bringing together different strands leads to stronger total portfolios. So, it's not active versus passive, but active *and* passive, together — using index investments the right way, and being active where it matters.

One way of framing the issue is through the fee lens. No investor has an unlimited fee budget and so oftentimes gaining broad and cost-efficient market exposure to certain markets and assets by investing passively — to the global share market, for instance — makes sense.

With the global share market, as measured by the MSCI All Country World Index ($A, Net) having returned a whopping 11.5% per annum (in Australian dollars) for the 10 years to the end of December 2019,[1] it's hard to argue against passive investing in this instance.

An investor having achieved cost-efficient exposure to the global share market, in this example, could use other parts of their fee budget to access assets and strategies where risk-management is especially important, or where there are reasonable odds for better-than-benchmark returns.

Protecting capital is important for long-term returns

Investment legend Warren Buffett's quip that, "You only find out who is swimming naked when the tide goes out" comes to mind when thinking about risk management, or more accurately, the dangers of a lack of risk management, which arguably is a downside of passive investing.

A drawback of passive investing is that there's no protection during lengthy bear markets as an investor with a passive-only portfolio would be exposed to 100% of the downside.

Some figures from the US share market emphasise the point.

From the peak in 2000 to the bottom in 2002, the S&P 500 Index (a well-known measure of US share market performance) fell 49%, and from the peak in 2007 to the bottom in 2009 it fell 58%.[2]

Meanwhile, the technology-focused Nasdaq Index plunged 78% in 2000-2002 and tanked 56% from 2007-2009![3] To make matters worse, it took the Nasdaq about 15 years before it reached its previous high back in March 2000.[4]

---

[1] Source: FastSet and MLC Asset Management Limited

[2] *Two Reasons Why Active Management Matters Now.* Adam Sarhan in *Forbes*, Aug 16, 2018. https://www.forbes.com/sites/adamsarhan/2018/08/16/2-reasons-why-active-managment-matters-now/#709dc52758aa. Accessed 27 January 2020.

[3] Ibid

[4] Ibid

That means a passive-only investor's money would have plummeted nearly 80% and they would have been staring at losses for nearly 15-16 years before it got back to even, if they had bought in 2000 during the 'tech boom'.[5]

What this underscores is that long-term investment success is not just about accumulating strong returns in good times. It's also important to protect capital on the downside as this has a material impact on total returns due to the power of compounding.

If an investment falls 50% in value, it must rise 100% just to get back to its original value. That's very sobering. Downside protection can only be done actively. This is done through active asset allocation in diversified portfolios, or stock selection in share-only portfolios.

Active fixed income matters

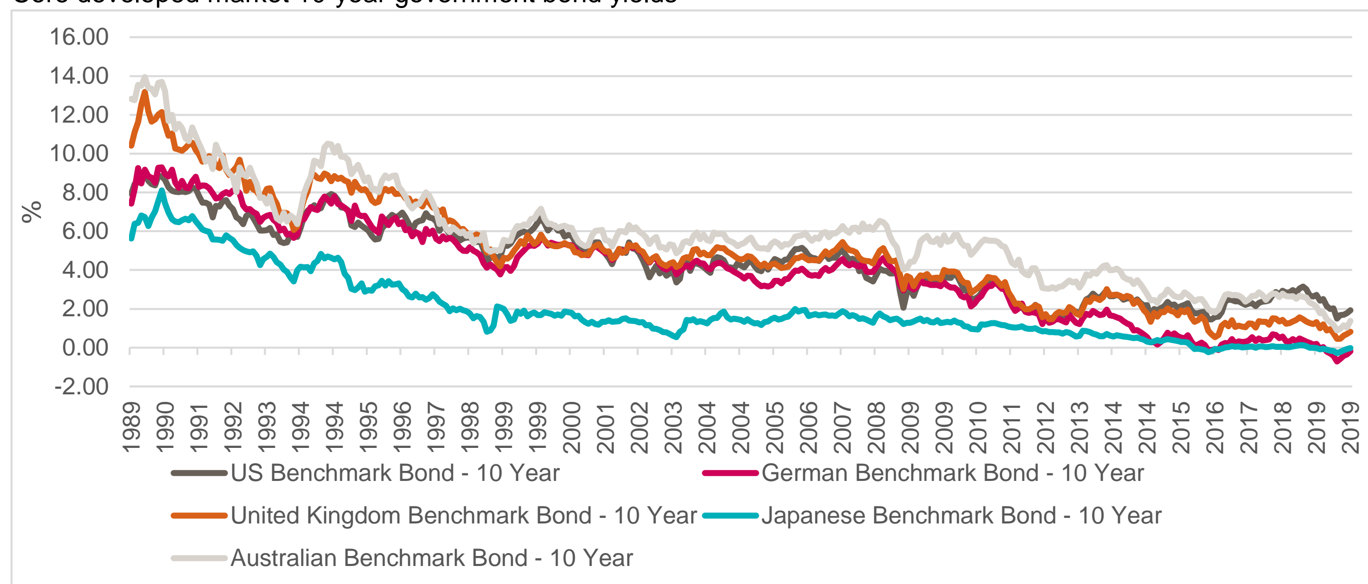
Fixed income investments have traditionally been regarded as 'defensive assets' as they tend to go up in value when share markets go down, and move down when share markets are strong. But this isn't always the case — it depends on the investment environment at the time.

We believe there needs to be a rethinking of traditional views of the relative security of fixed income investments and how they should be managed, particularly in today's ultra-low interest rate environment.

With official interest rates across the world's wealthy countries ranging from a remarkable -0.10% in Japan, and 0.0% in the Euro area,[6] 1.63% in the US to a high of 1.75% in Canada,[7] and bond yields so low (prices high, **see chart**), risks in fixed income markets are high.

Government bond yields across key developed countries have fallen over recent decades

Core developed market 10-year government bond yields



31 December 2019
Source: FactSet

[5] Ibid

[6] Euro area refers to the member countries of the European Union that use the euro.

[7] *F13 International Official Interest Rates*. https://www.rba.gov.au › statistics › tables › xls. Accessed 6 January 2020.

It's possible that fixed income yields and interest rates could go down further, and that would be positive for bond prices. Still, with fixed income yields and interest rates already so low, there must be doubt over their likelihood of going much lower.

This makes fixed income investing riskier, currently. Even small rises in market interest rates could wipe out the annual income that an investor would receive from Australian and global fixed income.

We'd strongly argue that active investing is the best way to manage such risks.

Passively investing in fixed income benchmarks would mean holding bonds weighted towards countries and companies issuing the most debt. In other words, indiscriminately taking on increasing risk. That's probably not what most investors would want.

Active management allows fixed income investors and managers to, amongst other things, avoid parts of the market where the risk/reward trade-off doesn't make sense. This includes avoiding the most indebted countries and companies.

It also means managing duration[8] by pulling back exposure to rising interest rates when the risks are judged to be too high, or when the risk of lopsided outcomes seems high. For example, taking on large risks for potentially small gains, when in the same situation, loss potential may be high.

Yes, passive investing does make sense at times and in certain markets and asset classes. Equally, we think active investing is also valid when thoughtfully used with passive investing. It's an intelligent partnership and together they result in stronger total portfolios than just a passive only or active only portfolios.

Important information

This communication is provided by MLC Investments Limited (ABN 30 002 641 661, AFSL 230705) (MLC), a member of the National Australia Bank Limited (ABN 12 004 044 937, AFSL 230 686) group of companies (NAB Group), 105–153 Miller Street, North Sydney 2060.

This information may constitute general advice. It has been prepared without taking account of an investor's objectives, financial situation or needs and because of that an investor should, before acting on the advice, consider the appropriateness of the advice having regard to their personal objectives, financial situation and needs.

An investment with MLC is not a deposit with or liability of, and is not guaranteed by NAB or any of its subsidiaries.

Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market. The returns specified in this communication are reported before management fees and taxes.

Any opinions expressed in this communication constitute our judgement at the time of issue and are subject to change. We believe that the information contained in this communication is correct and that any estimates, opinions, conclusions or recommendations are reasonably held or made as at the time of compilation. However, no warranty is made as to their accuracy or reliability (which may change without notice) or other information contained in this communication.

This information is directed to and prepared for Australian residents only.

[8] Duration is a measure of the sensitivity of a fixed income asset or portfolio to market interest rate movements. As a rule, for every 1% change in interest rates (increase or decrease), a fixed interest asset's price will change approximately 1% in the opposite direction, for every year of duration. If a bond has a duration of five years and interest rates increase 1%, the fixed interest asset's price will drop by approximately 5% (1% X 5 years). Likewise, if interest rates fall by 1%, the same bond's price will increase by about 5% (1% X 5 years).